National Public Works Council Inc

Improving Security of Payment
in the
Building and Construction Industry

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1.1 Background to the Consultancy

The National Public Works Council Inc ("NPWC") (among many others) has been examining the problem of security of payment in the Building and Construction Industry for a number of years.

There have been numerous reports and studies undertaken into the issue which have suggested a variety of solutions but there is no empirical data available which quantifies or analyses the extent of the problems with security of payment as suggested by anecdotal evidence.

This Consultancy defines the problem as "ensuring that a Subcontractor is paid on a timely basis and his entitlement to payment is secured".

The Consultancy starts with the premise that any one solution to the security of payment problem by itself will not be satisfactory to alleviate payment problems to Subcontractors.

Accordingly, this Consultancy recommends a series of interlocking and interactive solutions. In determining our recommendations, we examined the following possible generic solutions:

- Trusts
- Proof of Payment
- Prompt Payment Legislation
- Priority Payments
- Insurance
- Mutual Fund Insurance
- Prequalification

Our recommendations and proposed implementation plan are detailed at Sections 1.2 and 1.3 respectively.

The interlocking and interactive nature of our proposed recommendations is detailed at Section 1.4.

We summarise our views on the characteristics of the industry at Section 1.5 in order that the commercial and practical nature of our inter-linked recommendations is balanced against the industry's operating environment. Section 1.6 then provides an overview of our findings.

1.2 Recommendations

1.2.1 Trusts

- This Consultancy does not recommend the use of trusts as a solution for improving security of payment in the Building and Construction Industry. Complex commercial and administrative burdens and obligations prevent the implementation of trusts on a widespread basis throughout the industry and the workability of trusts would be severely compromised by the detailed legal issues and considerations involved with trust law.

1.2.2 Proof of Payment

- This Consultancy recommends the use of proof of payment, similar to the approaches used by Queensland Build and the Victorian Catholic Building Office coupled with the use of a consensual dispute resolution mechanism.

1.2.3 Consensual Dispute Resolution

- Consensual dispute mechanisms should be provided for in all standard from building contracts so as to allow disputes to be resolved in an expedient and efficient manner.

- Consideration should be given to the following timetable being inserted into standard form building contracts:

  - The parties be directed to negotiate a settlement of the dispute between themselves within 48 hours of the dispute arising.

  - If direct negotiation is unsuccessful in resolving the dispute, the parties must appoint a conciliator/mediator by agreement to conciliate or mediate the dispute.

  - Within seven (7) days of the appointment of the conciliator/mediator, the parties must make written submissions to the conciliator/mediator as to their points of claim and points of defence.

  - These submissions should not be technical or legal.

  - The conciliator/mediator must within the next three (3) days bring the parties together for conciliation or mediation.

- Consensual dispute resolution mechanisms need to be introduced to the industry through an education program.

- This Consultancy suggests that it will be effective to establish specialist Building and Construction Industry mediators/conciliators who would be available Federally and in each State to handle building disputes at short notice.

1.2.4 Prompt Payment Legislation

- This Consultancy recommends that the extent of the security of payment problem should be re-evaluated in three (3) to four (4) years. If the problem has not diminished significantly, we believe that some form of prompt payment legislation similar to that used in the United States of America with draconian penalties could be implemented to improve the security of payment problems in the Building and Construction Industry. Given the extent of the cultural change that would need to happen and the limited empirical data on the current size of the problem with security of payment in the Australian industry, we believe that this form of legislation with its draconian penalties should be considered as a "last resort".

1.2.5 Priority Payments

- This Consultancy recommends that a priority claim be granted to Subcontractors in the event of the insolvency of a Head Contractor and we propose that Section 556 of the Corporations Law be amended by the introduction of a new sub-clause (i):

  "556(1)(i) next, amounts due to Subcontractors pursuant to a building and construction contract".

- A "building and construction contract" should be defined to cover "any written contract" as prescribed by the Regulations from time to time. The Regulations should prescribe "any written contract" as standard form building contracts such as AS2124-1992.

- "Subcontractors" should be defined as "any persons or corporations who have entered into a standard form building contract as prescribed by the Regulations from time to time for the provision of personal exertion, labour and building materials used in the construction of a building", or such other appropriate description.

- This Consultancy recommends also that a priority cap at a monetary level of $10,000 inclusive of personal exertion, labour and materials in total be given to each respective Subcontractor pursuant to Section 556, with the balance ranking as an ordinary unsecured claim.

- Similar amendments should be made to Section 433 of the Corporations Law and Section 109 of the Bankruptcy Act.

1.2.6 Insurance

- This Consultancy recommends that quantitative research be undertaken to empirically determine the size of the problems with security of payment in the Building and Construction Industry in Australia. Unless such a study is undertaken, then the Insurance Industry has indicated that it is unable to consider insurance to the industry for security of payment.

- On the presumption that further research indicates Subcontractor payments are insurable, this Consultancy recommends that the insurable event be defined to be an "insolvency" pursuant to the Corporations Law at Section 95A or "bankruptcy" pursuant to the Bankruptcy Act at Section 5 of the Head Contractor . The premium for such an insurance cover (which should be mandatory) should be borne by the Head Contractor, as it is in the Head Contractor's interest to maintain the services of the Subcontractors to complete the building or construction task in the event of the insolvency of the Head Contractor. Such an insurance scheme would significantly alleviate duress payments and the like on the Principal on the insolvency of the Head Contractor even though it is likely the Principal will incur a higher build cost due to the Head Contractor passing on the cost of insurance.

1.2.7 Mutual Fund Insurance

- As with Insurance, further research is required, however this Consultancy recommends that a Mutual Fund should be considered for establishment to provide a "catastrophe" cover to Subcontractors in the event that a Head Contractor becomes insolvent and the Insurance Industry does not wish to provide cover for the security of payment. The concept of a Mutual Fund within other industries in Australia is not new, with the existence of such funds as the Solicitors Guarantee Fund and previously the Housing Guarantee Fund in Victoria.

- The concept would work on the premise that it is a universal scheme and the Head Contractor would pay a percentage of the value of the building contract to the Fund, which would not be refundable. The Fund would be used for the reimbursement of Subcontractors on the default of a Head Contractor due to insolvency.

1.2.8 Prequalification

- This Consultancy recommends that voluntary prequalification mechanisms should be used by Principals where the building contract is $5 million or more. These mechanisms are currently used in some form in both the public and private sector by the Principal on the Head Contractor. The voluntary performance of this prequalification process should be supported by Industry guidelines on effective prequalification.

- We do not recommend the use of prequalification for contracts less than $5 million, nor do we believe that Subcontractor prequalification evaluation of Head Contractors would be cost-effective.

1.3 Proposed Implementation Plan

	Immediate Implementation	Await Results of Further Research	Delayed Implementation	Do Not Implement
(i) Trusts				✓
(ii) Proof of Payment Procedures	✓			
(iii) Consensual Dispute Resolution ("CDR") Mechanisms	✓			
(iv) Education Program for CDR Mechanisms	✓			
(v) Specialist Industry Mediators/Conciliators		✓		
(vi) Prompt Payment Legislation - USA Style			✓	
(vii) Draconian Penalties - USA Style			✓	
(viii) Priority Claim in Insolvency	✓			
(ix) Insurance against Insolvency		✓		
(x) Mutual Fund Insurance - Catastrophe Cover		✓		
(xi) Prequalification Mechanisms	✓ (voluntary)		✓ (mandatory)	

1.4 Interlocking Characteristics of our Recommendations

This Consultancy believes that the following approach needs to be adopted to allow the necessary inter-linkage of our recommendations to a level that is sufficient to ensure that Subcontractors are paid on a timely basis and their entitlements to payment are secured. No one recommendation alone will be sufficient in itself to ensure that Subcontractors will receive this level of protection.

- **Immediate Implementation**

  We believe that some form of proof of payment mechanism, similar to the approaches used by Queensland Build and the Victorian Catholic Building Office, coupled with the use of a consensual dispute resolution mechanism should be implemented. The proof of payment approaches currently used do not contain a consensual dispute resolution mechanism. This Consultancy views such a mechanism as imperative if timely repayments to Subcontractors are to be achieved.

  Further, the use of consensual dispute resolution mechanisms will not be effective unless the parties to a building contract understand the fundamental principals of and the use for these mechanisms. Accordingly, an education program needs to be developed for the Building and Construction Industry participants. We recommend that the need for "specialist" Building and Construction Industry mediators/ conciliators be further considered by the industry to assist in consensual dispute resolution mechanisms.

  We believe that amending Section 556 of the Corporations Law to allow Subcontractors to be able to receive a priority for amounts outstanding due to the insolvency of the Head Contractor is imperative if Subcontractors are to secure their payments. By limiting the use of the priority status of the Subcontractors to those Subcontractors who have privity of contract with a Head Contractor, the contract being a written contract that the Corporations Law Regulations prescribe and the definition of Subcontractors being drawn appropriately, then this would "encourage" Building and Construction Industry participants to adopt the use of unamended standard forms of written contract, such as AS2124-1992, which in turn will mean a cultural change from the way industry participants generally "do business".

  Further, the use of standard contracts will enable the proof of payment and consensual dispute resolution mechanisms to be inserted into those standard contracts prescribed by the Regulations and thus, incorporated into contractual terms of the parties. Anecdotal evidence suggests that standard forms of contract are extensively used in the public sector, but only have limited use and acceptance in the private sector. Through the use of unamended standard forms of contracts, disputes relating to a building contract would be limited to the performance of the parties to the contract and not to the terms of or the intentions of the parties to the contract. By limiting the scope of potential disputes, mediators/conciliators are not required to interpret the "intentions" of the parties to the contract and make a legal determination, rather their role would to be adjudicate only on the building/ construction process, which would lead to time and cost effective resolution of disputes.

The use of voluntary prequalification mechanisms by Principals should be "encouraged" where the building contract is $5 million or more. We contend that if the Principal completes an effective prequalification process on the Head Contractor then there would be little value in the Subcontractor completing the same process. Through the Building and Construction Industry providing guidelines on the appropriate prequalification procedures to follow, Principals should be able to carry out an effective process.

- **Await the Results of Further Research**

  There is a lack of empirical data on the size of the problem with security of payment particularly Head Contractor insolvency and its flow-on effects in the Building and Construction Industry in Australia. This Consultancy believes that quantitative research needs to be undertaken before we are able to be more specific about the concept of an insurance type scheme, and whether it should be in the form of an Insurance Industry scheme or an industry mutual fund to further protect the security of payment of Subcontractors.

- **Delayed Implementation**

  This Consultancy believes that when the approaches outlines above have been implemented that the security of payment problem should be re-evaluated in say three (3) to four (4) years. If the problem has not diminished significantly, then we believe that some form of prompt payment legislation similar to that used in the United States of America with draconian penalties coupled with mandatory industry approved prequalification procedures for Principals on Head Contractors should be implemented.

  If the cultural change needed in the Australian industry, ie that a Subcontractor has a right to be paid and in a timely fashion, cannot be nurtured through "encouragement", then we contend that the most appropriate measure to induce the change would be to legislate.

- **Do Not Implement**

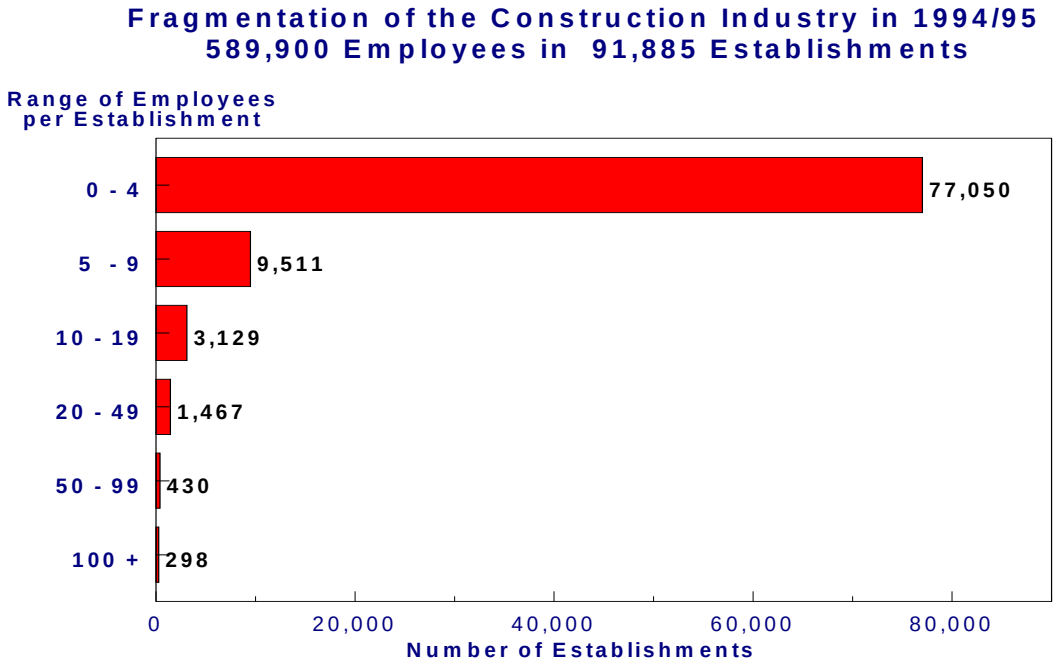
  This Consultancy does not recommend the use of trusts, whether express or implied, in any form as a solution for improving security of payment in the Building and Construction Industry.

1.5 Industry Characteristics

- While there have been numerous reports, studies, enquiries and surveys undertaken into the issue of security of payment in the Building and Construction Industry in Australia there is no empirical data available which quantifies or analyses the extent of the problems with security of payment. There has been little action undertaken in dealing with what many perceive as the greatest problems within the industry, namely to ensure that a Subcontractor is paid on a timely basis and his entitlement to payment is secured.

- The Building and Construction Industry is highly correlated to the state of the Australian economy, with many of the problems highlighted in this Consultancy being such that they would be made more serious by economic difficulties.

- There are minimal or no barriers to entry to the Building and Construction Industry; it is not a highly regulated industry; there are no significant forms of industry assistance and the industry is open to international competition.



Source: Integrated Business Register, June 1995

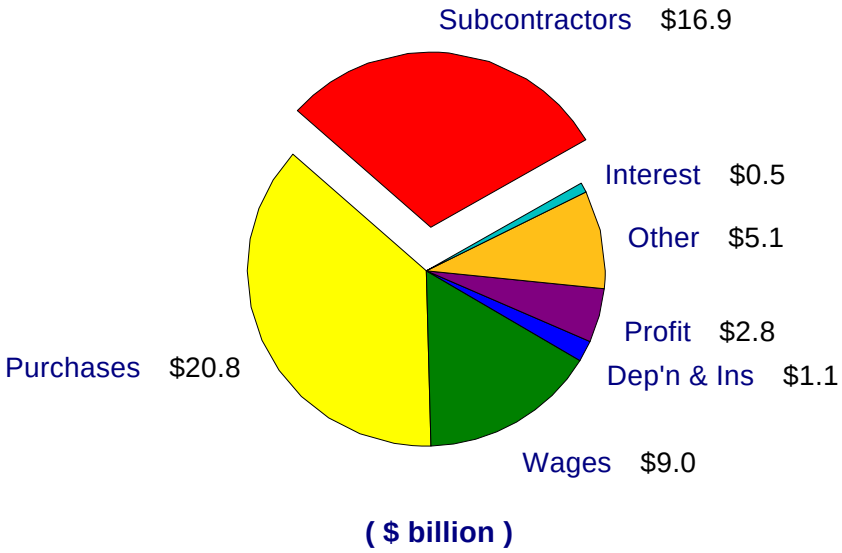
- The Construction Industry is Australia's second most fragmented industry after Agriculture as evidenced by the following chart:

- While it may not be a precise measure, the above chart suggests that there are a significant number of "employees" engaged in the Building and Construction Industry through small establishments that have "subcontracting" relationships as the basis of their operating capability. We contend that these "Subcontractors", because of the structure of the industry, are for all intents and purposes "employees".

- Further, we would also contend that the 77,050 establishments with 0 - 4 employees comprise family businesses with one or two husband and wife partnerships teaming together, perhaps with an apprentice, in a form of commercial venture practising in a particular building industry trade. These ventures, while having corporate structures, are essentially driven by the personal exertion and labours of the principal tradespeople behind the corporate structure.

- IBIS estimates that the Construction Industry ranks 6th amongst the 17 industry divisions that make up the Australian economy. They estimate its cost structure

Analysis of the Construction Industry Cost Structure
1994/95 Industry Turnover $56.2 billion



Source: IBIS Business Information Service

profiles as follows:

- IBIS estimates that the payments to Subcontractors of $16.9 billion comprise mainly labour costs.

- The structuring of Subcontractors is explained by the differing, but compatible objectives of the principal tradespeople (Subcontractor/employee) and building manager (Head Contractor/employer).

- Subcontractors seek to be "self-employed" for the following reasons:

    - masters of their own destiny;
    - tax planning opportunities;
    - flexibility in work commitments;
    - part of the industry culture; and
    - concentration on their particular specialist trade.

- Head Contractors engage Subcontractors as:

    - the Head Contractor is not responsible for:

        - industrial relations and human resource issues;
        - superannuation;
        - payroll tax;
        - workers' compensation insurance;
        - group tax; and
        - holiday pay and other entitlements.

    - the Head Contractor only pays for work done caused by:

        - intermittent work loads; and
        - specialist trades not required full-time.

    - Subcontractors minimise the Head Contractor's investment in working capital.

- As a consequence there has been substantial pressure to provide security of payment to Subcontractors to ensure that they are paid on a timely basis, and due to their "employee" characteristics that their entitlement to payment is secured in the event of Head Contractor insolvency.

1.6 Overview of Findings

1.6.1 Trusts

- This Consultancy does not recommend the use of trusts as a panacea for security of payment, although trusts can legally assist to improve payment in the Building and Construction Industry. Complex commercial and administrative burdens and obligations prevent the implementation of trusts on a widespread basis throughout the industry and the workability of trusts would be severely compromised by the detailed legal issues and considerations involved with trust law.

- However, if trusts are to be considered for the Building and Construction Industry, it would seem appropriate that they be introduced across the board rather than within individual sections of the Building and Construction Industry. This would require legislation to be introduced to the effect that a standard form building contract such as AS2124-1992 be used by the Building and Construction Industry, so that the trust provisions are properly documented.

- We would suggest the use of cascading trusts as opposed to single or multiple trusts, although there is no legal distinction between the three forms of trust.

- A cascading trust is where there is one trust entity responsible for one or more building and construction contracts for one project site and for multiple layers of Subcontractors and/or Sub-Subcontractors.

- We would recommend that the trustee be the person who contracts for work and materials to be supplied or performed. Under these circumstances, the beneficiaries of the trust simply become those Subcontractors who undertake to provide labour and materials to the trustee (ie the Head Contractor).

- We recognise that under this scenario the trustee will not be independent, therefore, an underlying safety mechanism such as a mandatory external audit requirement would need to be introduced.

- We suggest that the trustee's powers, duties, responsibilities and obligations be pursuant to statute and common law and that the trust deed be encapsulated in a standard form building contract.

- A difficult issue will arise where there are disputes between Head Contractors and Subcontractors as it is likely that a trustee will not want to make any payment until absolutely certain that the dispute has been resolved. We recommend that a direction be made in any trust deed or standard form building contract such that a trustee must refer disputes to alternative or consensual dispute resolution. We would envisage an independent, but qualified and experienced panel of mediators/conciliators being available to enable trustees to refer disputes at the earliest opportunity.

- It would appear necessary that a proper education program be instituted so that the Building and Construction Industry becomes aware of the powers, duties, responsibilities and obligations of trustees. Such a program would take considerable time to put into place with the benefits perhaps taking many years to come to fruition. It would be necessary to start the education program at the earliest opportunity, which we believe might occur as early as the apprenticeship stage.

1.6.2 Proof of Payment

- The proof of payment approaches adopted by Queensland Build and the Victorian Catholic Building Office appear to be acceptable in order to ensure payment reaches the Subcontractor at the earliest opportunity. However, both approaches will not ensure prompt payment is made to a Subcontractor where there are disputes.

1.6.3 Consensual Dispute Resolution

- Direct negotiation is in our opinion the best approach to resolve any dispute as it is likely to result in an early resolution at minimum cost to the parties. However, if direct negotiation between the parties will not resolve a dispute, consensual dispute resolution such as conciliation and mediation are desirable in that they are more likely than not to lead to an early resolution of a dispute with a "win/win" position being achieved for each of the parties. Ultimately, if disputes cannot be resolved by direct negotiation or consensus (alternative dispute resolution), they will be resolved by arbitration or through the Courts. In such a situation, it is usually the case that there is great delay involved in having a case heard, with much expense incurred in legal fees. Further, the ultimate result will only make one party happy as there must always be a winner and a loser.

- It is the recommendation of this Consultancy that all standard form building contracts make provision for disputes to be resolved by alternative dispute resolution methods prior to any arbitration or Court intervention. Ideally, all contracts relating to the construction of a building should be in writing. Of course, it is not practical for all construction contracts to be documented. In any event, the Building and Construction Industry must be influenced to grasp the concept of alternative dispute resolution as a means of resolving disputes.

- There is a truism in alternative dispute resolution which is "you can lead a horse to water, but you can't make it drink". Alternative dispute resolution methods can be made compulsory in an attempt to settle disputes. However, alternative dispute resolution will not resolve disputes unless both parties to the dispute are prepared to compromise their position. Equally, alternative dispute resolution will not resolve issues of fraud, duress and "bully boy" tactics.

- To have the Building and Construction Industry embrace alternative dispute resolution as a means of resolving disputes quickly will require an education program being introduced to explain the processes of alternative dispute resolution.

- Further, it is unlikely that parties will embrace alternative dispute resolution unless

they have faith in an independent third party who can act as conciliator or mediator. Many organisations are in existence which provide expert mediation and conciliation services such as the various Law Institutes and Bar Councils in each State, the Australian Commercial Arbitration Centre and the Australian Commercial Disputes Centre to name a few. This consultancy recommends that research be undertaken to ascertain whether or not it is cost effective to establish specialist industry mediators/conciliators who would be available in each of the States to handle building disputes at short notice. These specialists could be attached to an independent body set up by the Building and Construction Industry, pursuant to a code of conduct.

- If disputes are to be resolved by alternative dispute resolution, consideration should be given to a timetable being inserted into standard form building contracts.

1.6.4 Prompt Payment Legislation

- The United States of America ("US") has enacted various Acts, both State and Federal, to ensure prompt payment for Subcontractors in the contractual chain. Implementation of the various Acts led the Construction Industry through a period where a new industry culture developed, ie a Contractor has the right to be paid in a timely manner for work completed.

- The use of unethical or illegal behaviour, including both "stand-over" and duress tactics, has been minimised by the enactment of the various Acts.

- The success of the prompt payment provisions in the US is driven by both the draconian penalties that exist for a breach of the provisions and the laws which govern the behaviour of lawyers, embodied in the applicable rules, which prohibit lawyers from assisting their client's fraudulent or criminal activities or filing meritless lawsuits.

- This Consultancy understands that the US Industry in the early 1980s was faced with the same problems that the Australian Industry currently faces, ie unethical or illegal behaviour; inadequate financial structuring and technical ability of industry participants; inadequate business acumen, industry structure and practice issues; failure to pay on time and insolvency of the Principal or Head Contractor. Although it is impossible to legislate against the insolvency of the Principal or Head Contractor, it is possible to legislate and impose draconian penalties against the other problems that exist within the Australian Industry.

- The issue in Australia is that the US type of legislation, which relies on people within the Industry acting as "watchdogs", may not be as effective in Australia as there exists an Australian cultural characteristic that seems to premise all activities, namely "you do not dob on your mates!". It is primarily for this reason that the success of such legislation would probably not succeed to the same degree in Australia. However, the legislation seems to be effective in the US.

- This Consultancy believes that some form of US legislation with similar draconian penalties could improve the ethical behaviour and practices of participants within the Australian Building and Construction Industry. However, given the extent of the cultural change that would need to happen in the industry, we believe that this form of legislation with its draconian penalties should be used as a "last resort".

1.6.5 Priority Payments

- We contend that the 77,050 establishments with 0 - 4 employees in the Building and Construction Industry comprise family businesses with husband and wife partnerships teaming in the Building and Construction Industry together, in a form of commercial venture practising in a particular building industry trade. These partnerships, while having corporate structures, are essentially driven by the personal exertion and labours of the principal tradespeople behind the corporate structure.

- Therefore, it is the nature of the Building and Construction Industry that many of the small establishments involved with the Head Contractor may be legally Subcontractors, rather than employees of the Head Contractor, whereas the commercial nature of the relationship with the Head Contractor is more closely aligned to that of employee/employer.

- This Consultancy believes that Subcontractors in the Building and Construction Industry have many features and characteristics of "employees" and as a consequence, could be treated as "employees" for the sole purpose of being granted a measure of security of payment upon the insolvency of a Head Contractor, in the same manner that employees receive a priority for unpaid employment entitlements.

- This Consultancy therefore recommends that a capped priority claim of $10,000 be granted to Subcontractors in the event of the insolvency of a Head Contractor and we propose that Section 556 of the Corporations Law be amended and that similar amendments be made to Section 433 of the Corporations Law and Section 109 of the Bankruptcy Act to codify the proposed priority claim.

1.6.6 Insurance

- On the assumption that empirical data, once researched, justifies the concept of insuring Subcontractor payments in the event of default by an insolvent Head Contractor, we believe that a compulsory insurance scheme could be introduced at reasonable cost provided industry participants initiate action to reduce their risk profile.

- The industry's risk profile can be reduced by addressing the causes and treating the symptoms of security of payment as collectively discussed in this Consultancy.

1.6.7 Mutual Fund Insurance

- If insurance companies will not provide cover for Subcontractor security of payment, then an opportunity exists for the industry to establish a Mutual Fund to provide catastrophe cover.

- To protect all Subcontractors, a universal approach will need to be adopted which we believe can only be achieved by legislation.

- Introduction of other recommendations of this Consultancy either before or simultaneously with insurance cover would lower the risk profile of the industry and lower the cost of cover to ensure that all Subcontractors attained security of payment in the event of Head Contractor insolvency.

1.6.8 Prequalification

- Currently, the only level at which a full prequalification process occurs in the construction chain is between the Principal and Head Contractor primarily in the public sector. Realistically, this is due to the combined effect of the relative financial exposure of the Principal and the ability of the Principal to command the information to undertake such a process.

- Prequalification has limited scope to protect the Subcontractor from non-payment or slow payment. Its role is to aid in identifying the risk of failure of the Head Contractor.

- For prequalification to be effective it must involve the verification, review and assessment of current information on the financial, technical and management capacity of the Head Contractor by competent assessors.

- For projects above $5 million prequalification should be undertaken voluntarily by the Principal on the Head Contractor and the process should be supported by other publications outlining the prequalification process.

- Prequalification undertaken by the Subcontractor does not diminish the risk of Head Contractor failure, nor improve the risk of exposure to failure for the Subcontractor.

- For projects below $5 million prequalification is not an effective mechanism to protect the Subcontractor as the level of financial and non-financial information available in respect of smaller Contractors and the ability of the users (Subcontractors) to assess the information are prime restrictions.

- If the problem of security of payment has not diminished in the future, consideration could be given to compulsory implementation of prequalification procedures prior to the awarding of a building contract.

IBIS Business Information Service ("IBIS") estimates that the Construction Industry (ANZSIC code E4100) had the following characteristics in 1994/95:

Industry turnover:	$56.2 billion
Employment:	589,900 people
Number of establishments:	91,885
Average turnover per employee:	$95,300
Average turnover per establishment:	$612,000
Average employees per establishment:	6.4 people

The Construction Industry is Australia's second most fragmented industry after Agriculture as evidenced by the following table sourced by us from the Integrated Business Register of June 1995, which categorises the 589,900 people employed in the industry in 1994/95 by size of the employing establishment:

Number of Employees	**Number of Establishments**	**%**
0 - 4	77,050	83.9
5 - 9	9,511	10.4
10 - 19	3,129	3.4
20 - 49	1,467	1.7
50 - 99	430	0.5
100 +	298	0.1
	91,885	100%

IBIS estimates that the Construction Industry ranks 6th amongst the 17 industry divisions that make up the Australian economy.

Also, IBIS estimates the average cost structure of the Construction Industry in 1994/95 was:

	$ billion	**%**
Industry Turnover	**56.2**	**100**
Purchases of goods and materials	20.8	37
Payments to Subcontractors	***16.9***	***30***
Other selected expenses	5.1	9
Wages and salaries	9.0	16
Depreciation, insurance	1.1	2
Interest expense	0.5	1
Operating profit before tax	2.8	5

IBIS estimates that Payments to Subcontractors comprise mainly labour costs.

The IBIS estimates are based on sources such as ABS cat no 8140.0 Business Operations and

Industry Performance and the Integrated Business Registers.

It is clear that the structure of the Building and Construction Industry has changed over the last few decades. Currently the primary contracting builder ("the Head Contractor") will engage Subcontractors to conduct a significant component of the construction work required. In these circumstances, the Head Contractor really operates as a project manager.

Subcontractors engage in their trades via a number of trading entities, such as:

- sole traders;
- partnerships;
- joint ventures; and
- corporations.

They seek to be "self-employed" for the following reasons:

- masters of their own destiny;
- tax planning opportunities;
- flexibility in work commitments;
- part of the industry culture; and
- concentration on their particular specialist trade.

Head Contractors engage Subcontractors as:

- Head Contractors are not responsible for:
    - industrial relations and human resource issues;
    - superannuation;
    - payroll tax;
    - workers' compensation insurance;
    - group tax; and
    - holiday pay and other entitlements.
- Head Contractors only pay for work done caused by:
    - intermittent work loads; and
    - specialist trades not required full-time.
- Subcontractors minimise the Head Contractor's investment in working capital.

As a consequence there has been substantial pressure to provide security of payment to Subcontractors due to their "employee" characteristics in the event of Head Contractor insolvency.

It is not the intention of this Consultancy to provide reasons for the development of this type of structure in the Building and Construction Industry. Suffice to say that good economic reasons are no doubt suggested (see the Discussion Paper on Financial Protection in the

Building and Construction Industry [Project No 82] of the Law Reform Commission of Western Australia [page 6]).

Invariably, privity of contract is between the Principal and the Head Contractor in the first instance, the Head Contractor and Subcontractors in the second instance and Subcontractors with Sub-Subcontractors in the third and subsequent instance. In contract law a person can only sue to recover a debt for work and labour done where there is a direct contract between the debtor and the creditor.

Therefore, security of payment has been a matter of significant debate within the Building and Construction Industry for some years. The issue is complex and controversial. Numerous studies, reports, enquiries and surveys have been undertaken by industry bodies and various State and Federals Governments, but no consensus as to the causes of the problem, nor remedies have emerged.

Our experience and review of the extensive research to date suggests that there are three divergent positions on the issue within the Building and Construction Industry**:**

- the issue is complex and difficult to measure;
- there is insufficient evidence to confirm the size of the problem suggested by anecdotal evidence; or
- the problem is significant and requires complex and costly remedies to protect industry participants.

To date the industry has been unable to guarantee payments between various parties despite the existence of contractual obligations. The problem of security of payment is by no means unique to the Building and Construction Industry. However, it is perceived that its impact is greater in this industry primarily due to the traditional hierarchy of Contractors with cascading payment obligations, low capital backing and reliance on cashflows to sustain business, the ease of entry into the industry and the disproportionately large number of enterprises employing very small numbers of people.

Anecdotal evidence suggests that this problem is particularly prevalent with payments from Head Contractors to Subcontractors. Subcontractors provide a substantial proportion, if not all, of the trade work associated with projects in the industry and it is considered that they have not been sufficiently secured in regards to amounts owing to them for services and materials rendered. The problems for Subcontractors include not being paid on time, not being paid at all or only receiving part payment for work completed. This is especially evident where a Contractor higher in the contractual chain becomes insolvent and its affairs are then administered through an insolvency process.

Anecdotal evidence also suggests that Contractors at various levels in the contractual chain suffer from loss of retention monies and cash securities. It appears that it is not uncommon for such monies to be forfeited unfairly or negotiated away in response to perceived problems and disputes. Accordingly, Contractors load their tender prices to manage this risk, thereby increasing overall industry costs.

Set out below are the primary causes identified as contributing to the problems associated with security of payment:

- Unethical or illegal behaviour;
- Inadequate financial structuring and technical ability of industry participants;
- Inadequate business acumen;
- Industry structure and practice issues;
- Failure to pay on time; and
- Insolvency of the Principal or Head Contractor.

These issues are of particular significance and importance to specialist Contractors and Subcontractors as the loss of a single substantial payment or a number of payments can be sufficient to close down a Contractor's business. The closing down of a business will invariably, directly or indirectly, affect other industry participants further down the contractual chain.

Non-payment of Subcontractors also causes delays to projects with Subcontractors being reluctant to continue with contract works where payments are not being made promptly by the Head Contractor. Also, where the Head Contractor's contract has been determined, difficulties are experienced in having an unpaid Subcontractor return to site to finish off works, as well as subsequent industrial disruption that may be caused by the non-payment of Subcontractors.

The National Public Works Council Inc ("NPWC") has been addressing the security of payment issue by developing a set of over-arching principles of conduct that industry participants should observe in order to assist in securing payment and also a set of agreed National actions to be implemented in all jurisdictions by Government Principals.

Alongside the work being done by the NPWC, there have been or currently are, a number of initiatives being developed to address and resolve the problem. In this regard, we note the following:

- The Queensland Government's Inquiry into Security of Payment Within the Building

Industry, under the chairmanship of Mr Arthur Scurr which is expected to report in September 1996.

- The Law Reform Commission of Western Australia's Discussion Paper on Financial Protection in the Building and Construction Industry (Project No 82) and Issues Paper, which sought comments by March 1996.

- The Fifth Report of the Parliamentary Inquiry into the Victorian Building and Construction Industry by the Economic Development Committee on the Matter of Security of Payments, in September 1994.

This issue is not unique to Australia. Research has also been initiated overseas, for example:

- The Latham Report in the UK, July 1994
- The Palmer Report in the UK, November 1995
- The Construction Industry Development Board in Singapore, 1995
- The European Commission Recommendation, May 1995

It appears to this Consultancy that a number of the remedies which have been proposed to date to guarantee payment at all levels of the contractual chain, be they based on a legislative framework or by industry initiative, are potentially so legally and commercially onerous and so organisationally and administratively burdensome, that they would most likely be ineffective in terms of cost/benefit in alleviating the problem that the industry and Government are endeavouring to solve.

The NPWC wishes to ensure that proposed remedies are legally and commercially sound and can be implemented practically and cost-effectively to improve security of payment.

It is this desire which forms the basis of this Consultancy.

The stated objectives of the Consultancy are:

1. To review the existing legal framework, in particular Corporations and Bankruptcy law, to ascertain the extent to which existing laws protect security of payment down the contractual chain in the Construction Industry.

2. To propose any ways of better utilising/applying existing laws to improve security of payment.

3. To propose any (minor) modifications to existing laws which would improve security of payment.

4. To comment briefly on the type of additional/new legislation (if any) required to achieve the goals sought in 1 to 3.

5. To review currently available voluntary mechanisms, such as insurance schemes, that afford financial protection to construction industry participants in addition to that available under contractual terms and relevant existing law.

6. To propose possible new voluntary mechanisms, such as improved access to credit ratings information, that would afford enhanced financial self-protection to Construction Industry participants.

7. If 5 and 6 above offer little hope of significantly improving security of payment in the Construction Industry, the Consultant is required to comment briefly on "obligatory" schemes such as default funds that industry sectors might be prepared to adopt to achieve this goal.

The Consultancy is to include in its consideration the following possible remedies:

1. Trusts

Deemed and formal trust arrangements for monies owed by Head Contractors to Subcontractors and cash security/retention monies held by the Head Contractor for Subcontractor performance.

2. Proof of Payment

Available types and viability of proof of payment mechanisms (other than statutory declarations) as a security of payment measure.

3. Prompt Payment Legislation

Possible forms of legislation which might be introduced to ensure prompt payment down the contractual chain.

4. Priority Payments

This Consultancy not only addresses the three specific remedies detailed above, it also

evaluates an alternative response to the issues; consideration of granting a priority in insolvency administration to Subcontractors by amendment to the priority provisions in Section 556 of the Corporations Law and related legislation.

5. Insurance

(a) Limited universal insurance schemes to make payments to Subcontractors in the event of insolvency of a Head Contractor; and

(b) Industry default funds to make payments to Subcontractors in the event of insolvency of a Head Contractor.

6. Mutual Fund Insurance

This Consultancy not only addresses the two specific remedies above, it also evaluates an alternative response to the insurance issue; consideration of a scheme similar to the Housing Guarantee Fund concept where a percentage of value of each building contract might be paid into a separate statutory fund. This could then enable Subcontractors to achieve security of payment in the event of the collapse of the Head Contractor.

7. Prequalification

(a) Prequalification systems, as now used widely in the public sector;
(b) Financial criteria/benchmarks used in prequalification criteria ("PQC") to select project participants;
(c) Access to and usefulness of credit ratings information; and
(d) Access to such systems and information by a wider group of participants.

Notwithstanding the need to consider existing and potential options, the Consultancy has to deliver a clear recommendation and conclusion as a basis for action.

4.1 Recommendations

- We describe trusts in the following way:

  - Single trust - a single trust is where there is one trust entity responsible for the one building and construction contract for the one project site for a single layer of Subcontractors.

  - Cascading trust - a cascading trust is where there is one trust entity responsible for one or more building and construction contracts for one project site and for multiple layers of Subcontractors and/or Sub-Subcontractors.

  - Multiple trust - a multiple trust is where there is one trust entity responsible for a number of building and construction contracts for a number of project sites for a single layer of Subcontractors.

- If trusts are to be introduced into the Building and Construction Industry, it would seem appropriate that they be introduced across the board rather than within individual sections of the industry. This would probably require legislation to be introduced to the effect that a standard form building contract such as AS2124-1992 be used by the Building and Construction Industry so that trust provisions are properly documented.

- We would suggest cascading trusts as opposed to single or multiple trusts be used. These trusts should be set up pursuant to a standard form contract. We believe that the Canadian privity of trust/privity of contract approach introduced into various Provinces within Canada would be an appropriate structure to introduce.

- As far as the issue as to who is to be the trustee is concerned, we recommend that the trustee be the person who contracts for work and materials to be supplied or performed. Under these circumstances, the beneficiaries of the trust simply become those Subcontractors who undertake to provide labour and materials to the trustee (ie the Head Contractor).

- We recognise that under this scenario the trustee will not be independent, therefore, an underlying safety mechanism such as a mandatory external audit requirement would need to be introduced to protect the interests of all parties to the contract.

- We suggest that the trustee's powers, duties, responsibilities and obligations be pursuant to statute and common law and that the trust deed be encapsulated in a standard form building contract.

- A difficult issue will arise where there are disputes between Head Contractors and Subcontractors as it is likely that a trustee will not want to make any payment until absolutely certain that the dispute has been resolved. This is due to the potential liability imposed upon a trustee for improper appropriation of trust funds. We recommend that a direction be made in a standard form building contract such that a trustee must refer disputes for alternative dispute resolution rather than having an unfettered discretion to settle disputes by whatever means the trustee considers desirable. Clearly, it would be unconscionable for a Head Contractor in its capacity as trustee to settle its own dispute by unfettered discretion. We would envisage an independent, but qualified and experienced panel of mediators/conciliators be available to enable trustees to refer disputes at the earliest opportunity.

- An independent trustee may, because of the duties, responsibilities and obligations upon a trustee to act with the utmost of good faith towards beneficiaries, delay payment to Subcontractors until absolutely certain that a payment to a particular Subcontractor is to be correctly made. A trustee that has privity of contract, although under the same duties, responsibilities and obligations as an independent trustee, would, because of his involvement in the contract, be in a position of greater knowledge and could use his commercial common sense when making payments.

- If there are to be trusts along the lines of the Canadian approach (ie cascading trusts) with those trusts being administered by the parties privy to the building contract, it would appear necessary that a proper education program be instituted so that the Building and Construction Industry becomes aware of the powers, duties, responsibilities and obligations of trustees. Such a program would take considerable time to put into place with the benefits perhaps taking many years to come to fruition. It would be necessary to start the education program at the earliest opportunity, which we believe might occur as early as the apprenticeship stage.

- However, this Consultancy does not recommend the use of trusts as a panacea for security of payment although trusts can assist to improve payment in the Building and Construction Industry. The complex, commercial and administrative burdens and obligations of trusts are likely to prevent their implementation on a wide spread basis throughout the Building and Construction Industry. Also, the detailed legal issues and considerations involved with trust law and the onerous trustee obligations negate the workability of trusts within the industry.

4.2 Background

One of the issues for determination in this Consultancy is whether or not a trust would be a sufficient vehicle to provide adequate protection for security of payment for work done and materials supplied by a Subcontractor.

The use of trust funds is commonly found within the legal, accounting and stockbroking professions and the real estate industry as there is a fiduciary relationship based on generally discrete and distinct financial transactions between principals and agents where funds are held on trust over time. The use of trust funds is controlled either by legislation or membership rules of the relevant professional associations. A breach of the legislation provisions or membership rules is not tolerated, with severe consequences flowing from a significant breach.

There is usually an underlying safety mechanism (for example, external audit requirements, Solicitors Guarantee Fund, Professional Indemnity Insurance, The National Guarantee Fund administered by the Securities Exchanges Guarantee Corporation, etc) that may protect, to some extent, trust beneficiaries where the trustee has been unethical, unscrupulous or fraudulent. However, this may not fully protect all affected parties.

The trustee of a trust holds a fiduciary position and must protect the interests of the beneficiaries of the trust. He must not put himself in a position in which his duty conflicts, or has the capacity to conflict, with these interests unless beneficiaries agree to this conflict. The trustee may bind the trust and has recourse to trust assets for liabilities incurred in carrying out his duties.

Generally, most trust funds are operated through a simple bank account with control vested in the trustee. The use of trust funds that have been outlined in your Brief would, in practice, be operated through simple bank accounts.

Because trust funds are normally operated through a simple bank account, various external audit requirements are established to protect beneficiaries (to a limited extent) from the dissipation of trust funds. However, neither the use of these audit techniques nor comprehensive legislative requirements can fully protect beneficiaries from unethical, unscrupulous or fraudulent behaviour of the trustee or any of his agents. These behavioural aspects are not controllable and are usually evident at times of cash flow difficulties.

This is no more evident than from the 1990's. The 1990's are littered with cases where people in positions of trust abused their power to benefit themselves to the detriment of their creditors and beneficiaries. These cases are not limited to the Building and Construction Industry.

We consider that the trust options outlined in your Brief are not mutually exclusive but are really one in the same, ie monies will be held in trust by the trustee for Subcontractor performance. Further, we believe it makes no difference (unless otherwise indicated) whether the monies are held formally in trust or deemed to be held in trust.

Most, if not all, of our discussion which follows on trusts is based on the premise that the Head Contractor is the trustee and the Subcontractors would be classified as the beneficiaries of the trust. The ramifications of the use of a trust scheme may be different where the trustee is not the Head Contractor, but some third-party, eg a Government body.

It is not the intention of this Consultancy to provide a complete legal analysis of the law of trusts as such an exercise would require an extremely large treatise and is outside the scope of the Brief.

We have examined the legal implications of how trust arrangements could be applied to security of payment issues and combined this legal perspective with an evaluation of the key commercial and practical aspects of operating within a trust environment.

4.3 Definition of "Trust"

Many attempts have been made to describe the meaning of a "trust". However, it is sufficient to say that a trust exists when one person holds legal or equitable title to property and is bound by an equitable obligation to hold the interest in that property for the benefit of another person and not exclusively for himself.

A Trust has been defined in the 12th Edition of the Law of Trustees by Underhill as:

> "..... an equitable obligation, binding a person to deal with the property over which he has control for the benefit of persons of whom he may himself be one, and any one of whom may enforce the obligation".

This definition has been approved in Re: Williams [1897] 2 Ch 12 and Glenn -v- Federal Commissioner (1915) 20 CLR 490.

The above definition relates to a private trust. However, there are other classes of trusts known as public or charitable trusts and special purpose trusts. These trusts are generally set up pursuant to particular legislation or regulation.

Trusts may be classified as expressed or declared (ie in writing), presumed or implied (ie the law presumes that a trust was intended notwithstanding that it was not expressly done so in writing) or constructive (ie a trust arises without any reference to the intentions of the parties either expressly or by implication).

The concept of a trust in the Building and Construction Industry is a simple one, namely that monies properly earmarked for payment to the Head Contractor and Subcontractors end up with each party respectively by virtue of a trust, such that the trustee holds monies specifically for its obligations incurred as trustee and for the beneficiaries of the trust and cannot use those monies for diversion to other areas. It should be noted that if the trustee of the trust is the Head Contractor, then it should not also be a beneficiary. If the trustee was also a beneficiary a "cloud" over both perceived and actual independence would arise.

In times of cash flow crisis, it is simple and in most instances a commercial tactic, for the Head Contractor to divert funds to pay more demanding creditors, rather than specific Subcontractors, in the hope that cash flow will improve during the building process to pay Subcontractors at a later date. Technically, a trust may prevent such a diversion of funds.

There are four essential elements in a trust:

(i) the trustee (possibly the Head Contractor);
(ii) the trust property (contract sums due and payable);
(iii) the beneficiary (the Subcontractor); and
(iv) obligations imposed upon the trustee when dealing with trust property (trust deed).

Although the concept of a trust might be a simple one, a number of legal and commercial issues and problems arise in the implementation of a trust. These are discussed below.

4.4 Types of Trusts

4.4.1 Private Trust versus Statutory Trust

A trust can be set up privately or pursuant to legislation. Whether a trust is private or statutory is really a policy decision and depends upon what form of control the Government may wish to adopt in the Building and Construction Industry.

A private trust can be set up pursuant to a trust deed or contract. Indeed, some standard form building contracts already contain trust clauses relating to payments. The Supreme Court of New South Wales has held in the case of KBH Constructions Pty Ltd -v- Lidco Aluminium Products Pty Ltd & Others (unreported) 27 June 1990 that the interest of the builder in an amount retained under a contract was held by the Principal as a fiduciary trustee (clause 10.24.05 of the SCJCCA 1985). Similar clauses relating to retention of monies have been held to be trusts in the United Kingdom; (In this regard see the case of Re: Arthur Sanders Ltd (1981) 17 BLR 125).

4.4.2 Determining the Type of Trust

There are no legal or statutory impediments which would prevent the creation of single, multiple or cascading trusts. However, administrative and cost impediments may arise. A single trust is where there is one trust entity responsible for the one building and construction contract for the one project site for a single layer of Subcontractors. A multiple trust is where there is one trust entity responsible for a number of building and construction contracts for a number of project sites for a single layer of Subcontractors. A cascading trust is where there is one trust entity responsible for one or more building and construction contracts for one project site and for multiple layers of Subcontractors and/or Sub-Subcontractors.

A single trust may be easier to administer than cascading or multiple trusts. However, a trustee over a single trust may suffer from the difficulty of identifying funds for each beneficiary, in that there may be a mixing of funds. The earmarking of funds for specific beneficiaries would be the most difficult task of the trustee where there is a single trust covering a construction project involving a single layer, but multiple numbers of Subcontractors.

Multiple trusts also suffer from the difficulty of a mixing of funds and the accounting requirements would be significantly more complex than single or cascading trusts.

A cascading trust recognises the commercial operation of a project site and although careful accounting would be required to identify funds, we suggest that a cascading trust is the preferable type of trust.

If the Head Contractor was to be the trustee, the trust could be set up pursuant to a building contract such that the beneficiaries under the trust would be all Subcontractors in the construction process. A very wide and all encompassing definition of "Subcontractor" would be required in the contract between the Principal and Head Contractor and the subsequent contracts between the Head Contractor and the respective Subcontractors, which would encapture all Subcontractors with privity of contract. The setting up of a trust by way of a contract would prevent the need to have a formal trust deed and therefore costs could be saved.

4.5 Trustees

4.5.1 Fiduciary Obligation of The Trustee

A trust turns an ordinary debtor/creditor relationship into a fiduciary relationship between trustee and beneficiary. The obligations imposed upon a trustee are far greater than those obligations imposed upon a debtor. A creditor who owes money to a debtor will be obliged pursuant to contract law to pay the debtor. However, the law imposes obligations upon a trustee of a fiduciary nature. A trustee is bound to exercise rights, obligations and powers in good faith and for the benefit of a beneficiary. A creditor does not have a good faith obligation towards a debtor.

4.5.2 Determining Who is to Act as a Trustee

In its simplest form, a trustee is a legal person who holds property on trust for a beneficiary.

In the Building and Construction Industry, a trustee may be either of the following:

- the Principal;
- the Head Contractor and various Subcontractors down the construction chain; or
- a third-party (Private or Government).

There are no legal impediments which would prevent either the Principal, Head Contractor, various Subcontractors or a third-party from being a trustee of a building and construction trust provided proper mechanisms were in place to implement the trust's and trustee's requirements.

A trustee can be either an individual, a corporation or a Government enterprise. A Government enterprise might be formed under specific legislation set up for administration of a trust.

If a third-party was to be the trustee, the trustee should be independent of the Building and Construction Industry. It would seem a third-party trustee, in particular a third-party Government body trustee, would be an entity less likely to misappropriate monies identified under a trust for a beneficiary and perhaps may lead to less spurious disputes pursuant to that trust.

However, we see no special reason why the trustee cannot be a party in the construction process.

4.5.3 Who is to Hold Trust Monies

The following entities might act as a trustee and hold monies in trust for the beneficiaries:

- the Owner;
- the Head Contractor and various Subcontractors; or
- an independent third-party either being a Private or Government body.

Whether or not a Private or Government body were to hold trust funds is a policy decision as the obligations upon the trustee would be the same whether or not the trustee was a Private or Government body.

4.5.4 Powers of Trustees

The powers of a trustee may be grouped into specific powers and discretionary powers. Discretionary powers are all acts which the trustee may do in the administration and management of the trust. Provided a trustee exercises a discretionary power honestly and with professional judgment, such a discretion cannot be set aside as being invalid. A Court will not control a trustee's discretionary powers, unless the trustee acts with

bad faith or with the intention to do so.

Other powers of the trust may specifically require a trustee to do or refrain from doing a particular act. Under those circumstances, there is no discretion for the trustee as to what he does; he must do or refrain from doing a particular act specified in the trust deed.

The various powers that a trustee might have are covered by common law and pursuant to statute under Trustee Acts operating in each of the States and the Commonwealth. In addition, powers can be expressly given pursuant to contract, trust deed or legislation. What those powers might be will be dependent upon policy considerations, for example, whether a trustee has power to settle building disputes.

Under the Trustee Acts, disputes can be resolved by direction and order of the various Supreme Courts. For example, the Supreme Court has power to make an order appointing a new trustee(s), either in substitution for or in addition to any existing trustee(s) (see Section 48 of the Trustee Act 1958 [Vic]). It is submitted that the powers granted under the Trustee Acts may not of themselves be sufficient to enable a trustee to properly administer a trust in the Building and Construction Industry.

Powers to be given to trustees in addition to those powers given to trustees pursuant to common law and statute should include two important powers, the power to distribute trust funds and the power to resolve disputes.

4.5.5 How to Distribute Trust Funds?

Assuming that the requisite work and materials have been supplied, how is a Subcontractor to obtain payment from the trustee? An express formula may be required to enable a trustee to make payment to a Subcontractor, as and when the work and materials are supplied. Certification of completion of various phases of the construction and building process are currently made by, for example, Architects, Quantity Surveyors or Superintendents. Disputes can arise as to whether or not a job has been satisfactorily completed. How quickly funds end up with a Subcontractor will depend upon the effectiveness of any dispute resolution process. Disputes between parties will ultimately be resolved by agreement, alternative dispute resolution or judicial intervention.
How would a trustee distribute funds available for distribution when those funds are not sufficient to pay all amounts owing to Subcontractors? Should the trustee distribute those funds on a first in best dressed basis or upon a pari passu basis? Direction should be given to a trustee pursuant to the express terms of the trust. This direction could be given by trust deed or pursuant to specific terms in a building contract. Having regard to the principles of equity, it would seem that a pari passu basis of distribution would be preferable.

A trust in the Building and Construction Industry is unlikely to be a trading trust and therefore, will not incur trade creditors. Accordingly, problems associated with priorities of insolvent entities pursuant to Sections 556 and 433 of the Corporations Law and Section 109 of the Bankruptcy Act would not apply. Further, the difficulties

of preferential payments and the recovery thereof by a Liquidator of the trust would not arise.

4.5.6 How are Trust Disputes to be Resolved?

Trust disputes can be resolved by agreement, by alternative dispute resolution (arbitration, conciliation and mediation) and by Court order. Resolution of disputes through the Courts is generally slow and extremely expensive. A direction in a contract, trust deed or otherwise might direct that disputes are to be resolved by first attempting alternative dispute resolution prior to Court intervention. Such a direction should lead to a quicker, less costly and perhaps more equitable resolution to the dispute, rather than from a Court intervention. This is in accordance with the principle that there can only be one winner and one loser in a Court determination, whereas there can be a "win/win" position through alternative dispute resolution.

4.6 For Whom Should the Trustee Hold the Trust Funds

If there were cascading trusts set up in the construction process, trust monies should only be held in trust for those parties upon which there is privity of contract. This is the notion of the so called "privity of trust" approach. This approach has been adopted in some provinces in Canada.

The privity of trust approach is a simple one. Each trustee knows specifically who the beneficiaries are, which should lead to an orderly flow of funds down the contractual chain. The obligation of the trustee would be fulfilled when the trustee has paid the party to whom he has contracted. That party, in turn, would then have trust obligations of payment to the party with whom he contracted, and so on.

Provided beneficiaries were properly defined, the trustee ought not have difficulty in deciding to whom to distribute the trust funds.

4.7 Problems, Difficulties and Legal Ramifications of Trusts

There are numerous problems, difficulties and legal ramifications from the use of trusts. Set out below are the main issues, outside the questions raised in the Brief (discussed at Section 4.8) from the use of trusts.

Most of the following discussion in Section 4.7 is based on the premise that the Head Contractor is the trustee. The ramifications for the trust scheme may be different where the trustee is not the Head Contractor, but some third party.

4.7.1 Trust Accounts

There are three possible trust structures available. These have been considered previously, and can be described as single trusts, multiple trusts or cascading trusts.

Irrespective of the structure adopted, trusts may be deemed (ie implied at law) or formal (ie expressed in formal terms such that their content is evident in trust documentation which in turn binds the parties).

As indicated, one potential difficulty arising from the use of trusts occurs when trust funds become mixed, either with monies from other trust funds held by the trustee, or with the trustees own money, or both.

It has been previously stated in this Consultancy that the likelihood of mixing of funds is much less likely to occur in the case of cascading trusts.

4.7.2 Monies Mixed in Trustee's Account

If monies are mingled with the trustee's general account, they become unidentifiable. This means that tracing, in the case of an action brought for breach of trust, may not be possible. There are three points to note where retention monies have been required to be held on trust by Head Contractors:

(i) As a result of the Head Contractor's fiduciary relationship with the Subcontractor, a Head Contractor was under a duty to set the monies aside in a separate account. (Wates Construction (London) Ltd v Frantham Property Limited (Unreported) referred to in F Fitzpatrick *Retention of Funds in Building Contracts* [1991] New LJ 1007)

(ii) The above proposition means that in the case of a solvent Head Contractor, an injunction is available to the Subcontractor to secure funds, and an order can be made setting aside as a separate trust fund a sum equal to that part of the sum owing as retention monies under the project. (*Re Arthur Sanders Limited* (1981) 17 BLR 125, 136)

(iii) In the case of an insolvent Head Contractor who has not maintained separate accounts, no injunction will be ordered to constitute the funds as in (ii) above. However, beneficiaries are also entitled, in certain circumstances, to trace

dissipated funds and recover them. The general rule of tracing provides that the beneficiary will be entitled only to the lowest intermediate balance standing to the credit of the account after the date of mixing and before the date when the claim is made. (*Re Hallet's Estate* (1880) 13 Ch.D. 696). Tracing is a very complicated procedure and can be extremely technical.

In Australia, where a third party is a participant in a breach of trust, it will be liable to the beneficiaries (Barnes v Addy (1874) L.R 9 Ch. App. Cas. 244). Thus, a Bank which holds those trust funds in a mixed account and allows those funds to be dissipated may be liable to beneficiaries of the trust if it had notice, either actual or constructive, that the funds were indeed subject to a trust. In this regard, one would assume that the impression of a statutory trust would provide requisite notice upon which a beneficiary may found a claim against the Bank.

The above discussion focuses on the ability of the cheated beneficiary to have direct recourse to funds held in the trust account (or in the account of a third party) once the breach has been detected.

Additionally, the aggrieved beneficiary will have a right to seek compensation from the trustee personally, arising out of the trustee's breach of duty to preserve trust assets.

Finally, where the trustee is a corporation, directors and officers of that company, being the "controlling mind" of the company, may also be personally liable under the Corporations Law for the debts incurred by the trust (Sections 233, 588H and 592 of the Corporations Law).

4.7.3 Monies Separated from Trustee's Own Account

Where funds held in trust are an amalgamation of several trusts, but are nevertheless separate from the trustee's account, the right of the beneficiary to trace funds dispersed in breach of trust will depend upon the rule in *Clayton's case* ((1816)1 Mer.572). This rule dictates that a payment out of a Bank account will be treated as a withdrawal of the money which has been in the account for the longest period, ie the first drawings are attributed to the first payments in. This rule, also known as the "first in, first out" rule has been criticised for its harsh results in some circumstances.

Additionally, a beneficiary may also have recourse to the arguments discussed under *Barnes v. Addy* above, so that if the trustee is required to maintain a trust account separate to that of its own general account, then the Bank will be imputed with at least constructive notice of the monies being subject to trust. Thus, any dissipation of funds will result in the Bank being held accountable.

Separate trust accounts will also stand outside the reach of a liquidator in the case of an insolvent Head Contractor (assuming the Head Contractor is the trustee).

Finally, it should be noted that the likely position regarding tracing of funds in Australia when applied to trusts in the Building Industry can be contrasted with the position in Canada, where trustees are required to keep a separate trust account from their general account, but may control a number of projects from the one trust fund (ie multiple trusts). If funds are dissipated in breach of trust from such a mingled trust account, Subcontractors from different projects are all rated equally, ie on a pari passu basis.

4.7.4 Other Remedies

The above discussions have focused on the remedy of tracing as the primary remedy available to an aggrieved beneficiary, mainly because anecdotal evidence suggests that a mixing of funds, followed by payment of "mixed" funds to third parties (usually other Subcontractors) would be the most likely scenario if the trust fund framework was to be imposed on current building practise.

However, in the event that there are other misappropriations of trust funds by a trustee for purposes such as purchasing property or investment, a beneficiary is entitled to an election of a charge over the property purchased for the amount of trust monies used (*Re Hallett's Estate*). If the trustee later sells the property at a profit, the profits will probably belong to the beneficiaries (*Re Pumfrey*).

4.7.5 Effects on Third Party Rights

Third Parties may have a claim against beneficiaries of a trust. The issue of priority in this case will largely be determined by when the trust came into existence vis-a-vis the third party entitlement.

(i) Judgement creditors with attachment orders

Where a creditor obtains a judgment against a debtor who is a beneficiary of a trust fund (eg a Subcontractor), that judgment may be enforced by obtaining an attachment order, attaching funds owed to the debtor by a third party.

Thus, it may be argued by a creditor with an attachment order against the beneficiary that, if the trust did not come into being until after the trust money became payable to the debtor (beneficiary), then the trust does not attach to those funds for the purpose of satisfying the attachment order against the beneficiary. The creditor would simply argue that the monies available for

distribution are not trust monies and, therefore, are available for distribution to the creditor.

It would seem inequitable to give the judgement creditor a greater right against the garnishee than it would otherwise have against the beneficiary owing the debt. Furthermore, if the Subcontractor's right to dispose of monies is subject to trust restrictions, then it could be argued that this should also be the judgement creditor's right.

Legislation has been enacted in the Canadian province of Manitoba where money due to be paid to a Head Contractor or Subcontractor is not capable of being the subject of an attachment order (*Manitoba) Builders' Liens Act* RSM 1987 cB91).

(ii) Trust beneficiaries and assignees of accounts/debts

It may be, as is common practice, that a Contractor would wish to assign present or future monies that will become payable on account of the contract price to a third party. Under these circumstances it could be argued that to allow such third parties to retain these monies free from the trust would defeat the purpose of imposing the trust in the first place. However, this runs contrary to the general proposition of keeping trust monies within the "chain".

As in (i) above, there is legislation in Manitoba which addresses this problem. It provides that no assignment, such as that described, is valid against any trust created under the Act and that where a right to payment of monies that are subject to a trust is assigned, those monies remain subject to the trust. Furthermore, the assignee is the trustee (presumably of those monies only.)

4.7.6 Secured Funds that Form Part of the Trust

Often, the funds with which the Principal intends to finance the project are sourced from a financier, who, as a matter of course, would most probably hold some form of security over the funds, such as a mortgage or other charge.

Under the current legal framework, if there was a default under the terms of the security mortgage, then the mortgagee (financier) would have priority over those monies through mortgage.
This problem may not be as drastic as it may appear. Firstly, we understand that the incidence of Principal failure (that would trigger a default in the mortgage and result in funds that were to be dissipated to Subcontractors being called up by the mortgagee) is low.

Secondly, a trust could be imposed at the time funds are due to be paid from the mortgagee to the Principal, and the Principal holds these funds on trust until they are dissipated. This mechanism has been imposed in two Provinces in Canada through the *(Ontario) Construction Lien Act* RSO 1990 c C.30 and the *(Manitoba) Builders' Lien Act* RSM 1987 c B91.

This proposal was rejected by CIDA at their National Conference in 1995. The issue was dealt with by acknowledging that the Head Contractor ought to be given the opportunity to assure himself that appropriate finance is in place. This would take the form of a warranty in the building contract.

CIDA felt that it would not be appropriate to impose on the relationship between the Principal and financier. Ultimately, any commercial risk would be borne by the Head Contractor. The requirements of the warranty are aimed at reducing that risk.

4.7.7 Evasion of Trust Scheme

If legislation was enacted to invoke provisions covering the use of trust schemes, it may be that Head Contractors and Principals will set up residencies or obtain finance from outside the relevant State where the legislation applies in an attempt to evade the requirements of the scheme. However, this could be countered by appropriately worded legislation or by making the legislation Federal.

4.7.8 Effect of Insolvency of One or More Beneficiaries

The effect of bankruptcy of a beneficiary on others will depend on the structure of the trust.

If there is a "privity of trust" approach adopted as to the structure of the trust (Canadian approach), then an insolvent beneficiary higher up the contractual chain may "block" the flow of funds down the chain to those below, who will then have to wait for an insolvency administrator to be appointed and then perhaps dispute their entitlement to the monies received by the administrator.

On the other hand, if there is a cascading trust, where monies are held for all those down the chain, then the insolvency of a co-beneficiary will not impinge upon the distribution of funds to the other beneficiaries.

4.7.9 Insolvency of the Trustee

It may be that the trustee itself becomes insolvent. What effect this has on the business of beneficiaries will depend on the structure of the trust.

The general equitable principle, however, is that each beneficiary is rated equally and funds should be distributed on a pro-rata basis.

The implications of an insolvent trustee of a trust which is not a cascading trust, would have the same effect as if there were an insolvent beneficiary, ie funds will become "blocked".

Any monies left in trust at the time of insolvency can be distributed to the appropriate Subcontractor without amounting to a preferential payment.

4.7.10 Tax Implications

It is likely that there will be tax implications arising as a result of interest earned on trust accounts during the term of the project. This will necessarily carry with it certain obligations at law eg accounts, tax returns etc.

4.7.11 Educating the Trustee

There are onerous requirements imposed upon trustees concerning their fiduciary duties. In particular, the duty to account carries with it a requirement that all money held by the trustee is able to be accounted for. This, in turn, carries with it strict requirements as to the maintenance of accounts.

Assuming the trustee is to be an industry participant, he will need to be trained in the area of operating and maintaining trust accounts, as well as being required to demonstrate an understanding of the requirements of the position of trustee.

It has been suggested that such a training and education requirement may be used to form the basis of a builder's or Subcontractor's licence.

This requirement may be obviated if the trustee is an independent third party such as the State Trustee, or an fund management company as they are already well versed with the requirements of the position.

4.7.12 Limitation Period

The law currently provides for a variety of limitation periods to proceed against a trustee for breach of trust, ranging from no prescribed period in the case of a fraudulent breach of trust (except New South Wales where the period is 12 years) to six years in the case of an innocent breach, including a failure to maintain accounts. Because of the potential crippling effect of a delay in the flow of funds down the contractual chain, such periods provided for under the Statutes may be too long. A shorter period, perhaps within one year from the date of completion, abandonment or

discharge of the contract, could be imposed. A shortening of the limitation period may be justified on the basis that it is likely that any breach of trust in the Building Industry will be detected much more readily and quickly than a breach of trust in other circumstances.

4.7.13 Remedies for Breach of Trust

Two questions arise:

(i) What is my remedy?; and
(ii) Who can I enforce it against?

Often, the second question is more important than the first, since a judgement against a $2 company acting as a corporate trustee with no assets will do little to assuage a cheated beneficiary facing insolvency.

- *Against whom should a breach be enforceable?*

  If each director, officer, or person having effective control of the trustee company were to be made personally liable for a breach of trust, there would be greater recourse open to the aggrieved beneficiary. Legislation to this effect already exists in some States (eg Victoria, Section 54A of the *Trustee Companies Act* and Western Australia, Section 75 of the *Trustees Act* 1962). Some Canadian jurisdictions also have provisions to this effect.

- *What are the remedies available?*

  - Criminal

    Some States already provide for criminal sanctions where a breach of the legislation relating to trustees occurs. If tighter criminal provisions were imposed, it would certainly act as a greater deterrent against misappropriation of funds.

  - Civil

    A trustee is liable to restore trust funds and make good any loss caused by a breach of trust. A number of other remedies available allow monies to be reclaimed from third parties where they have not received money in good faith, as well as allowing tracing of funds in certain circumstances.

  Substantial pecuniary penalties, irrespective of the loss flowing from the breach, could also be provided as an added deterrent.

  The Courts have power to remove a trustee on the application of a beneficiary in the case of a breach or suspected breach of trust. This remedy could be used effectively where the trustee is a builder, where it could be combined

with the requirement that a builder's registration is removed if found guilty of a breach of trust or is removed from office as trustee on application of a beneficiary.

- *Observations*

  It should be noted that the complex nature of remedies may be seen as an impediment to the adoption of a trust scheme. However, most of the limitations occur in situations where the trustee is insolvent.

  In any situation where there are parties seeking to recover monies from an insolvent estate, the likelihood of a return is diminished substantially. The remedy of tracing at least affords a beneficiary some ability to recover some monies ahead of other creditors. The success or otherwise of tracing will be dependent upon the extent that trust funds are mixed.

  Where the trustee is solvent, remedies *in personam* will be readily available to an aggrieved beneficiary.

4.8 Questions Outlined in the Brief

Set out below are a number of questions on trusts that the Brief wished this Consultancy to consider from both a legal and insolvency perspective.

4.8.1 Is legislation required to enable legal redress for the misuse of monies required to be held "in trust", or is a contractual requirement sufficient?

Whilst in theory proper contractual requirements ought to be sufficient for the proper policing of monies held in trust, the realities are such that legislation should be introduced to cover misappropriation of trust monies. Misappropriation of trust monies is more likely to occur where the trustee is one of the parties in the contractual chain under a building and construction project. Where a trustee is a third-party Government body, mis-use of trust monies is less likely to occur. Civil remedies are available for a breach of trust pursuant to the various Trustee Acts enacted in each State. Further, damages are available at common law for breach of contract and negligence. Where there is a situation of fraud or theft, criminal penalties are available. The difficulty with policing fraud in financial matters is one relating to general proof. The issues involved are complicated and generally Juries are not sufficiently sophisticated to deal with technical financial transactions.
If the trustee is to be either the Head Contractor or other Subcontractors down the contracting chain, it should be a requirement to continue to hold a licence under building licensing regulations, that a Head Contractor or Subcontractor shall not have committed a breach of trust. Further, legislation should be implemented to make it a criminal offence for a misappropriation of trust monies knowing that such monies were identified for a specific Subcontractor. Such criminal offences would equally have to cover directors and officers in the event that the Head Contractor or Subcontractor was a corporation acting as trustee.

4.8.2 If monies held "in trust" are in an account which is allowed by the trustee (the Contractor) to be drawn down below zero or at least below the level of the total value of monies required to be held "in trust", what effect does this have on the rights of the trust beneficiaries?

The fiduciary nature of the obligations of the trustee dictate that such a position should not arise. The trustee should not allow funds to be paid out of trust in excess of the obligations of the trust and the trustee should at all times ensure that sufficient monies are held in trust to meet its obligations.

However, if such a situation occurred, Subcontractors would not obtain full payment for work and materials supplied. A proper accounting would be required to determine why insufficient monies were in the account. Under those circumstances, it may be that civil and/or criminal prosecution should be sought against the trustee.

However, what is to be done to those Subcontractors still owed monies pursuant to the trust? Should Subcontractors be paid on a "first come best dressed" basis or should they be paid on some more equitable basis such as a pari passu basis? A "first in best dressed" basis is inequitable. It is submitted that equitable principles dictate that payment should be made on a pari passu basis.

4.8.3 Current advice is that the banking system does not allow the identification of separate deposits or withdrawals made on the same day. It has been suggested that this will make it impossible to identify how much trust money "is owed by or owed to whom", that is, monies are no longer traceable. Clarify this and advise what effect this would have on either types of trust proposal if records from a defaulting Head Contractor were not available.

Our advice is that the banking system does allow the identification of separate deposits or withdrawals made on the same day. Therefore, monies are traceable.

The banking system runs on a "next day" basis, ie deposits and withdrawals made on a day can be traced the following day via "online" reports which give full details of all credits and debits that transact on an account on the previous day. The report records all transactions from the previous day irrespective whether the funds have cleared or not. Therefore, the monies are traceable.

However, if a request to trace particular monies was made on the same day as the transaction, the Bank can only identify that a particular deposit or withdrawal has occurred; a Bank is not able to identify where the particular monies have come from or gone to. This practicality only presents a timing delay as the transaction can be traced on the following day.

Accordingly, in general, it is possible to identify how much trust money "is owed by or owed to whom".

Where there is one trust account used to administer a pool of funds for many projects (ie multiple trust), the identification of trust monies available for distribution to

specific Subcontractors may become blurred where insufficient records have been kept by the trustee. If there was a defaulting Head Contractor, it may be difficult, if not impossible to determine what monies were available in the trust for distribution to Subcontractors.

In summary, if records from a defaulting Head Contractor were not available then trust monies may not be readily traceable. This would be readily apparent where "cash" monies are deposited or withdrawn by the Head Contractor and the cash books recording receipt or payment of the monies were not "available" from the Head Contractor. The "cash" would only be traceable if the serial numbers of the notes were recorded by the payee in respect of a receipt to a Head Contractor and the Bank in respect of a withdrawal by the Head Contractor. Accordingly, in reality, a "cash" transaction would not be traceable.

However, where monies are held in trust pursuant to a specific written trust, with proper administering procedures in place, the same situation would be unlikely to occur, because monies would be held in separate identifiable accounts.

4.8.4 If monies held in trust are misused by a Head Contractor and not replaced, and then the Head Contractor fails or is placed into receivership, what legal action is available to the Subcontractor against the trustee, ie the Head Contractor?

The Subcontractor would be able to institute civil proceedings against the trustee for breach of trust and perhaps for breach of contract and/or negligence. Provided the Head Contractor has sufficient funds available to meet a judgment debt, the Subcontractor ought to be paid.

However, where trust monies are not easily identifiable, a dispute is likely to arise as to whether the monies available for distribution should go to the Subcontractor or the Receiver. Whether the Receiver takes priority will be dependent upon whether the charge was fixed or floating. If the charge is a floating charge, the actual time of crystallisation of the charge will become important. If the charge is a fixed charge, the time of the breach of the debenture will then become important. A simple answer to this issue cannot be given. The answer will depend on the facts and circumstances of each individual case.

4.8.5 If a Head Contractor fails and there is some money which is held in trust still left, is payment of these monies to the appropriate Subcontractors a preferential payment?

We have assumed that in answering this question the reference to "fails" means that the Head Contractor is placed into some form of insolvency administration. The process of an insolvency administration falls into two categories, namely corporate and personal insolvency. There are different forms of both corporate and personal insolvency, however, for the purpose of answering the question at hand we will only consider the forms of insolvency that a preferential payment has a direct impact on. These forms of insolvency are as follows:

- Liquidation
- Bankruptcy
- Deed of Assignment

The issue of preferential payment does not apply to Receivership and accordingly, a Receiver does not have recourse to such a payment.

Briefly, a preferential payment is voidable against the Liquidator or Trustee in Bankruptcy, ie the Liquidator or Trustee in Bankruptcy will have recourse against the payment. Preferential payments are governed by Section 565 and 588FA, FC and FE of the Corporations Law and Section 122 of the Bankruptcy Act.

Basically, the above provisions apply if:

(i) a debtor and creditor are parties to a transaction;

(ii) the transaction results in the creditor receiving payment for an unsecured debt, more than the creditor would receive from the debtor if the transaction was set aside and the creditor was to prove for the debt in a Liquidation/Bankruptcy of the debtor; and

(iii) the transaction occurred within the relevant time period to be classified as a preference payment.

The transaction would be considered a preference payment even if the transaction was entered into because of an Order of an Australian Court, a direction of an agency or pursuant to the terms and conditions of legislation (not including the Corporations Law or Bankruptcy Act).

A Liquidator or a Trustee in Bankruptcy is entitled to void the payment only if the transaction involved the dissipation of assets which would otherwise have vested as assets in the Liquidation or Bankruptcy and the beneficiary was a creditor.

It is well settled that if property was held on trust and a repayment was afforded to a beneficiary or claimant prior to either Liquidation or Bankruptcy, such a transaction would not be considered a preference (under either Section 565 or 588FA of the Corporations Law or Section 122 of the Bankruptcy Act), as the claimant or beneficiary is not a creditor.

The above assumes that the trust arrangement is embodied within the trading activities of the corporate trustee. This is the basis on which we have considered the use of trusts by a corporate trustee to afford security to the Subcontractors. The proposition can be different if the company was acting as trustee under a trading trust arrangement and in certain circumstances, the monies are recoverable as voidable dispositions. However, this is considered outside the scope of this Consultancy and we make no further comment.

4.8.6 What rights does a liquidator (or Trustee) have to monies:

- ***deemed to be held in trust and***
- ***held in a formal trust account?***

(i) Bankruptcy

Where the trustee of the trust is a natural person it appears that the trust assets do not vest in the Trustee in Bankruptcy, ie the Trustee in Bankruptcy would not have any rights to the monies held in trust. Accordingly, the monies held in trust would be able to be disbursed to the beneficiaries in accordance with their respective rights. Monies paid to Subcontractors would not be considered a preference payment. If there was a shortfall in payment of the amount owed to a Subcontractor, then the Subcontractor would be able to prove in the Bankruptcy for the shortfall.

Property held in trust for another is exempt. Section 116(2)(a) of the Bankruptcy Act explicitly excludes property held by a bankrupt in trust for another person. The trust property must be capable of being distinguished (ie identifiable) from other property of the bankrupt. The trust property remains vested in the trustee subject to the normal claims by creditors as set out in the authorities.

(ii) Liquidation

There is no statutory exemption for trust monies given pursuant to the Corporations Law. However, individual items of trust property are exempt under the general law.

When a company is the trustee holding monies in trust and is subsequently placed into Liquidation, the trust property is not available for distribution to general creditors. A beneficiary, unlike a creditor, can stand outside the liquidation and assert an equitable proprietary interest in the trust property, unaffected by general creditor claims.

(iii) Application to both Bankruptcy and Liquidation

The trust property must be capable of being distinguished from other property of the individual or company. If the trust funds have been dissipated, then no property remains exempt. Trust creditors have no exclusive claim to other property of the bankrupt or insolvent company. The need to identify trust property gives rise to the procedure of tracing trust property into other property to which it has been converted, as the converted property remains exempt. Where those monies cannot be specifically identified pursuant to a trust, a dispute may arise as to whether those monies are monies of the individual or company or the Subcontractor.

If trust property is somehow mixed with the bankrupt's or company's own property, it has been settled in Frith v Cartland (1865) 34 LJ Ch 301 that the whole of the property would be treated as trust property, except that specifically distinguished as non-trust property. If money was held by the bankrupt or company in a fiduciary capacity and was paid into a simple bank account, the claimant should be able to trace the monies. Accordingly, the monies would then, in effect, be charged and available to settle any account owing to the claimant. If a Bank then mixed funds with the bankrupt's or company's own monies and the bankrupt or company subsequently drew upon the mixed account, the effect of the decision in Re Hallet's Estate; Knoathbull v Hallet (1879) 13 Ch 696 means that the bankrupt or company will be deemed to have taken out his own monies in preference to the trust money. However, as was held in Roscoe Ltd v Winder (1915) 1 Ch 62 the trust monies in the account can only be represented by the reduced balance.

It makes no difference whether the monies are deemed to be held in trust or are held in a formal trust account. Where there is a mixing of funds without proper identification of those funds, problems will always arise in the eventuality of a liquidation or bankruptcy.

Accordingly, it is clearly preferable to have a requirement that monies held in trust shall be specifically held in a separate trust account with the identification of those monies earmarked for a specific Subcontractor.

4.8.7 If the obligation to hold monies in trust, whether deemed or otherwise, is only for one level in the contractual chain, that between the Head Contractor and Subcontractors, does the Principal or client/owner have any fiduciary obligations towards a Subcontractor if the Head Contractor defaults?

It is unlikely that the law, as it currently applies, would deem a Principal to have fiduciary obligations towards Subcontractors of the Head Contractor where there is no privity of contract between them. However, a contract might create a deemed trust and the Principal may be held to be a fiduciary of the Subcontractor. Clear terms in the contract would be required to the effect that monies held by a Head Contractor were held on trust for a specific Subcontractor or Subcontractors, otherwise a fiduciary obligation would not be imposed upon a Principal.

4.8.8 What methods of recovery are there for trust beneficiaries on monies paid out by the trustee (Contractor) improperly to another party following the Head Contractor's insolvency?

Beneficiaries are not creditors of the Bankruptcy or Liquidation per se. Their right to claim against the property lies where there is insufficient trust property to settle their account. Failing the availability of trust property, the claimant will inevitably have a creditor's claim against the Bankruptcy or Liquidation arising from a breach of trust or breach of contract.

If the Contractor misappropriates monies knowing that they were trust monies, it may be that a criminal prosecution could be instituted against the Contractor for fraud or theft. The criminal law may then impose a requirement as a term of penalty for payment to be made to the Subcontractor by way of restitution.

A Subcontractor may be able to recover monies paid out improperly to another party by way of the doctrine of constructive trust. A constructive trust can attach to specific property which is not the subject of any express trust, but is held by a person in such circumstances where it would be inequitable to allow him to assert full beneficial ownership of that property. Under those circumstances, that person would hold the property as constructive trustee for the Subcontractor. A constructive trust will be specifically formed where monies are appropriated by way of fraud.

Further, if the Trustee in Bankruptcy or Liquidator was aware of the existence of the exempt property, but failed to retain it for the claimant, then the claimant may have a claim against the Trustee in Bankruptcy or Liquidator personally.

If a Head Contractor improperly pays monies earmarked for a Subcontractor to a third-party, the Subcontractor is able to recover those monies pursuant to the doctrine of tracing. This is the equitable right of beneficiaries under a trust to follow assets to which they are entitled, or other assets into which they have been converted, into the hands of those who hold them. At first instance, a Subcontractor would have to attempt to recover monies directly from the Head Contractor. A failure to recover those monies from the Head Contractor would enable the Subcontractor to apply the equitable doctrine of tracing to the third-party in order to recover those funds. Of

course, if those funds were mixed with other funds it may be more difficult and, in some cases, perhaps impossible to properly trace those monies as being the trust funds specifically earmarked for the Subcontractor.

4.9 Commercial Issues Considered

The following commercial questions and issues are considered:

4.9.1 Must there be mutual sign-off by trustees before the distribution of trust funds, by the Principal, the Head Contractor and Subcontractor?

A Trustee should authorise or sign-off before there is any distribution of trust funds to any Principal, Head Contractor or Subcontractor. This is simply on the basis of the fiduciary duty of a trustee to satisfy itself that payments made out of trust funds are paid to the correct beneficiaries, always remembering that a trustee has a fiduciary duty to act bona fide in the interests of beneficiaries. With the trustee signing off before distribution, a check or counter-balance is put in place such that funds are paid to the party justly deserving them, rather than there being a misappropriation of funds.

The Head Contractor should not, without trustee obligations, control the funds distribution as there is no check or counter-balance to ensure funds are paid to the correct party.

In theory, the idea that all parties to a contract sign-off prior to any funds being distributed sounds plausible. However, in practice, the idea as a stand alone mechanism, without some form of effective dispute resolution mechanism, would not be effective. All parties to the contract would need to sign-off that work has been satisfactorily completed, with one dissident party effectively being able to control the cashflow and thus, the lifeline of a Subcontractor.

4.9.2 How does the Head Contractor obtain a distribution from the trust fund for payment of his project management time and profit margin?

We assume that an independent third-party is acting as the trustee.

A trust fund mechanism implies that a Head Contractor (who is not acting as the trustee) will be required to disclose commercially sensitive information such as profit margins to the trustees in order for it to substantiate payment. Accordingly, Head Contractors would be adverse to the introduction of trust scheme arrangements as their competitive advantages would be disclosed, unless there were mechanisms in place to protect against the disgorging of such sensitive information.

A trustee must be satisfied that any payments made to any party in the contractual chain are justified in the sense that the payments are properly made in accordance with the various contracts between the parties.

It may be a term of the contract or trust deed that the trustee is not to impart sensitive commercial information to other parties within the contractual chain. Under those circumstances, the trustee may well be aware of the profit margin of the Head Contractor, but is not permitted, pursuant to contract, to advise any other parties in the contractual chain of that profit margin, including the Principal.

Furthermore, the fiduciary duty of the trustee would most probably prevent him from disgorging any such information.

Where the trust mechanism provides for the Principal to act as trustee, such problems would probably not arise. In the ordinary course of events, a Head Contractor would provide the Principal with perhaps an hourly rate when negotiating the primary contract. To a large degree, the profit percentage that accrues to the Head Contractor under that hourly rate is of no concern to the Principal, as it should only be concerned with what the hourly rate is.

To improve the security of Subcontractor payments it would be prudent for the Head Contractor to receive payment only for his base project management time, with the profit margin of the time being distributed to the Head Contractor once all other monies have been correctly dissipated. However, this may lead to the practice of the Head Contractor "loading" his project management time rates to compensate for the lead time for receiving payment of his profit margin and thus removing the protection afforded to Subcontractors through the use of trusts.

4.9.3 The concept should address the issue of cascading trusts (Head Contractor to Subcontractor to Sub-Subcontractor), although the consultancy Brief excludes cascading trusts.

We have previously addressed the issue of cascading trusts in this Consultancy from a legal perspective. The use of such trusts from a commercial perspective is feasible, but with the structure of such trusts being commercially complex and costly. Administratively, the use of such trusts would be onerous and burdensome, with the result being that all parties associated with the trusts being faced with "paper warfare". However, when balanced with the legalities of the various trust structures, cascading trusts are probably more efficient than simple or multiple trusts.

4.9.4 The proposition would need to deal with projects which may be running at a loss where there are no fund inflows from the Principal as it is the Head Contractor who is funding the loss.

A Head Contractor would not want to fund a loss and, in all likelihood, would not be in a position to fund the loss. A Head Contractor would most likely not have sufficient "free cash" to hold in trust and a financier would most likely be reluctant to lend monies for such a purpose, unless it was able to obtain some form of security against the monies lent.

However, unless the Head Contractor was able to fund the loss, the trust mechanism would not be able to be implemented and therefore, the security of Subcontractor payments would not be protected.

4.9.5 What will be the position with variations to the Building contract?

This issue envisages a situation where a Head Contractor or Subcontractor files for a variation to the contract. Standard building contracts provide for variations to allow for the situation where a Head Contractor or Subcontractor will need to ask for payments over and above what is already provided for in the contract.

Assuming that the price of the contract is required to be varied up or down because of some eventuality which has occurred during construction, if the trustee is satisfied with the variation, then the trustee could ask the Principal for further payment into trust. Presumably this would be done pursuant to contractual arrangement at the start of the project.

The trustee would be under an obligation to ensure that the variation was appropriate and thus it may be that the trust arrangement would have to provide for the trustee to approve any variations to the contract before they are made. Deciding whether the variations were valid would be administratively onerous and burdensome and may be outside the expertise of the trustee who could not then act without additional third-party advice.

Unless some percentage of funds are retained in trust to fund the variations, the Head Contractor would, in the first instance, be required to fund the variations. This could

be costly and affect profit.

There would need to be a time limit applied to the retention of monies in trust. It would be impractical for the trust to continue infinitum.

4.9.6 Could trust funds stop unethical conduct or unscrupulous behaviour?

The use of trust funds will not stop unethical conduct or unscrupulous behaviour. It is impossible to fully legislate against this type of conduct. Even if it was possible to legislate, it would be impossible to police and completely eradicate. Morally, such conduct and behaviour will not be tolerated. However, such tactics have existed for some time and human nature being what it is, total eradication will not be possible.

The example Code of Practice for Security of Payment in the Building and Construction Industry is built on the principles of honesty, integrity and good faith. In particular it states that no participant in the industry shall engage in any act or conduct which is unfair, unconscionable, improper or unlawful. However, the practices of unethical conduct and unscrupulous behaviour in the industry continue.

Unethical and unscrupulous tactics have been demonstrated to have been used in the past within the industry to obtain such things as work without payment or work at a reduced cost. These practices include refusing to pay on time, wrongfully disputing that work has been completed satisfactorily, using the threat of no further work unless current work is completed, contriving to invent a dispute in order not to pay and illegal cancellation of cheques after payment has supposedly been made.

Further, the industry has allowed re-entry into the industry of participants with a previous record of unethical or unscrupulous behaviour.

However, if there is a breach of trust, there are various remedies against the trustee personally for such a breach. Trust deeds usually provide that a trustee can obtain indemnity for any liability under the trust, although the liability of the trustee arising from fraud or mala fides against the beneficiaries would mean that such an indemnity would not be available.

The imposition of rigorous penalties for breaches of trust (ie those arising from unethical or unscrupulous conduct) may, however, curb such conduct considerably.

4.9.7 Acting as a trustee is an onerous position and the nature of the obligations that go with the position are complex. Therefore significant care and due diligence would need to be exercised by trustees to ensure that the trust requirements are met at all times. Can this be achieved?

The trustee has a fiduciary obligation to the beneficiaries of the trust. The obligations imposed on the trustee are complex and onerous. Therefore, the trustee must exercise significant due diligence and care to ensure that all trust requirements were met accordingly.

The trustee has both specific and discretionary powers and his actions are governed by the respective State Trustee Acts and common law.

The obligations of a trustee in the Building and Construction Industry are no different to that of any other industry. Proper education of those players in the Building and Construction Industry as to the obligations of trustees should ensure that trust requirements are met. Of course, this will be dependent upon the structure of the trust. An independent trustee such as a Government agency or indeed experienced large Head Contractor or Subcontractor, will have available to them the best advice. Accordingly, they will be aware of the obligations of a trustee. It is the smaller Head Contractor and Subcontractor who may be unaware of trust obligations and requirements. As such education requirements at an early instance, perhaps at Trade School, would assist.

4.9.8 Operating cashflows through trust arrangements does not recognise the commercial reality of the building industry where projects often run concurrently and cashflows are pooled, not separated on a project by project basis. Can the use of trusts overcome this?

The use of trusts may be able to overcome some of the problems created as a result of this practise through the doctrine of tracing. However, their effectiveness will also be dependent upon whether proper administrative and accounting procedures have been put into place to identify funds that have been pooled.

To a large extent, the answer to this issue will depend on the structure of the trust used.

As previously mentioned, if monies are mingled with the trustee's general account they may become unidentifiable. Accordingly, tracing those monies may not be possible.

The principle in *Clayton's case* attempts to redress the problem of pooling cashflows, but only succeeds to a limited extent. The rule in this case is that each beneficiary is entitled to a return according to when the money that they were entitled to receive was placed into the trust account. This is not the most ideal situation and the principle is harsh towards those beneficiaries whose monies were placed into the account last and there are insufficient funds to pay these beneficiaries.

4.9.9 Is there to be a separate trust arrangement between the Head Contractor and each Subcontractor (and possibly Sub-Subcontractor) or is it envisaged that each project be operated by a separate trust arrangement?

The most effective means of protecting and improving the Subcontractor's security of payment would be to have a separate trust arrangement between the Head Contractor and each Subcontractor. However, the most effective means of implementing a trust mechanism would be to operate each project by one all encompassing trust arrangement, which would encompass the trustee and all beneficiaries. This form of trust arrangement would be less administratively burdensome and cumbersome than the former arrangement.

Commercially, the greater single pool of funds that would be created through the latter trust arrangement would probably increase the risk of illegal dissipation of funds and accordingly, a breach of trust.

4.9.10 Would such arrangements apply to all classes of Subcontractors or only those Subcontractors who have the characteristics of employees?

The answer to this question is really a policy decision. Generally speaking, there is no restriction on who can be a beneficiary of a trust. There is no legal or commercial reason to prevent splitting or combining beneficiaries into classes such as Subcontractors in general on the one hand and Subcontractors having characteristics of employees on the other.

4.9.11 Would a large administrative burden arise for the parties in setting up, monitoring, administering and closing trusts?

The use of trusts from an administrative view point is both burdensome and cumbersome. There is a substantial investment in time needed by the trustee to set up the appropriate procedures to monitor and administer the trust and its practices. Whether there was a large administrative burden would be dependent upon the terms of the trust and the actual obligations imposed on the trustee.

The introduction of a formal written trust would require a trust deed to be prepared which can be lengthy, complicated and expensive in its preparation. However, where there are standard building contracts, trust terms could be implemented simply into those building contracts rather than the need to have individual trust deeds.

As a general rule, a trustee must not delegate powers and duties attached to the trust. However, the trustee may employ agents to carry out trust responsibilities. The trustee responsibilities are generally onerous.

There are accounting and taxation reporting provisions required for trusts which are complicated. Whether or not those accounting and taxation requirements can be made less onerous is a policy issue as to what the level of reporting requirements are to be.

Closing the trust, once its usefulness has passed, is also administratively burdensome

and cumbersome.

5.1 Recommendations

- This Consultancy has been asked to research and advise on two approaches which deal with payment of amounts owing to Subcontractors. The first approach is the "Queensland Build Approach" which has a requirement in the building contract that the Head Contractor must obtain from a Subcontractor a signed acknowledgment that payment has been received. The Head Contractor then submits a statement to the Principal that the Subcontractor has acknowledged payment. Further, the Head Contractor's statement will identify those Subcontractors who have not acknowledged receiving payment to the Principal. The Principal will then make a payment to the Head Contractor for work undertaken by the Head Contractor, together with those amounts paid to Subcontractors.

- The second approach is the "Victorian Catholic Building Office Approach" which has a requirement in its building contract that progress claims from the Head Contractor have separate identifiable amounts claimed for each trade item. The total amount due for each trade item is then paid by the Principal to the Head Contractor who must then pay Subcontractors within six (6) days. Following proof that Subcontractors have been paid, the Principal then pays the balance of the claim to the Head Contractor within five (5) days.

- Both approaches also require a Subcontractor to acknowledge payment by the Head Contractor.

- Both approaches appear to be an acceptable position in order to ensure payment reaches the Subcontractor at the earliest opportunity. However, both approaches will not ensure prompt payment is made to a Subcontractor where there are disputes of one nature or another, unless some mechanism is in place to settle those disputes efficiently and expeditiously.

- Difficulties arise when there is pressure brought to bear by the Head Contractor upon a Subcontractor such that the Head Contractor, by duress or other means, has the Subcontractor falsify acknowledgment of payment statements. Alternatively, Subcontractors may mis-use the acknowledgment of payment mechanism to pressure the Head Contractor for payment of monies in disputes between those parties. It may be that the Subcontractor will want to continue and extend the dispute so as to pressure the Head Contractor into negotiating a better outcome for the Subcontractor.

- Issues of duress, fraud, perjury, "bully boy" tactics and deceit are issues that require better policing, greater penalties and a change of mind set in the Building and Construction Industry. This can only be achieved through enhanced education programs being implemented for industry personnel. This is, by its nature, a long term preventative position. Education cannot "stamp out" duress and fraud in the short term.

- Genuine disputes arise in the Building and Construction Industry for a whole raft of reasons, some of which include variations to the building contract, disputes as to

quality of work and materials supplied, as well as the amount of work undertaken by a Subcontractor for the Head Contractor. Disputes can be resolved in a number of ways which include the following:

- direct negotiation;
- conciliation;
- mediation;
- arbitration; and
- courts/tribunals.

- Direct negotiation is in our opinion the best approach to resolve any dispute as it is likely to result in an early resolution at minimum cost to the parties. However, if direct negotiation between the parties will not resolve a dispute, consensual dispute resolution such as conciliation and mediation are desirable, in that they are more likely than not to lead to an early resolution of a dispute with a "win/win" position being achieved for each of the parties. Ultimately, if disputes cannot be resolved by direct negotiation or consensus (alternative dispute resolution), they will be resolved by arbitration or through the Courts. In such a situation, it is usually the case that there is great delay involved in having a case heard with much expense incurred in legal fees. Further, the ultimate result will only make one party happy as there must always be a winner and a loser.

- It is the recommendation of this Consultancy that all standard form building contracts make provision for disputes to be resolved by alternative dispute resolution methods, prior to any arbitration or Court intervention. Ideally, all contracts relating to the construction of a building should be in writing. Of course, it is not practical for all construction contracts to be documented. In any event, the Building and Construction Industry must be influenced to grasp the concept of alternative dispute resolution as a means of resolving disputes.

- There is a truism in alternative dispute resolution which is "you can lead a horse to water, but you can't make it drink". Alternative dispute resolution methods can be made compulsory in an attempt to settle disputes. However, alternative dispute resolution will not resolve disputes, unless both parties to the dispute are prepared to compromise their position. Equally, alternative dispute resolution will not resolve issues of fraud, duress and "bully boy" tactics.

- To have the Building and Construction Industry embrace alternative dispute resolution as a means of resolving disputes quickly will require an education program being introduced to explain the processes of alternative dispute resolution.

- Further, it is unlikely that parties will embrace alternative dispute resolution unless they have faith in an independent third party who can act as conciliator or mediator. Many organisations are in existence which provide expert mediation and conciliation services such as the various Law Institutes and Bar Councils in each State, the Australian Commercial Arbitration Centre and the Australian Commercial Disputes Centre to name a few. This consultancy recommends that research be undertaken to ascertain whether or not it is cost effective to establish specialist industry

mediators/conciliators who would be available in each of the States to handle building disputes at short notice. These specialists could be attached to an independent body set up by the Building and Construction Industry, pursuant to a code of conduct.

- If disputes are to be resolved by alternative dispute resolution, consideration should be given to the following timetable being inserted into standard form building contracts:

  - We would envisage that following a dispute, the parties be directed to negotiate a settlement of that dispute between themselves within 48 hours of the dispute arising.

  - If direct negotiation is unsuccessful in resolving the dispute, the parties must appoint a conciliator/mediator by agreement to conciliate or medicate the dispute.

  - Within seven (7) days of the appointment of the conciliator/mediator, the parties must make written submissions to the conciliator/mediator as to their points of claim and points of defence.

  - These submissions would not be technical or legal.

  - The conciliator/mediator must within the next three (3) days bring the parties together for conciliation or mediation.

- If the dispute cannot be resolved, the parties can either elect to appoint an expert whose opinion shall be final as to the dispute or they can proceed to arbitration or the Courts.

- Clearly, once the dispute is at the stage of being referred to arbitration or the Courts, large legal fees will start to be incurred which cannot be in the interests of anyone save for lawyers.

- If alternative dispute resolution is embraced by the Building and Construction Industry in the spirit in which it was designed, it is likely that disputes will be resolved within a reasonable timeframe and costs will be greatly saved. This will lead to Subcontractors receiving payment in a much reduced timeframe.

5.2 Background

There are various options which this Consultancy considers in relation to the viability of proof of payment mechanisms (other than statutory declarations) as a security of payment measure.

Proof of payment as a security of payment measure is predicated upon the concept that a Subcontractor be paid at the same time as or before a Head Contractor receives payment from his Principal.

Most standard form building contracts contain the Statutory Declaration form of proof of payment, but the anecdotal evidence is that while they are relatively simple to administer, Statutory Declarations are not considered effective because of the many loopholes that are available in making a declaration in respect of payment.

A variation on this approach is the use of Records of Payment. Prior to the Head Contractor becoming entitled to receive any progress payment from the Principal, the Head Contractor must obtain a receipt from each Subcontractor that all monies due and payable have been paid. This is a relatively effective system, but requires significant administrative costs for both Principals and Head Contractors. However, the system is open to abuse by disputation and its success depends on the record-keeping skills of all the contracting parties.

As a consequence, we explore various alternatives.

5.3 Queensland Build Approach

The first option is the "Queensland Build Approach" ("QBA") which requires the Head Contractor to obtain from the Subcontractor a signed acknowledgment that payment has been received and the Head Contractor is then required to submit to the Principal a statement to that effect. The Head Contractor also identifies those Subcontractors who have not lodged such an acknowledgment prior to further payments being made by the Principal under the primary contract to the Head Contractor.

The QBA contractual arrangements were implemented by QBuild Project Services, which is a business unit of the Queensland Administrative Services Department. The QBA was implemented on Department projects from 1 July 1992 and further amended in October 1993. The QBA is only mandatory for Departmental contracts and accordingly, is optional for private contracts.

The contractual arrangements rely on Subcontractors being proactive in reporting to the relevant Department a default of payment by a Head Contractor and also rely on Subcontractors exercising their rights under the *Queensland Subcontractors' Charges Act* ("SCA") immediately they are able to do so. The onus is on the Subcontractors recovering monies from defaulting Head Contractors through either the provisions of the SCA or mutual agreement with the respective Head Contractor.

In summary, the QBA is as follows:

- The onus for proof of payment rests with the Subcontractors. Head Contractors must set up a payment recording system in a standard form which must be produced to the Department upon demand. The form incorporates a provision for a Subcontractor's signature which evidences that it has been paid all monies due and payable at that date. Accordingly, it thereby constitutes a proof of payment record.

  Further, the Head Contractor must give notification to the Department of any Subcontractor who has failed or refused to execute a record of payment form or any Subcontractor who has been contracted but to whom no payment is yet due and payable. A period of ten (10) days is then given to the Subcontractor whereby he is able to seek to enforce a claim by lodging a Subcontractor's charge, otherwise the claim by the Head Contractor will be processed with no reduction for possible non payment to the Subcontractor.

- It is a contractual requirement that the Head Contractor must submit a Statutory Declaration to the Department that all Subcontractors and workers have been paid all outstanding monies due and payable up to the date of submission of a progress claim. If the Statutory Declaration is not provided or it is not provided with documentation attaching to the declaration as requested by the Department, then the Department may suspend payment and request the Head Contractor to show cause.

- There is mandatory use of the standard form of subcontract AS2545 where the provision of work exceeds $50,000. Subcontract AS2545 must be unamended and include proof of payment provisions. For work where the value is less than $50,000 the contract must embody proof of payment provisions.

- The Head Contractor must (to protect Subcontractors) do one of the following:

  (i) lodge with the Principal cash or an unconditional undertaking to the value of 5% of the contract sum. This security is then available (in order of priority) to satisfy any Subcontractors charges; other claims of Subcontractors; and any claims of the Principal. Any "draw down" on the security is required to be "topped up" by the Head Contractor.

  OR

(ii) set up a retention trust fund whereby:

(a) the fund is in the joint names of the Head Contractor and Subcontractors. Withdrawals may only be made upon the fund via joint signatories; or

(b) The fund is in the sole name of the Head Contractor. Withdrawals may only be made with the prior written consent of the Subcontractors.

- Contract conditions must include a provision so that the security, whether it is in cash or an alternative form, is firstly available to satisfy any claims of the Principal and secondly, available to satisfy Subcontractors charges.

- Failure to comply with the approach is a breach of contract. The breach could result in a takeover/cancellation of the contract and/or the application of sanctions against the Head Contractor.

The QBA is technically very appealing. The use of the approach has been successful in the public sector. However, to our knowledge, it has not been implemented in the private sector. The approach seems to be administratively onerous, cumbersome and burdensome and does not provide for the quick and efficient resolution of disputes between Head Contractor and Subcontractors.

5.4 Victorian Catholic Building Office Approach

The second option is the "Victorian Catholic Building Office Approach" ("VCB") which utilises the standard JCC contracts (now JCC-C and JCC-D) as amended. These amendments (amongst other things) change the procedure relating to progress payments and also provide for additional security to ensure that Subcontractors are paid. It is recommended by the Diocesan Building Advisory Service that the amended JCC form of contracts be used when the contract sum is in excess of $100,000.

The VCB approach requires progress claims from the Head Contractor to separately identify amounts claimed for each section and trade item. The Head Contractor then presents this Progress Certificate to the Principal. The total amount due to Subcontractors for each section and trade item is then paid by the Principal to the Head Contractor (within the period specified in the contract or otherwise within five (5) days) who must then pay Subcontractors within six (6) days on receipt of payment the full amount referred to in the Progress Certificate, unless the Architect has authorised the Head Contractor to pay a lesser sum. On receipt by the Architect of the written acknowledgement of payment from all Subcontractors, the Principal then pays the balance of the claim to the Head Contractor within the period specified in the contract or otherwise within five (5) days.

These provisions are provided for in the contract between the Head Contractor and Principal. The approach is technically appealing as it attempts to offer security to Subcontractors for payments due to them.

However, the VCB approach does not provide mechanisms for advising the Principal of a

dispute between Head Contractor and Subcontractor, for dealing with disputes, or for monies to be set aside pending resolution of a dispute. Once the monies have been dissipated it is impossible for security of payment to exist.

Further, Head Contractors believe that such a process interferes with the contractual relationships it has with Subcontractors and accordingly, they do not support such an approach. It is our understanding that Head Contractors believe they should be entitled to invest and use the total amount outstanding from the Principal as they wish and not to be so accountable to the Principal.

5.5 Alternative Dispute Resolution Mechanisms

One of the real problems which arises in the Building and Construction Industry is the non-payment of monies to Subcontractors due to disputes (legitimate or otherwise) with respect to the quality of construction, quality of materials supplied, stage of completion and as to variations to building contracts.

Many standard form building contracts such as AS2124-1992 have provisions available for settlement of disputes. However, provisions for the settlement of disputes invariably take some considerable time to resolve. In the interim period, the aggrieved Subcontractors may remain unpaid, which affects their cash flow and this in turn may also mean that Subcontractors further down the contractual chain are left also awaiting payment.

It is with this in mind that it is thought that alternative dispute resolution mechanisms could lead to swifter and cheaper resolution of disputes.

There are five ways by which a dispute may be resolved. These dispute resolution mechanisms are as follows:

(i) Direct negotiation between the Head Contractor and Subcontractor;
(ii) Mediation;
(iii) Conciliation;
(iv) Arbitration; and
(v) Courts and Tribunals.

With reference to the above, Options (iv) and (v) are generally the last means of resolving a dispute and entail an adversarial approach to resolution. This generally leads to large expenditure in legal fees and the dispute being resolved over a very lengthy period.

Although it is not the intention of this Consultancy to provide an in depth account of the various means of dispute resolution mechanisms, it is desirable that a short synopsis be given to each option in order to comprehend those issues for consideration under proof of payment.

5.5.1 Direct Negotiation

Many disputes on a building and construction site will be resolved by direct negotiation between the Principal, Head Contractor and Subcontractor as appropriate. It is perhaps trite to say that direct negotiation between the parties to a dispute is the

most desirable dispute resolving mechanism as it will entail little expense and will resolve the dispute generally in a very short time period. Parties involved in the Building and Construction Industry should be encouraged to resort to direct negotiation before any other form of alternative dispute resolution is entertained.

5.5.2 Mediation

This is an informal mechanism used to resolve disputes in which an independent mediator brings an impartial perspective to the dispute and encourages the parties to negotiate to resolve their dispute. A mediator does not have authority to make a decision for the parties. However, a mediator would encourage discussion between the parties, perhaps highlighting those important issues which need discussing.

The former Chief Justice of the Supreme Court of New South Wales, Sir Laurence Street, identified three elements in mediation as follows:

> "The first is that the parties call in the aid of an impartial third-party to structure a process for them within which they can negotiate a resolution of their dispute in the course of which they will meet and talk together with the mediator and the mediator will talk privately with each party in the course of the discussions.
>
> The second... is that the third-party has no power at all under the.... mediation agreement to impose any decision or to hand down a determination. The third-party is there simply to facilitate the flow of communication and to develop mutual understanding and help the parties towards a consensus.
>
> The third... is that the process is consensual throughout. It is consensual from the beginning... consensual in that it continues as long as the parties want to go on negotiating... consensual in its culmination in that a successful mediation results in a contract... which is just as enforceable as any other contract".

5.5.3 Conciliation

Conciliation is a process similar to mediation in which a conciliator, who may not necessarily be a neutral person, will cause the parties to discuss their dispute and make submissions to each other on their points of view, with the objective that the parties resolve their dispute by agreement. A conciliator may indicate to the parties the strengths and weaknesses of each other's case and may propose various options for settlement. As is the case with a mediator, a conciliator does not have the power to make decisions on behalf of the parties.

5.5.4 Arbitration

An arbitrator is an independent third-party empowered with the ability to make decisions for the parties and resolve the dispute for the parties by ultimately making

an award. Therefore, an arbitration bears resemblance to Court proceedings. Arbitration is an adversarial form of dispute resolution as opposed to direct negotiation, mediation and conciliation which are consensual dispute resolution mechanisms. Invariably at an arbitration the parties will be represented by lawyers or parties experienced in the particular field which is being arbitrated. As with a Court or Tribunal, in arbitration there can only be one winner and one loser, rather than there being the "win/win" position that occurs in consensual negotiation to resolve disputes.

5.5.5 Courts and Tribunals

The Courts and Tribunals are an adversarial system in which a Judge, Magistrate or Tribunal Member are empowered with the authority to make judicial or quasi judicial decisions and are obliged to finally resolve a dispute between the parties. This process can be and usually is costly, time consuming, confusing for the lay person and will lead to one party in the dispute being dissatisfied with the decision. Further, a Court/Tribunal is in most cases a forum which is open to the public and therefore the dispute is aired publicly.

5.6 Dispute Resolution by Consensual Agreement

Dispute resolution by consensual agreement has various advantages over the adversarial Court/Tribunal/Arbitration system. At the outset, it is likely that there will be a great saving in legal fees. The process is informal, can be commenced at a very early point in the dispute process with the negotiation for a resolution of the dispute being always in the control of the parties themselves. Further, the process of consensual dispute resolution is done away from the public eye and under confidential circumstances. Indeed, it is generally a prerequisite to consensual dispute resolution by way of mediation or conciliation that the parties agree at the outset that whatever is said in the mediation or conciliation shall remain private and confidential between the parties and their advisers.

Mediation and conciliation are particularly apposite to resolving disputes in the Building and Construction Industry. Provided an acceptable procedure is adopted with suitable flexibility, a dispute can be resolved quickly and cheaply. Many contracts will contain clauses which provide for alternative dispute resolution prior to the implementation of the Courts or arbitration to resolve a dispute. For example, the Law Institute of Victoria's home renovations and extensions contract contains the following clause:

"The parties must mediate disputes:

20.1 a party must use the mediation process to resolve a dispute before commencing legal proceedings;

20.2 the mediation procedure is -

20.2.1 the party who wishes to resolve a dispute must give a notice of dispute to the other party, and to the selected mediator, or, if that mediator is not available, to a mediator appointed by the President of the Law Institute;

20.2.2 the notice of dispute must state that a dispute has arisen, and state the matters in dispute;

20.2.3 the parties must co-operate with the mediator in an effort to resolve the dispute;

20.2.4 the mediator may engage an appropriate qualified expert to give an opinion on technical matters. Each party must pay a half share of the cost of the opinion;

20.2.5 if the dispute is settled, the parties must sign a copy of the terms of the settlement;

20.2.6 if the dispute is not resolved in 14 days after the mediator has been given notice, or within an extended time that the parties agreed to in writing, the mediation must cease;

20.2.7 each party must pay a half share of the cost of the mediator to the mediator.

20.3 the terms of the settlement are binding on the parties and override the terms of the contract if there is any conflict.

20.4 either party may commence legal proceeding when mediation ceases.

20.5 the terms of settlement may be tendered in evidence in any mediation or legal proceedings.

20.6 the parties agree that written statements given to the mediator or to one another, and any discussions between the parties or between the parties and the mediator during the mediation are not admissible by the recipient in any legal proceedings".

The Law Society of New South Wales has recommended the following dispute resolution clause which may be inserted into a contract:

"If a dispute arises out of or relates to this contract (including any dispute as to breach or termination of the contract or as to any claim in tort, in equity or pursuant to any Statute) a party to the contract may not commence any Court or arbitration proceedings relating to the dispute unless it has complied with the following paragraphs of this clause except where the party seeks urgent interlocutory relief.

A party to this contract claiming that a dispute ("the dispute") has arisen under or in relation to this contract must give written notice to the other party to the contract specifying the nature of the dispute.

On receipt of that notice by that other party, the parties to the contract ("the parties") must endeavour in good faith to resolve the dispute expeditiously using informal dispute resolution techniques such as mediation, expert evaluation or the termination or similar techniques agreed by them.

If the parties do not agree within 7 days of the receipt of the notice (or such further period as agreed in writing by them) as to:

(i) the dispute resolution technique and procedures to be adopted;
(ii) the timetable for all steps in those procedures; and
(iii) the selection and compensation of the independent person required for such technique;

the parties must mediate the dispute in accordance with the Mediation Rules of the Law Society of New South Wales and the President of the Law Society of New South Wales or the President's nominee will select the mediator and determine the mediator's remuneration."

5.7 Are Contractual Terms in a Contract Requiring ADR Valid?

A term in a contract requiring the parties to undertake alternative dispute resolution prior to any Court proceedings has been held to be enforceable in the case of Hopper Bailie Associated Ltd v. Natcon Group Pty Ltd (1992) 28 NSWLR 194.

Whilst this authority suggests that a clause in a contract requiring the parties to mediate or conciliate before attempting Court proceedings is enforceable, there is also authority which suggests that such a clause is not enforceable. For example, in the case of Walfort v. Miles [1992] 2 AC 128, Lord Ackner in deciding whether a term to the effect that "to continue to negotiate in good faith" was enforceable, said that such a clause was unenforceable as it lacked certainty. His Lordship had the following to say:

> "The concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiation is entitled to pursue his (or her) own interests, so long as he avoids making misrepresentations. To advance that interest he must be entitled, if he thinks it appropriate, to threaten to withdraw from further negotiation or to withdraw in fact, in the hope that the opposite party may seek to reopen the negotiation by offering him improved terms. ..... a duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with a position of a negotiating party. It is here that the uncertainty lies. In my judgement, while negotiations are in existence, either party is entitled to withdraw from those negotiations, at any time and for any reason. There can be thus no obligation to continue to negotiate until there is a "proper reason" to withdraw. Accordingly, a bare agreement to negotiate has no legal content".

Lord Ackner's view should be contrasted with that of Mr Justice Giles in the case of Hooper Bailie Associated Ltd in which His Honour had the following to say:

> "The proponents of enforceability contend that this misconceives the objectives of alternative dispute resolution, saying that the most fundamental resistance to compromise can wane and turn to co-operation and consent if the dispute is removed from the adversarial procedures of the Courts and exposed to procedures designed to promote compromise, in particular where a skilled conciliator or mediator is interposed between the parties. What is enforced is not co-operation and consent but participation in process from which co-operation and consent might come".

There are conflicting views on the enforceability of terms in a contract requiring alternative dispute resolution. Nevertheless, it is recommended that such a requirement continue to be used in building and construction contracts, because those parties not prepared to negotiate by consensus will be few in number.

Of course, there is merit in the old adage that "you can lead a horse to water, but you can't make it drink". Indeed, you can lead a party to mediation or conciliation but you can't make them agree. Nevertheless, it is submitted that a term in a contract that mediation or conciliation be first applied prior to any arbitration or Court proceeding being entered into, is more likely to lead to a swift successful resolution of a dispute than not requiring the parties to so attempt consensual resolution of the dispute.

5.8 Other Issues Considered

Set out below are the issues that the Brief required us to consider in respect of proof of payment.

5.8.1 The possibility of the Head Contractor exerting pressure on Subcontractors to sign an acknowledgment, even though the Subcontractors may not have been paid or have only been partly paid

In reality, neither proof of payment approaches detailed in the Brief (ie QBA or the VCB Approach) are able to control a Head Contractor from exerting pressure on Subcontractors to sign such an acknowledgement. These types of unethical behaviour can only be controlled through education and through implementing sufficient deterrents for undertaking this action(s).

Whilst the proof of payment approaches identified in the Brief provide different mechanisms for ensuring payment is made to appropriate parties down the contractual chain, their interrelationship with alternative dispute resolution is the same. This is because of the premise that underscores the alternative dispute resolution procedure, namely, that there is a dispute already in existence.

Thus, in addressing the issues for consideration, there has not necessarily been a conscious attempt to create a dichotomy for the purposes of the discussion concerning the application of alternative dispute resolution. Rather, we have focussed on the point of relevance common to both models in the dispute.

When speaking at the CIDA National Conference in May 1995 (p314), John Pilley (Construction Industry Engineering Services Group) had some anecdotal evidence regarding fabricated disputes. Mr Pilley had the following to say:

> "There are plenty of instances that I have seen in Victoria where the Head Contractor has not made payment and then has invented a dispute and there is no doubt that he has invented the dispute in order to say that 'I do not owe the money and that is where I can truthfully say in a statutory declaration that I do not owe any money'. He manufactures the dispute in order to be able to swear to that statutory declaration."

Where the Head Contractor exerts pressure on Subcontractors to sign an acknowledgment of proof of payment, notwithstanding that those Subcontractors may not have been paid or only partly paid, alternative dispute resolution will not provide a panacea for this situation as (in reality) there is no dispute to be resolved. Indeed, the Head Contractor and the Subcontractors have settled their dispute even though the Subcontractor may not be entirely happy with the situation.

The only way to sort out the problem of Head Contractors exerting pressure on Subcontractors to falsely sign acknowledgments of payment, is to provide a mechanism that prevents this situation from occurring in the first place, and even this is only likely to limit the level of the problem. Some suggested solutions to this

problem would include proper education of the Head Contractor and Subcontractors about the legal consequences of false acknowledgments being executed and introducing a greater emphasis on Building and Construction Industry ethics (as exists in the United States of America). Greater penalties for perjury, fraud and blackmail could be instituted or alternatively, offenders be more vigorously pursued by prosecution.

However, the difficulty lies with the Head Contractor and the Subcontractor not coming forth and admitting the falsity of the acknowledgment of payment. Alternative dispute resolution will resolve disputes. It will not prevent fraud or blackmail.

5.8.2 The misuse by Subcontractors of the acknowledgement mechanism to pressure the Head Contractor for payment of monies in dispute between those parties

Just as a Head Contractor can exert pressure upon a Subcontractor to incorrectly sign an acknowledgment of proof of payment, Subcontractors can misuse the acknowledgment of payment mechanism to pressure the Head Contractor for payment of monies in dispute between those parties. Again, this type of unethical behaviour can only be controlled through education and through implementing sufficient deterrents for undertaking the action(s).

The question begs to be asked, why would a Subcontractor want to misuse the acknowledgment of payment mechanism ?

It may be that a Subcontractor wants the dispute to continue because he knows that the Head Contractor has cashflow problems and the lengthening of the dispute process may improve the Subcontractor's negotiating position. Alternative dispute resolution could apply a mechanism to settle this dispute at an earlier opportunity than might otherwise be the case, because the parties would be required to pursue a settlement of their dispute via alternative dispute resolution prior to arbitration or Court proceedings being instituted. The time taken to implement Court proceedings is a lengthy process. Mediation and conciliation will provide a mechanism for resolving a dispute, but they will not impose a resolution of the dispute upon the parties. On the other hand, arbitration and the Courts will impose a result upon the parties. Of course, how long it takes to achieve a result will reflect the effectiveness of arbitration or the Courts to make a decision.

5.8.3 The problem of cash flow being held up because either a dispute exists between the Principal and the Head Contractor or the Head Contractor and a Subcontractor

As a result of the contractual framework upon which most building projects are based, ie where payment at one level is dependant on the provision of a statement to the effect that payment at a lower level has been made, any dispute as to whether payment has been made or should be made will have repercussions up and down the contractual chain.

The use of proof of payment approaches should provide for alternative dispute resolution to "quicken up" the resolution of the dispute and accordingly, "quicken up" the flow of monies through the contractual chain. Alternative dispute resolution would provide a mechanism for sorting out disputes of this nature. The critical and probably most fundamental point concerning the implementation of alternative dispute resolution is that the mechanism must settle the dispute as soon as possible, bearing in mind the cashflow problems that would otherwise result. Thus, the quicker the dispute is identified and referred to alternative dispute resolution, the quicker it will be resolved and cashflow restored. Essentially, this will be determined by the administrative efficiency of the framework adopted to conduct the alternative dispute resolution.

5.8.4 In the Queensland Build Approach if the Head Contractor advises the Principal that certain Subcontractors have failed to sign acknowledgments, two possibilities have been posed:

(i) the Principal advises the Subcontractor that payments to the Head Contractor are to be made and the Subcontractor is free to take whatever action he sees fit; or

(ii) the Principal withholds monies due to these Subcontractors until the dispute is resolved ie until the Subcontractor signs the acknowledgment".

The first possibility would appear to be a laissez-faire approach, allowing the Principal to extricate itself from the dispute. Furthermore, the approach seems to be in direct conflict with presumption that no payment is to be made by the Principal to the Head Contractor until the acknowledgment is received.

We do not believe such an approach should be adopted.

The second possibility appears to be more in accordance with the presumption behind the acknowledgment mechanism. Nonetheless, it would be still necessary to sort out the dispute as soon as possible, bearing in mind the ramifications of cashflow problems should payment not be made. With the Principal withholding the monies or with the use of an escrow mechanism, where security of the monies is maintained whilst they are in dispute, monies will not end up in the Subcontractor's hands either at all or within any satisfactory time limits unless the dispute is resolved.

Clearly a proper alternative dispute resolution mechanism is required in order to handle disputes at the earliest opportunity.

5.8.5 The ramifications of being seen to interfere in the contractual relationship between a Head Contractor and Subcontractor

If a Principal was to interfere in the contractual relationship between a Head Contractor and Subcontractor, an important issue that arises is the ramification that might flow from such an interference. An interference in this context is perceived by the Head Contractor as reducing his contractual negotiability with the Subcontractors.

If a proper alternative dispute resolution mechanism is instituted pursuant to a contract, then it is submitted that there should not be any significant ramifications due to interference by the Principal with any contractual relationship between the Head Contractor and the Subcontractor. Indeed, if a trust is set up pursuant to a contract or other direction, an interference with that contractual relationship has already taken place. It would seem necessary that some interference by the Principal or some other third-party to the dispute would be preferable, rather than no interference at all, if the dispute is not resolved. To leave it to the parties themselves to resolve the dispute may not provide a quick dispute resolution mechanism. Interference connotes some form of disruptive or unwarranted influence whereas, in actual fact, interference may have the reverse effect and perhaps is better phrased as being a "constructive involvement" in the dispute resolving process.

5.8.6 How is a Principal to know if a dispute between a Head Contractor and Subcontractor has been settled satisfactorily without interfering ?

The simple answer to this question may be that the Principal finds out that the dispute was in existence and has settled simply by the Subcontractor or the Head Contractor requesting payment.

Contracts between the Principal and the Head Contractor and the Head Contractor and the Subcontractor, could provide that where there are disputes between the parties, those disputes must firstly be notified to the Principal and secondly, resolution of the dispute must also be notified to the Principal. There could also be a contractual term that the Principal be involved directly in the dispute resolution process himself.

It would seem to be in the Principal's interest to be involved with a dispute at the earliest opportunity, so that the dispute resolution process could be put in place expeditiously and with the least amount of cost. Otherwise, the construction time on the project may be blown out and deadlines not reached.

Further, disputes between Head Contractors and Subcontractors may create some cashflow difficulties or budget difficulties for the Principal during the construction process, as deadlines and construction targets are not met. Indeed, cashflow and budget difficulties may also fall upon Subcontractors lower down the contractual

chain.

5.8.7 The viability and potential problems if the Principal withholds payment of monies not acknowledged as having been received by Subcontractors

This will clearly have adverse cashflow effects on the Subcontractor and may well have cashflow effects further down the contractual chain.

Given that much of the effectiveness of alternative dispute resolution is dependant upon the speed within which disputes are identified, addressed and resolved, alternative dispute resolution may prove most effective, because it requires the Principal to become involved as well as the parties in the dispute (assuming that most disputes do not involve the Principal).

Further, the contract could provide that, where a dispute is encountered, the Principal is to refer the matter to alternative dispute resolution so that a speedy resolution to the dispute can be sorted out resulting in the Principal being able to release funds to the appropriate party. Again, if a dispute under these circumstances occurred without some alternative dispute resolution mechanism, ramifications may flow to Subcontractors further down the contractual chain who may not be involved in the dispute, but who will not get paid until those Subcontractors further up the contractual chain get paid first.

5.8.8 Other ways of protecting disputed Subcontractor payments

The most effective method, both in legal and commercial terms, of resolving disputes is by consensual agreement, which has been mentioned above. One other possibility of resolving disputes is through a mechanism known as "expert evaluation". This mechanism involves the parties agreeing, usually at joint cost, to appoint an expert to provide an evaluation or opinion of the dispute. The parties are then free to adopt this evaluation or commence further negotiations. In a sense the expert evaluator becomes a de facto arbitrator. In one scenario, the parties may agree to be bound by the expert's opinion. A speedy result could be obtained at perhaps minimum cost.

A number of mechanisms other than consensual agreement, expert evaluation and adversarial dispute resolution are available to protect disputed Subcontractor payments. We offer no recommendations on the effectiveness or otherwise of these alternatives. They include the following:

- **Payment Bonding and Guarantees**

  Pursuant to a payment bonding and guarantee scheme, a Head Contractor could be required to obtain an insurance bond or a bank guarantee which in effect guarantees payment to all Subcontractors and their employees. Payment bonding and guarantees are used extensively in the United States of America. Unfortunately, payment bonding and guarantees can be expensive to purchase.

- **Principal Pays Subcontractors Directly**

  Under this mechanism, contractual terms are set up such that the Principal will pay Subcontractors of the Head Contractor directly when the building is finalised or reaches some agreed stage of completion. Such a payment mechanism reflects the structure of the modern day Building and Construction Industry in that Head Contractors, in most instances, are really project managers.

- **Payment by a Covenanting Agency**

  In essence, the covenanting agency (ie independent agency) is no more than a trustee. Under this mechanism payments normally earmarked for a Head Contractor, which in turn would be earmarked for a Subcontractor, are paid to the covenanting agency who would then disburse monies to the Head Contractor and Subcontractors.

- **Principal is Required to Provide Proof of Funding**

  In some instances in the Building and Construction Industry, it is not the Head Contractor who has failed in a financial sense, but it is the Principal who has failed due to poor funding facilities being put in place. Under this mechanism, a Principal is required to provide satisfactory proof to the Head Contractor and Subcontractors that effective funding arrangements are in place. The Head Contractor and the Subcontractors can then assess any information obtained so as to make an informed decision as to whether they will contract with the Principal.

- **Romalpa Clauses**

  If a Romalpa Clause is contained in a supply contract, the clause will ensure that property and title in goods supplied by a Head Contractor or Subcontractor in a building are not transferred to the Principal until payment is made (for an analysis of a Romalpa Clause, see case of Clough Mill Ltd v. Martin [1985] 1 WLR 111 at pages 117-118 per Lord Justice Goff).

- **Direct Payment from Financier to the Head Contractor upon Receipt of Progress Certificates**

  If funds for a construction project are provided by a financier and the funds are dissipated by the Principal, then the Head Contractor and other Subcontractors may be placed in a situation where they may not receive recompense for their services and materials. To prevent this unsatisfactory situation from occurring, a contractual term in the primary building contract can be inserted to enable the financier to make payment directly to a Head Contractor upon receipt of a satisfactory progress certificate.

- **Liquidated Damages**

  It is usual in building contracts to have a clause relating to liquidated damages where a building project runs over a specified time. Under those circumstances, liquidated damages usually apply on a daily basis for each day over the specified time. In many situations, the Head Contractor will pass on those liquidated damages to a Subcontractor such that the Head Contractor pays very little or no liquidated damages with the majority, if not all, liquidated damages falling upon Subcontractors. It has been suggested in the CIDA Report (recommendation 23) that liquidated damages should only fall upon those parties who create the damage and only to the limit that those damages are referable to individual Subcontractors.

- **Suspension of Works**

  Contractual terms can cover a situation where the Head Contractor and Subcontractors might suspend work if payment for work and materials supplied is not forthcoming from either the Principal or the Head Contractor. It is submitted that a failure to pay progress payments when properly due, is a fundamental breach of a contract. Accordingly, it could be expressly written into a building contract that any failure to reasonably pay progress payments when due and payable may result in a termination of the contract at the election of the Head Contractor or Subcontractor for a fundamental breach of the contract.

- **Retention Funds Held in Trust**

Where a contract provides for a certain percentage of the contract price to be held by way of retention funds, such retention funds could be held on trust for Subcontractors, either pending finalisation of the project or finalisation of various stages of the project. This at least means that the Principal and the Head Contractor's fiduciary duties as trustee provides a mechanism for proper payment to Subcontractors. If either the Principal or a Head Contractor was to then become insolvent, monies identified for Subcontractors should reach them, assuming that they have undertaken the work and supplied materials referable to those monies and those monies are identifiable or traceable.

- **Retention Funds Held in a Joint Account**

  Pursuant to clause 5.9 of the standard form building contract AS2124-1992, retention funds are required to be held in a joint account of the Principal and the Head Contractor. This resembles a trust type of arrangement and accordingly, reference is made to the above.

- **Credit Indemnity Insurance**

  It is not the intention of this section of the Consultancy to discuss insurance arrangements for the protection of payments to Subcontractors, as the insurance approach is discussed at Sections 8 and 9. Suffice to say Head Contractors or Subcontractors can protect themselves by way of credit indemnity insurance, although it is likely that premiums for such insurance will be high. This may make such a mechanism prohibitive. Issues relating to who should be covered under insurance, what losses should be so covered and what is the "insurable event" make credit indemnity insurance a difficult and commercially sensitive panacea for payment problems.

- **Stop Notice**

  A stop notice is a statutory procedure by which a Subcontractor can force undisputed funds, which the Principal may owe to the Head Contractor, who in turn owes such monies to a Subcontractor, to be paid to the Subcontractor. If a stop notice is received by the Principal, the Principal would be required to withhold sufficient funds ("undisputed funds") from the Head Contractor in order to pay Subcontractor claims. The stop notice could also be directed to the financier.
  If a Head Contractor was then to pay a Subcontractor, then the Principal or financier would release funds to the Head Contractor. If the Head Contractor is unable to pay the Subcontractor because of insufficient funds (ie non payment by the Principal), then the Head Contractor could sue the Principal and join all Subcontractors entitled to any amounts due under the contract, as extra parties to the action.

  Further, if funds were disputed between the Head Contractor and

Subcontractor, the Principal could pay the disputed monies into Court and the Court would then determine who is entitled to the disputed monies.

The Western Australian Law Reform Commission Report (page 50/Chapter 3.3.77) has indicated the following limitations apply to statutory stop notices, namely:

"(a) A Subcontractor has no right to the stop notice unless the Head Contractor is entitled to payment under the contract. The owner (Principal) must therefore be indebted to the Contractor under the contract at the time the stop notice is filed;

(b) A Subcontractor has no right to a stop notice unless the Head Contractor is indebted to it at the time the stop notice is filed. Those further down the chain from the Subcontractor of the Head Contractor have no stop notice rights in relation to the owner's (Principal's) undisbursed contract funds;

(c) It freezes only the undistributed contract funds in the hands of the owner (Principal) at the time of the notice. The Subcontractor must, therefore, file its notice with the owner (Principal) before the owner (Principal) disburses all the contract funds;

(d) It may adversely affect the flow of funds from the owner (Principal) to the builder which could have an unfortunate effect on the project because the owner (Principal) may have to set aside funds needed to continue construction".

WL Smith and BS Hazard have noted in their article entitled "Mississippi Law Governing Private Construction Contracts: Some Problems and Proposals" (1976) 47 Mississippi LJ 437 at 456, certain limits as to the effectiveness of a stop notice as follows:

> "In many small construction contracts, only one or two payments are made by the owner (Principal) to the prime Contractor. Since a Subcontractor frequently will not be paid until the prime Contractor is paid, it is often too late to file a stop notice in such a contract; therefore, it is apparent that the Subcontractor can lose his right to file a stop-notice before he even learns of the need to file. .....The disruptive effect of a stop notice also limits its effectiveness. Since the notice frequently results in a halt in construction, many Contractors are reluctant to use it, fearing business retaliation from their own or other prime Contractors. In times of little construction, this limitation is even more stringent. In fact, it is not uncommon for the promise of not asserting a stop notice to be an express or implied pre-requisite to acquiring the sub-contract."

Stop notices are used to a varying degree in the United States.

As a stop notice is a statutory mechanism, whether stop notices are to be used in Australia will be dependant upon what level of Government interference is required in the Building and Construction Industry.

- **Hold Back Fund**

  Under this procedure, a Principal is required to retain a percentage of the contract price for a period of time after construction has been completed. During this period Subcontractors may claim on the fund if they have not been paid and they can prove entitlement to payment. Again, this is a defacto trust fund situation. Some form of alternative dispute resolution mechanism would be required to ensure prompt payment of those monies in dispute.

- **Grading or Licencing of Builders**

  Under this proposition, builders are required as a pre-requisite to obtaining a licence, which is graded according to skills, training and financial resources, to pass certain pre-requisites in order to build certain types of buildings.

  In his report of enquiry into the building industry of Western Australia in 1973-1974, Mr CH Smith QC recommended a grading of builders by way of a licensing scheme. At present in Western Australia, the Builders' Registration Board may suspend or cancel the registration of a builder where that builder does not have sufficient resources to meet its financial obligations (Builders' Registration Act 1939 Section 13(1)(b)(a)).

It is of interest to note that a ministerial working party in South Australia has recommended that applicants for building licences should meet certain financial requirements in order to obtain a licence. It was suggested that those financial requirements could be met by one or more of the following:

(a) personal guarantees to a certain value covered by registered securities over specific assets;

(b) bank guarantees to a certain value;

(c) indemnity insurance to a certain value;

(d) use of independently audited trust accounts to hold pre-payments;

(e) other financial resources agreed to by the commercial tribunal, which is responsible for issuing those licences (SA Working Party 12).

5.8.9 The effectiveness of proposals

The effectiveness of alternative dispute resolution in resolving disputes under the following approaches is set out below:

(i) Queensland Build Approach; and
(ii) Victorian Catholic Building Office Approach

The Victorian Catholic Building Office Approach has the advantage of restricting the Head Contractor's cashflow whilst the dispute remains unresolved, thus providing impetus for its speedy resolution.

According to Bob Giles, Manager of Contract Services in the Queensland Administrative Services Department and Chairman of CIDA's Security of Payment Action Team, the model in Queensland does not seem to be causing any problems in practise. However, this is more a comment on the effectiveness of the proof of payment model, rather than an observation on the specific effectiveness of alternative dispute resolution in resolving disputes that arise within that model.

Another perspective from which to examine the effectiveness of both approaches involves a consideration of whether or not changes should be legislated or simply incorporated into contracts through industry incentives.

From a legal perspective, a legislative requirement that disputes be referred to alternative dispute resolution as well as providing for the framework within which the dispute resolution is to be conducted, would be preferable in some, but not necessarily all cases. The problem with legislation is that it may impose an inflexible regime under which a dispute in a building contract must be solved, which may not be the most appropriate solution for the particular dispute. For example, a small project with a relatively simple dispute and one in which there are not many other Subcontractors down the chain awaiting the outcome before they are paid, may not be an appropriate situation for an inflexible alternative dispute resolution format. On the other hand, a large scale project would probably be well suited to a stricter legislative framework.

In any event, the availability of an alternative dispute resolution process is better than only having an adversarial approach available to dispute resolution.

5.8.10 Possible industry resistance and identify source of resistance

This issue, again a broad one, can be answered by reference to industry response to the use of alternative dispute resolution in the case of disputes under either of the two proof of payment models.

The report from the CIDA National Conference suggests that, at least in Queensland, a legislative response to the proof of payment issue as a whole is not desired, but that industry initiatives are preferred.

The Australian Constructors Association states that it favours "mandatory use of alternative dispute resolution..". Whether "mandatory" means that the process is required by Legislation or is contractually required, is unclear. It certainly appears that the use *per se* of alternative dispute resolution is favoured.

Similarly, the Metal Trades Industry Association/National Construction Council ("MTIA/NCC") support the incorporation of alternative dispute resolution as a mandatory requirement in all building contracts. The MTIA notes that this is to be contrasted with the current situation where alternative dispute resolution is simply incorporated with a reference to "best endeavour" clauses. Thus, it is not clear whether legislation is envisaged as a means of incorporating alternative dispute resolution into the dispute process or not.

Recommendation 25 of the CIDA Board endorses the incorporation of alternative dispute resolution mechanisms into all contracts.

It would seem that if there is any resistance to alternative dispute resolution, proper education programs are needed to be put in place to overcome this barrier. Whether alternative dispute resolution is effective will to some extent be dependent upon the party's perception of the effectiveness of the mediator/ arbitrator/conciliator being involved in the process. If the parties are happy with these people and have faith in their ability to settle disputes, then the Building and Construction Industry should show less resistance to adopting an alternative dispute resolution mechanism to

resolve disputes.

Generally speaking, a flexible alternative dispute resolution mechanism is more likely to find a successful resolution to a dispute. Perhaps there will be some resistance to alternative dispute resolution by the larger Principals, Head Contractors and Subcontractors not wishing to be involved in an alternative dispute resolution mechanism which concerns small disputes of up to say $5,000. Clearly these disputes will affect Subcontractors further down the contractual chain who are of a smaller size and have insufficient working capital to ride out any dispute occurring further up the chain.

On the whole, however, it appears that alternative dispute resolution is favoured as a means of solving building disputes.

6.1 Recommendations

- The United States of America ("US") has enacted various Acts, both State and Federal, to ensure prompt payment for Subcontractors in the contractual chain. Implementation of the various Acts led the Construction Industry through a period where a new industry culture developed, ie a Contractor has the right to be paid in a timely manner for work completed.

- The use of unethical or illegal behaviour, including both "stand-over" and duress tactics, has been minimised by the enactment of the various Acts. Further, the various Acts seem to be supported by both industry participants and their advisers.

- The success of the prompt payment provisions in the US seems to be driven by both the draconian penalties that exist for a breach of the provisions and the laws which govern the behaviour of lawyers, embodied in the applicable rules, which prohibit lawyers from assisting their client's fraudulent or criminal activities or filing meritless lawsuits.

- It appears that the Australian Construction Industry is currently practising where the US was in the early 1980's. This Consultancy understands that the US Industry at that time was faced with the same problems that the Australian Industry currently faces, ie unethical or illegal behaviour; inadequate financial structuring and technical ability of industry participants; inadequate business acumen, industry structure and practice issues; failure to pay on time and insolvency of the Principal or Head Contractor. Although it is impossible to legislate against the insolvency of the Principal or Head Contractor, it is possible to legislate and impose draconian penalties against the other problems that exist within the Australian Industry.

- The issue in Australia is that the US type of legislation, which relies on people within the Industry acting as "watchdogs", may not be as effective in Australia as there exists an Australian cultural characteristic that seems to premise all activities, namely "you do not dob on your mates!". It is primarily for this reason that the success of such legislation would probably not succeed to the same degree in Australia. However, the legislation seems to be effective in the US.

- This Consultancy believes that some form of US legislation with the draconian penalties could improve the ethical behaviour and practices of participants within the Australian Building and Construction Industry. However, given the extent of the cultural change that would need to happen and the limited empirical data on the size of the problem with security of payment in the Australian industry, we believe that this form of legislation with its draconian penalties should be used as a "last resort".

6.2 Background

The Brief requested that this Consultancy consider possible prompt payment legislation which could be introduced nationally to address the issue of security of payment in the Building and Construction Industry to ensure prompt payment down the contractual chain.

The issues identified for consideration centre on the form of legislation adopted in the United States of America ("US") and whether such legislation would be effective if it was introduced into Australia.

6.3 US Legislation

The US has various Acts to ensure prompt payment and security of payment for Subcontractors in the contractual chain.

The Principal legislative provisions covering prompt payment are as follows:

- Miller Act ("MA")
- Prompt Payment Act ("PPA")
- False Claims Act ("FCA")
- The Forfeiture Statute ("The Statute")
- Contract Disputes Act ("CDA")

6.3.1 The Miller Act ("MA")

- **Background**

  Under Federal US legislation, known as the MA (there are State equivalents throughout the US), Contractors on Federal construction projects are required to arrange for performance bonds to cover the Principal (the US Government) and also payment bonds ("surety bonds") to cover Subcontractors, Sub-Subcontractors and suppliers of materials who have direct contracts with the Head Contractor.

  Surety bonds can be compared with, but must be distinguished from bank guarantees that are currently used in Australia. Under a surety bond, the surety (usually an insurance company) undertakes to guarantee either for the performance of obligations (performance bond) or the payment of monies due from the Contractor to those performing work and supplying material (payment bond) under the construction contract.

For the purposes of the issue of prompt payment, it is important to note that a surety bond is conditional upon the default of the party taking out the bond (usually the Head Contractor, but it can also be the Subcontractor). This means that, unlike a bank guarantee which is unconditional, funds are not available immediately, but will only be available when the condition upon which the bond is given is fulfilled (ie an established default by the Contractor).

From the prompt payment perspective, the critical provision in the MA is Section 270b, which provides that Subcontractors and suppliers for whom a payment bond has been provided under Section 270a, have the right to claim against the surety for any unpaid amount due to them under the contract if payment has not been made within 90 days after the date on which the last of the work was performed.

This right is subject to the Subcontractor or supplier providing notice to the Head Contractor within 90 days of the date on which they last performed work or supplied materials.

Thus, in theory at least, there is a statutory suggestion that prompt payment may be achieved (if 90 days is considered "prompt").

- **Implications for Prompt Payment**

As a result of the operation of the MA (and its State equivalents), where a dispute occurs under a contract, the surety's liability is not crystallised until there is a confirmed default. Thus, where there is a dispute, either as between the Principal and Head Contractor as to the performance of the contract, or between the Head Contractor and Subcontractor, the surety must be assured that there has been a default.

In the event that the surety decides to step in and make payment prior to the resolution of the dispute and it subsequently transpires that there was no default, the surety will lose its right of indemnity and will not be able to recover from the Head Contractor (on the basis that it incorrectly intervened and either performed the contract or made the payments, depending on the type of bond). (Seaboard Surety Co v Dale Construction Co. 280 F. 2d).

Accordingly, in the event of a dispute, there will be a tendency for the surety to avoid prompt payment due to the fear that it might lose its right of indemnity. Thus, whilst there may be security of payment there will not necessarily be prompt payment made to a Subcontractor.

6.3.2 Prompt Payment Act ("PPA")

- **Federal Legislation**

  The US Federal Government has provided protection for Head Contractors and Subcontractors under its PPA. The PPA applies to Government contracts. The PPA provides that Head Contractors must be paid within seven (7) days of the Government receiving a payment request. Similarly, Subcontractors must be paid within seven (7) days after the Head Contractor receives payment from the Government.

  In order to trigger this flow of money from the Government to the Subcontractor, the Head Contractor must certify in its request for payment that, inter alia:

  > *"payments to Subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by the certification, in accordance with their sub-contract agreements..."*

- **State Legislation**

  Throughout the US, there are a number of States that have enacted some form of the PPA, providing for payment periods to both the Head Contractor and Subcontractor. They also operate in both private and public sectors. It would appear that there is greater protection for Subcontractors in the public sector (38 Acts to 13 Acts) and greater protection for Head Contractors in the private sector.

  Although providing for varying periods within which payments must be made to Subcontractors most PPAs provide for payment in the range of 7 to 14 days, but some allow for up to 30 or 45 days.

  Similar variation exists in relation to payments to be made to Head Contractors, although the payment periods are longer (between 20 to 60 days, although one State provides for 90 days).

Thus, there is prima facie protection for Subcontractors on Federal Government and State Government projects by ensuring that payment is received promptly for work performed.

The effectiveness of the PPA is markedly increased through the interaction with the False Claims Act ("FCA") and Federal Rules for Civil Procedure ("FR"), which relates to the professional conduct of lawyers.

6.3.3 False Claims Act ("FCA")

The FCA relevantly provides that any person who:

> *"knowingly presents, or causes to be presented, to an officer or employee of the United States Government...a false or fraudulent claim for payment or approval; or*
>
> *knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government...*
>
> *is liable [to the US Government] for a civil penalty of not less than $5,000 and not more than $10,000, plus three times the amount of damages which the Government sustains because of the act of that person."*

"Knowingly" includes constructive knowledge or reckless disregard.

Furthermore, private citizens, known as *qui tam* plaintiffs, are encouraged to assist in prosecution of claims under the FCA, either by assisting the Government, or bringing the claim themselves. Such persons are entitled to a reward of 15% for assisting the Government, or 25% if they prosecute the action themselves.

This amount is independent of legal costs which are also recoverable.

Where a Head Contractor falsely certifies that payments have been made to Subcontractors in order to receive payment from the Government, the FCA exposes the Contractor to extremely harsh penalties. (It should be noted that the civil penalty of $5,000 - $10,000 applies in respect of each false statement submitted.)

6.3.4 The Forfeiture Statute ("The Statute")

The Statute is often used in conjunction with the FCA. The Statute provides for the forfeiture of a claim brought against the US in the US Court of Federal Claims:

> " *by any persons who corruptly practices or attempts to practice any fraud against the United States in the proof, statement, establishment or allowance thereof."*

The reach of this provision is extremely wide. Thus, a fraudulent certification of one fact in a Government contract may result in the forfeiture of all sums owed to the Head Contractor, including the legitimate payment claims and those for equitable relief.

6.3.5 Contract Disputes Act ("CDA")

The CDA provides that a Head Contractor claimant which is unable to support any part of its claim due to misrepresentation of fact or fraud on the part of that Head Contractor shall be liable to the Government for an amount equal to the unsupported portion of the Head Contractor's claim plus all costs in reviewing the claim.

This relief is separate and distinct from relief under the FCA or The Statute. However, when the CDA, the FCA and The Statute are used together they form a particularly powerful defence and counterclaim weapon for the Government when a Contractor brings a suit in the Court of Federal Claims seeking an award of equitable relief.

6.3.6 Federal Rules for Civil Procedure ("FR")

As discussed above, the PPA's effectiveness is increased not only in conjunction with the FCA, but also through the interaction with Federal Rules controlling the professional conduct of lawyers.

FR prohibit lawyers from knowingly assisting in a client's fraudulent conduct and from presenting statements (in the form of pleadings) of such fraudulent or misleading content to the Court.

Additionally, the highly litigious nature of the US legal system renders a lawyer without sufficient expertise in the relevant area of law liable for damages in the event of an unsuccessful action.

It is suggested that these controls are analogous to the ethical requirements imposed upon legal practitioners in Australia. It is only the litigious nature of US society, fuelled mainly by the interaction of contingency fees, that embellish their effect.

6.4 US Prompt Payment - Enforcement

US prompt payment legislation appears to have been enacted from the premise that a Subcontractor must be paid if a project is to be completed satisfactorily. The premise has developed from the culture that says a Subcontractor has a right to be paid in a timely manner for work completed.

The use of unethical or illegal behaviour has been minimised by the enactment of the various US prompt payment legislative provisions. The legislation seems to be supported by industry participants and their advisers.

The promotion of and general compliance with business ethics in the US has meant

that Head Contractors are refraining from unethical and illegal behaviour.

In the public sector, the Head Contractors have an added "incentive" to practice good business ethics. The Federal Government, as the Principal, has stringent legal weapons to enforce a wide range of Federal policies which are onerous and a significant deterrent to malpractice.

6.5 UK Prompt Payment - "Pay When Paid"

In the UK, standard forms of subcontract are used throughout the Building and Construction Industry. The standard forms of subcontract explicitly make it the Head Contractor's duty to pay the Subcontractor, subject to the receipt of monies from the Principal and a grace period of up to seven (7) days in respect of progress payments and retention. This payment practice is referred to as "paid when paid". The final payment by the Head Contractor to the Subcontractors on the completion of the contract becomes due and payable within three (3) months after the end of the maintenance period or within 14 days after the Head Contractor has been paid by the Principal, whichever occurs first.

The efficacy of "pay when paid" clauses was impliedly accepted by the House of Lord in Modern Engineering (Bristol) Limited v Gilbert Ash (Northern) Limited.

"Pay when paid" clauses generally appear in most Head Contractor's forms of sub-contract or in separate terms and conditions which are intended to be supplemental to the standard forms of subcontract. The Subcontractor is entitled to remove the clause from a subcontract.

The implementation of such a clause allows the Subcontractor to receive prompt payment only where the Principal delivers timely payment to the Head Contractor. Where the flow of monies between the Principal and Head Contractor is slow, then prompt payment to the Subcontractor is not achieved.

6.6 Singapore Prompt Payment - "Pay When Paid"

The prompt payment position in Singapore basically mirrors the UK position discussed above. Head Contractors make significant use of "pay when paid" clauses. Clearly, these clauses provide a means of delaying payment which may assist interim cash flow of the Head Contractor. The clause has received judicial support in Singapore.

6.7 Possible Effect of US Legislation in Australia

It appears that the Australian Building and Construction Industry is currently practising where the US was in the early 1980's. This Consultancy understands that the US Industry at that time was faced with the same problems that the Australian Industry currently faces, ie unethical or illegal behaviour; inadequate financial structuring and technical ability of industry participants; inadequate business

acumen, industry structure and practice issues; failure to pay on time and insolvency of the Principal or Head Contractor. Although it is impossible to legislate against the insolvency of the Principal or Head Contractor, it is possible to legislate and impose draconian penalties against the other problems that exist within the Australian industry.

The issue in Australia is that the US type of legislation, which relies on people within the Industry acting as "watchdogs", may not be as effective in Australia as there exists an Australian cultural characteristic that seems to premise all activities, namely "you do not dob on your mates!". It is primarily for this reason that the success of such legislation would probably not succeed to the same degree in Australia. However, the legislation seems to be effective in the US.

This Consultancy believes that some form of US legislation with the draconian penalties could improve the ethical behaviour and practices of participants within the Australian Building and Construction Industry. However, given the extent of the cultural change that would need to happen and the limited empirical data on the size of the problem with security of payment in the Australian industry, we believe that this form of legislation with its draconian penalties should be used as a "last resort".

7.1 Recommendations

- This Consultancy recommends that a priority claim be granted to Subcontractors in the event of the insolvency of a Head Contractor and we propose that Section 556(1) of the Corporations Law be amended by the introduction of a new sub-clause (i):

"556(1)(i)	next, amounts due to Subcontractors pursuant to a building and construction contract".

- A "building and construction contract" should be defined to cover "any written contract" as prescribed by the Regulations from time to time.

- The Regulations should then prescribe "any written contract" as standard form building contracts such as AS2124-1992, but with the objective of avoiding the prescription of unrealistic, impractical, complex and lengthy subcontracts to recognise the commerciality of the industry and the range of sizes of projects.

- "Subcontractors" should be defined as "any persons or corporations who have entered into a standard form building contract as prescribed by the Regulations from time to time for the provision of personal exertion, labour and building materials used in the construction of a building", or such other appropriate description.

- This Consultancy recommends also that a priority cap at a monetary level of $10,000 inclusive of personal exertion, labour and materials in total be given to each respective Subcontractor pursuant to Section 556, with the balance ranking as an ordinary unsecured claim.

- Similar amendments should be made to Section 433 of the Corporations Law and Section 109 of the Bankruptcy Act.

- As with all suggested solutions to the security of payment problem, any one solution by itself is not satisfactory to alleviate payment problems to Subcontractors. Amending Sections 556 and 433 of the Corporations Law or Section 109 of the Bankruptcy Act is no different to any other solution. A Section 556 priority to Subcontractors will only go some way to providing security of payment to Subcontractors and only then in an insolvency context. Genuine disputes as to payments to Subcontractors arising out of matters other than a failure to pay due to insolvency, will not be covered by amending the above provisions of the law.

- This Consultancy recommends that the definition of Subcontractor be limited to those Contractors who enter into a written standard form contract such as AS2124-1992. Where a Subcontractor is undertaking work and supplying materials pursuant to an oral agreement, a priority would not be given. Whilst this might seem harsh to those Subcontractors who do not enter into a written contract, a provision such as that proposed for the amendment to Section 556 may provide some incentive for written form contracts to be entered into. Many Subcontractors take on work of a relatively small nature with there being no apparent necessity for a formal written contract to be entered into. In that situation it is the intention that the Head Contractor will pay when the job is done and likewise, that the Subcontractor will undertake work in a satisfactory manner. Non-formal contractual arrangements are undertaken with somewhat of a commercial gamble being assessed. Those parties who do not enter into a standard form building contract will therefore take a gamble that the Head Contractor will complete its part of the deal and make prompt payment, rather than obtain a measure of security for payment under the provisions of Section 556.

7.2 Background

The Construction Industry is a very fragmented industry as evidenced by the following table which categorises the 589,900 people employed in the industry in 1994/95 by size of the employing establishment:

Number of Employees	Number of Establishments	%
0 - 4	77,050	83.9
5 - 9	9,511	10.4
10 - 19	3,129	3.4
20 - 49	1,467	1.7
50 - 99	430	0.5
100 +	298	0.1
	91,885	100%

While it may not be a precise measure, the above table suggests that there is a significant number of "employees" engaged in the Building and Construction Industry through small establishments that have "subcontracting" relationships as the basis of their operating capability.

We would contend that the establishments with 0 - 4 employees comprise family businesses with one or two husband and wife partnerships teaming together, perhaps with an apprentice, in a form of commercial venture practising in a particular building industry trade. These partnerships, while having corporate structures, are essentially driven by the personal exertion and labours of the principal tradespeople behind the corporate structure.

The structuring of Subcontractors is then explained by the differing, but compatible, objectives of the principal tradespeople (Subcontractor/employee) and building manager (Head Contractor/employer).

Subcontractors engage in their trades via a number of trading entities, such as:

- sole traders;
- partnerships;
- joint ventures; and
- corporations.

They seek to be "self-employed" for the following reasons:

- masters of their own destiny;
- tax planning opportunities;
- flexibility in work commitments;
- part of the industry culture; and
- concentration on their particular specialist trade.

Head Contractors engage Subcontractors as:

- Head Contractors are not responsible for:
  - industrial relations and human resource issues;
  - superannuation;
  - payroll tax;
  - workers' compensation insurance;
  - group tax; and
  - holiday pay and other entitlements.
- Head Contractors only pay for work done caused by:
  - intermittent work loads; and
  - specialist trades not required full-time.
- Subcontractors minimise the Head Contractor's investment in working capital.

As a consequence there has been substantial pressure to provide security of payment to Subcontractors due to their "employee" characteristics in the event of Head Contractor insolvency.

A response which may redress some of the security of payment problems which has not been canvassed to any great extent in past studies is the proposition that a priority to payment be granted to Subcontractors in the event of the insolvency of a Head Contractor. The granting of a priority could be achieved by amending Sections 556 and 433 of the Corporations Law and Section 109 of the Bankruptcy Act, which grant priority to employees in insolvency administration.

7.3 The Nature of the Priority for Employees

Section 556 of the Corporations Law is the statutory scheme which provides priority to certain creditors specifically covered therein who obtain a priority ahead of other unsecured creditors of a corporation under an insolvency administration.

Discussions regarding priority under Section 556 should also include Section 433 of the Corporations Law and Section 109 of the Bankruptcy Act 1966. Section 433 embodies the provisions contained within Section 556 relating to employees where there is a floating charge in existence and a corporation is placed into some form of controllership position. Section 109 of the Bankruptcy Act applies to the position of priorities of creditors with respect to the bankruptcy of a natural person. However, for the purposes of this Consultancy, discussion will only centre around Section 556 as the principle of affording priority to Subcontractors in the event of a Head Contractor's liquidation, will equally apply to any form of formal insolvency administration and bankruptcy.

Pursuant to Section 556 and 433 of the Corporations Law ("the Law") and Section 109 of the Bankruptcy Act ("the Act") employees are generally entitled to receive priority to repayment in an insolvency context to monies that they are owed for performance of their duties as employees.

Section 556(2) of the Law describes an employee as

> "a person (a) who has been or is an employee of the company, whether remunerated by salary, wages, commission or otherwise; and (b) whose employment by the company commenced before the relevant date."

There is no limit on the amount of the priority allowed in respect of wages, superannuation contributions, injury compensation, leave of absence and retrenchment payments for ordinary employees.

There is a $2,000 limit on wages and $1,500 on leave of absence for excluded employees as a priority claim. Excluded employees essentially comprise directors of insolvent companies, their spouses and relatives. There is no limit on wages or leave of absence as an unsecured claim for excluded employees.

7.4 Employees and Subcontractors

It is the nature of the Building and Construction Industry that many parties involved with the Head Contractor may be legally Subcontractors rather than employees of the Head Contractor, whereas the commercial nature of the relationship with the Head Contractor is more closely aligned to that of employee/employer.

One of the dominating circumstances in determining whether or not a person is for all intents and purposes an employee has rested in case law on the evidence of supervision and control of the "employer" over the person, and whether the person has been required to observe the same working rules as other employees. It must be established that the particular relationship between the person and the insolvent entity is that of "employer and employee". The relationship must be a "contract of service" (an employee) as distinct from a "contract for service" (a Contractor). Therefore, theoretically, it is possible to be an independent Contractor and be classified as an employee.

As neither the Corporations Law nor the Bankruptcy Act provides a definition for an employee we must therefore turn to common law to determine who is an "employee".

In Readymix Concrete (South East) Limited v The Minister of Pensions and National Insurance (1968) QB 497 *McKenna J* stated that a contract of service (ie an employee) exists if the following three conditions are fulfilled:

(i) The servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in performance of some service for his master;

(ii) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make the other his master; and

(iii) The other provisions of the contract are consistent with its being a contract of service.

The second condition above states the concept of control which has been the traditional test applied in both English and early Australian decisions in determining for all intents and purposes that a person is an employee, no matter what pretexts that person had as his status. This concept of control was evidenced by *Latham CJ* in FC of T v J Walter Thompson (Australia) Pty Limited (1944) 69 CLR 227 where he said:

> "The distinction between a servant and an independent Contractor is generally explained by stating that in a case of a servant the employer has power, not only to direct what work the servant is to do, but also to direct the manner in which the work is to be done".

However, since the mid-1950's, the Australian decisions have tended to depart from this traditional test of the "fact of control" and have emphasised the concept of "right to control". In determining whether an employer/employee relationship exists, the Courts will consider the right to control and the degree of detailed control that the alleged employer has over the alleged employee.

In addition to the concept of the right to control, the Court will also consider and give significant weighting to such things as whether someone is giving detailed direction to a person as to the time and sequence of work (an employee), and whether a person provides his own material or instruments of work (a Contractor). The existence of a formal written contract by no means determines that the person is a Contractor.

This Consultancy believes that Subcontractors in the Building and Construction Industry have many features and characteristics of "employees" and, as a consequence, claim to be defined and treated as employees. Subcontractors want to be treated as "employees" for the sole purpose of being granted a measure of security of payment upon the insolvency of a Head Contractor, in the same manner that employees receive a priority for unpaid employment entitlements.

It is this Consultancy's experience, in an insolvency context, that most Subcontractors claims for priority as an employee fail. It is extremely difficult for a Subcontractor with a written contract or otherwise to claim to be an employee and, thus, receive a priority as an unsecured creditor. It is only an individual that can claim to be an employee and due to the situation that the debt owed is usually relatively small in the wider context and an action against the insolvency administration under common law would be time consuming and costly, most "Subcontractors" will "cut their losses" and seek no further recompense.

The concept of providing priority to a class of creditors when the Corporations Law is premised upon a principle that all debts and claims rank equally has already been embodied in the law by the granting of a priority to employees under Section 556.

Basically, the provisions of Section 556 apply when a corporation is in liquidation. Under those circumstances, the corporation's assets come under the control of and vest in the Liquidator. In general, where a Subcontractor is unsecured for amounts owing for labour, personal exertion and materials supplied, that Subcontractor ranks on a pari passu basis with every other unsecured creditor.

7.5 Granting a Priority to Subcontractors

If Section 556 was to be amended so that Subcontractors under a building and construction contract were to receive a priority, then security of payment for a Subcontractor would be improved.

The improvement is only achievable where a Head Contractor enters into a formal insolvency process with realisable assets. Of course, if there are no assets to distribute amongst unsecured creditors, whether or not a party has a priority under Section 556 becomes academic. However, in the case of liquidation, if the assets have been dissipated prior to liquidation then the Liquidator may have recourse against the resulting dissipation. Any recoveries from such an action by the Liquidator will be available for distribution amongst unsecured creditors and therefore, subject to the provisions of Section 556.

7.6 Which Subcontractors?

If amendment is to be made to Section 556 to grant a priority to Subcontractors, the issue that immediately presents itself is which Subcontractors in a construction and building project are to receive a priority.

It is the recommendation of this Consultancy that the Subcontractors to be covered by an amendment to the provisions of Section 556 should be limited to those Subcontractors who have privity of contract with the Contractor immediately above them in the contractual chain. We concede that a priority given to the Subcontractor contracting with the Contractor immediately above them in the contractual chain may mean that other Subcontractors down the subcontracting chain could be prejudiced. As such, it is the recommendation of this Consultancy that each Subcontractor should have a pro forma building contract in writing to be able to take advantage of any priority provisions of Section 556. From an insolvency perspective, the priority given by Section 556 can only be taken advantage of by a "direct" unsecured creditor, not a creditor more than one level down the contractual chain.

A benefit of granting some form of priority to Subcontractors if they have privity of contract is that it may encourage them to more readily enter into written contracts, which may be the start of a cultural change in the industry.

7.7 Which Building Contracts are to be Covered?

In order to bring some uniformity into the Building and Construction Industry, it is the recommendation of this Consultancy that there be back to back standard form contracts in existence, such as AS2124-1992, for each contract and each subcontract thereunder.

7.8 Proposed Amending Legislation

We recommend that Section 556(1) be amended to include a clause to cover Subcontractors. A new sub-clause (i) should be introduced into subparagraph 1 as follows:

> "556(1)(i) next, amounts due to Subcontractors pursuant to a building and construction contract".

A "building and construction contract" should be defined to cover "any written contract" as prescribed by the Regulations from time to time.

The Regulations should then prescribe "any written contract" as standard form building contracts such as AS2124-1992 but with the objective of avoiding the prescription of unrealistic, impractical, complex and lengthy subcontracts to recognise the commerciality of the industry and the range of sizes of projects.

"Subcontractors" should be defined as "any persons or corporations who have entered into a standard form building contract as prescribed by the Regulations from time to time for the provision of personal exertion, labour and building materials used in the construction of a building", or such other similar and appropriate description.

7.9 Limit to the Building Contract

If it was decided to limit the level of building contracts to be covered under the provisions of Section 556, a dollar level could be prescribed. For example, a priority could be provided to all Subcontractors providing labour and building materials up to a level on the total building contract of say $5 million.

However, we would not recommend any limitation level.

7.10 Other Employees

Employees of Head Contractors and Subcontractors are already covered under the priority provisions of Section 556 and therefore would not have to fall within the definition of Subcontractors. However, only the employees of the specific insolvent Contractor would be covered by the provisions of Section 556 as they only have a "direct" creditor relationship with that Contractor, not the Contractor one step up or down the contractual chain.

7.11 Should Subcontractor Priority be Limited?

This Consultancy accepts that there is likely to be a range of Subcontractors involved with any particular building and construction contract, but we lack empirical data to stratify the likely Subcontractor population and their particular characteristics. However, we believe that some Subcontractors will have more "employee" characteristics than others and that Head Contractor insolvency would be more devastating to the "employee" type Subcontractor than others.

Also, it is our view that financiers would restrict access to finance by Principals and Head Contractors if all Subcontractors were granted priority to secured creditors (eg Banks with fixed and floating charges) due to the detrimental effect, from the financier's perspective, on the financier's recovery in the event of the insolvency of its customer. However, if a priority to Subcontractors was limited in some way, it may be that financiers would be better disposed to lending to Principals and Head Contractors. The granting of some form of priority may avoid project delays, industrial disruption and may enable Subcontractors to return to a site in the event of the insolvency of a Head Contractor, thereby minimising the risk of the Principal and/or Financier being forced to "pay twice" to restart a project.

As a consequence, this Consultancy recommends that the Subcontractor priority should be capped at a particular monetary threshold to be inclusive of personal exertion, labour and materials that may have been supplied to the building project by the Subcontractor.

7.12 What Level of Monetary Priority Could be Given to Subcontractors?

The level of priority selected can only ever be arbitrary. It is this Consultancy's belief that when a builder goes into liquidation, it is likely that Subcontractors with employee characteristics will be owed the equivalent of approximately one month's labour and various amounts for materials supplied. There is a lack of empirical evidence as to the size and nature of Subcontractor claims in insolvent building and construction Administrations, but we suggest at any one time you could expect $4,000 for wages (ie two (2) week's wages of $1,000 per person per week for two (2) people (husband and wife)), $2,000 for annual leave (ie one (1) week's annual leave per person for two (2) people) and another $4,000 for materials (assuming a likely mix of labour and materials of approximately 50/50) to be outstanding to Subcontractors with employee characteristics. Therefore, a sum of around $10,000 could apply.

Section 556 currently caps the monetary level of priority that "excluded" employees can receive in priority, so the concept of "capping" is not new to the legislators. The balance of any claim against the Contractor would be an ordinary unsecured claim.

Accordingly, this Consultancy recommends that a priority of $10,000 inclusive of personal exertion, labour and materials in total be given to each respective Subcontractor pursuant to Section 556, with the balance ranking as an ordinary unsecured claim.

8.1 Recommendations

- This Consultancy recommends that further research be undertaken to obtain empirical data to quantify the number of Head Contractor insolvencies and their overall impact on Subcontractors in the Building and Construction Industry. The results of the research are needed before the concept of insuring Subcontractor payments is able to be considered by the Insurance Industry and the cost effectiveness of such an approach is able to be assessed.

- On the presumption the outcome of such further research suggests that Subcontractor payments are insurable in the event of Head Contractor insolvency, it is the recommendation of this Consultancy that the "insurable event" should be defined to be the default of the Head Contractor due to insolvency.

- Anecdotal evidence suggests that the Insurance Industry will not consider such insurance in the Building and Construction Industry unless there exists a universal approach. Universality can only be achieved through legislative force. Accordingly, all standard form building contracts should make provision for all Head Contractors to take out appropriate insurance cover against default in payment to Subcontractors due to insolvency.

- The market players within the Building and Construction Industry must as a whole improve their risk profile. Unless the risk profile of industry participants is able to be reduced to a sufficiently low level then the cost of insurance is likely to prohibitive. The risk can be reduced through the implementation of prequalification mechanisms, proof of payment procedures, consensual dispute resolution mechanisms and amendments to the priority claims in insolvency provisions of the Corporations Law.

- Construction Industry participants rely on the receipt of progress payments throughout the duration of the contract. Given our earlier recommendation that proof of payment mechanisms should exist in all standard form building contracts, we would contend that at any one time there would be only one payment outstanding to Subcontractors. Further, with amendment to Section 556 of the Corporations Law, the Subcontractors would receive a priority for their unsecured claims to $10,000 with the balance of the claim ranking as unsecured. Accordingly, the appropriate level of insurance cover would need to be determined after taking into account that on the default (ie insolvency) of a Head Contractor the maximum exposure to any Insurer would be one payment (either progress or final) less the priority afforded to Subcontractors.

8.2 Background

There are various options which this Consultancy considers in relation to the limited use of universal insurance mechanisms as a vehicle to secure payment to Subcontractors in the event of insolvency of a Head Contractor.

The use of insurance is prevalent throughout all industries. The types of cover that insurance provides are both varied and diverse. Insurance can be specific and/or general and there is usually no limit to the value that an insurable event may be insured against, however, there is a limit to the extent of a claim, that limit being the loss incurred.

It is not the intention of this Consultancy to provide a complete legal analysis of the law of insurance as such an exercise would require an extremely large treatise and is outside the scope of the Brief.

The NPWC Position Paper on Security of Payment (undated) identified three (3) insurance products which could provide security of payment for Subcontractors. In summary, these products are as follows:

- **Contractor Default Insurance**

  This approach is premised on the basis that the Head Contractor takes out an insurance policy to protect payments owed to Subcontractors in the event of it not being able to make payments due to insolvency. In the event of insolvency, the Subcontractors then make a direct claim on the Insurer for the losses incurred. There is no involvement of the Principal in the process. It was reported in the paper that industry experts estimated the cost of insurance as approximately 0.25 per cent of the project cost, based on 20 per cent project cost coverage.

- **Cash Security/Retention Insurance**

  This approach relies on Subcontractors providing cash security/retention to be held by a Head Contractor as a performance guarantee, which is in turn insured by the Head Contractor in the event it is unable to repay these monies. This mechanism would be used in lieu of requiring the security to be held in a trust account or to be provided by way of bank guarantees as these measures act to reduce available cash flows and, with respect to bank guarantees, are subject to bank charges. It was reported that the cost of such a scheme was anticipated as being slightly less than for Contractor Default Insurance.

- **Subcontractor Indemnity Insurance**

  This approach is where a Subcontractor takes out insurance as a protection against non-payment of monies due from a Head Contractor. It was reported that such insurance was considered relatively expensive at between three (3) to five (5) per cent of the subcontract price, which, if extended across a project as a whole, would result in a two and a half (2.5) to four (4) per cent project cost premium.

It was concluded in the NPWC paper that:

- Subcontractor indemnity insurance was not viable due to its high cost and difficulty in ensuring universal compliance.

- Contractor default insurance may prove to be viable, if the indicated premium levels could be realised, as the NPWC could provide universal Subcontractor payment security through contractual provisions, or could be extended in the private sector compulsorily through legislation.

- Cash security/retention insurance is only viable when the cost of premiums were less than the other options currently in use such as bank guarantees or trust arrangements.

Further, the NPWC also found that it was possible for Head Contractors or Subcontractors to protect themselves with credit indemnity insurance. However, it also found that, as such insurance was currently optional, it was relatively uncommon, resulting in an onerous premium price of around three (3) per cent of the value of the contract.

In accordance with the Brief this Consultancy has limited its examinations to Contractor default insurance and cash security/retention insurance where the insurance is to be effected under universal insurance schemes and it is taken out by the Head Contractor.

We contend that insurance under the above mechanisms should provide the Subcontractor with reasonably effective financial redress against a defaulting Head Contractor, although the cost of insurance may be prohibitive.

As with any service or product, insurance comes at a cost. When assessing a risk and accordingly, the cost of insurance, an underwriter will consider whether it can generate sufficient premiums to cover the following:

(i) Costs of claims;
(ii) Cost of administration and other operating overheads; and
(iii) Margin for profit.

Underwriter's are conservative by nature and disinclined to "take a punt". Therefore, underwriter's are likely to not participate in the underwriting of a risk when they are unable to obtain adequate assurances about the quality and quantity of the potential risk.

Clearly the success of an insurance scheme to cover Subcontractors will depend on the willingness of the Insurers to provide the appropriate product to suit the market at a cost that

is not prohibitive.

8.3 Definition of "Insurance"

Insurance can be defined as a contract between the Insurer and the Insured, which takes effect on the occurrence of a nominated uncertain event (insurable event), which may or may not happen.

An insurance policy is usually taken out by a party who wishes to minimise or eliminate his risk of loss should that uncertain event occur. To "insure" against such an event, the party must pay a premium to an Insurer to compensate for a potential claim against the event.

Insurance is premised on the principle of utmost good faith between the Insurer and the Insured. Accordingly, full disclosure must be made by the Insured to the Insurer in relation to all relevant facts and circumstances relating to the insured event. If full disclosure is not made the Insurer is able to avoid the insurance contract in the event of a claim.

In the current context, we describe an insurance policy as a contract between an insurance company and the Head Contractor (the Insured) the proceeds of which are payable to the group of Subcontractors upon default by the Head Contractor due to its insolvency.

Only those Subcontractors who have privity of contract with the Head Contractor, through a standard form building contract, should be able to participate within such an insurance scheme.

8.4 What to Insure

The cost of insurance premiums should be significantly reduced if the potential risk of the occurrence of insolvency and the overall financial exposure of insolvency is minimised. We believe by acting on the recommendations contained within this Consultancy that the risk may be reduced to a level where the potential risk and the financial exposure of insolvency will be minimised and hence, the cost of the premium should not be prohibitive.

The effective use of the proof of payment approaches previously mentioned combined with appropriate consensual dispute resolution mechanisms, should mean that Subcontractors receive progress payments on a timely basis throughout the duration of the building contract. Accordingly, a Subcontractor's exposure to non payment would be limited to two (2) aspects of financial exposure:

(i) amounts due for work performed since the last progress payment; or
(ii) the final progress payment.

Therefore, the risk of non payment by a Head Contractor would effectively be limited to one payment within the contract. If the recommendation for Subcontractors to receive a priority pursuant to an amendment to Section 556 of the Corporations Law is adopted, then we would contend that the financial exposure would be limited to a reduced percentage of the total subcontract value. This represents a substantial reduction to the risk of covering the full subcontract value without increasing the financial exposure of the Subcontractors.

Therefore this Consultancy recommends that the sum to be insured be the next net payment due as:

- proof of payment procedures should ensure that prior payments have been made by the Head Contractor and also that the Principal is withholding progress payments until proof of payment procedures have been complied with; and

- the next payment due should be net of any priority claim.

In relation to the cash security/retention monies held by the Head Contractor against Subcontractor performance the insurance scheme would need to cover the full amount held by the Head Contractor. The only scope for a reduction in risk with this scheme of insurance would be if the Subcontractor was prepared to cap the risk and accept insurance cover of something less than the full amount of the cash security/retention monies.

8.5 Insurance Industry Support

This Consultancy has undertaken preliminary enquiry on the likely insurance market acceptance of such insurance policies to improve the security of payment to Subcontractor on the default of a defaulting Head Contractor due to insolvency.

Insurance against "bad debts" is not a new concept within the Australian Insurance Industry. However, the area is specialised and only a few select Insurers participate in such insurance. Further, the underwriter's pay careful attention to the credit risk management techniques employed by the organisations seeking such insurance cover.

In summary, discussions with the insurance market have reinforced the need for a carefully considered approach when assessing the viability of such insurance. Discussions were held with four (4) local Insurers and the following comments provide a precis of their general reaction to the approaches:

- "The Building Industry suffers some enormous losses."

- "Clear evidence of adherence to some strict rules in relation to credit risk management would be required."

- "Poor credit risk management is part of the problem in the building industry."

- "This information is not new. It's been around for quite a few years. What has changed?"

All underwriter's approached declined to enter any negotiations or discussions in relation to providing this type of defaulting insurance until the extent of the problem in the Building and Construction Industry can be quantified.

However, the Insurers did dismiss altogether the thought of the insurance being anything other than mandatory for all Building Industry participants. The Insurers view the potential

insurance product as a "one in, all in" approach, otherwise they would not be able to achieve their required economies of scale.

The recent Victorian experience with its new Domestic Building Scheme illustrates greater willingness by Insurers to embrace a new insurance scheme in the Building and Construction Industry if such a scheme is supported with legislation making the use of the scheme mandatory. By making such a scheme mandatory this will produce a greater pool of funds, which in turn should enable more modest level of premiums for the market participants to bear.

Such an insurance scheme becomes much more attractive and viable with the implementation of other proposals contained in this Consultancy including prequalification mechanisms, proof of payment procedures, consensual dispute resolution mechanisms and the amendment to Section 556 of the Corporations Law (the priority claims in insolvency provisions).

8.6 Further Research

Further research needs to be undertaken to obtain empirical data to quantify the number of Head Contractor insolvencies and their overall impact on Subcontractors in the Building and Construction Industry before the Insurance Industry will seriously consider such an insurance proposal. Without providing empirical data the Insurance Industry is unable to appreciate the size of the problem and hence, the size of the potential risk.

Further research needs to be undertaken on Head Contractor defaults due to insolvency in the past five to ten years to determine the following critical factors in the Building and Construction Industry:

- The average number of Head Contractor insolvencies each year;

- The average loss that Subcontractors have incurred from defaulting Head Contractors;

- What is the nature of the loss for the Subcontractor (ie personal exertion, material, profits etc); and

- In which sector(s) of the industry, if any, is the Head Contractor becoming insolvent with the greatest frequency.

Capturing the above information is critical to the insurance decision making process when determining what is desirable and cost effective to insure.

Also, the methodology employed to assess the viability and cost effectiveness of a universal insurance scheme needs to be examined carefully to ensure a measured approach. The methodology that has been detailed below will deliver effective results and ensure that any decision in regards to the purchase of insurance is properly evaluated.

The approach when considering the insurance options is broken into three distinct phases:

(i) Phase 1 - Qualitative Assessment of the Risk

Analysis of available loss data to determine:

- Estimate of maximum potential single loss;
- Annual aggregate costs;
- Nature of loss (ie labour, materials, profit etc);
- Trends; and
- Benchmark comparisons, eg
  - Number of losses per 100 contracts; and
  - Average cost per loss

Using historical data, an estimate can be made as to potential future losses by applying varying deductible and aggregate deductible scenarios to measure their likely impact on insurance premiums. This information will be critical to the decision making process of Insurers when determining what is desirable and cost effective to insure.

(ii) Phase 2 - Evaluation of Risk Financing Options

The primary aim of risk management is to minimise the total cost of risk which is made up of the following components:

- Risk identification costs;
- Risk control costs;
- Self-retained losses;
- Insurance premiums; and
- Administration costs.

The optimum combination of these five areas of the total cost of risk, particularly the last three, will produce the best result.

The following steps will be required:

- Analysing of each of the risk financing options;
- Establishing deductible levels; and
- Analysing claims management options.

(iii) Phase 3 - Programme Development and Implementation

The commencement of this Phase is the preparation of an Underwriting Submission to present potential Insurers with all relevant information about the management of security of payment in the Building and Construction Industry. Naturally, the information will vary depending upon the risk financing option being pursued. However, the following is an example of the information likely to be included in the Underwriting Submission:

- A declaration of the current methods employed in order to secure payment to Subcontractors, for example:

  (ii) Legislation
  - Amendment to Section 556 of the Corporations Law
  - Prompt Payment Legislation

  (iii) Proof of Payment
  - Consensual dispute resolution

- A declaration as to the role of Government or other regulatory bodies in the management of security of payment.

- Industry approach to credit management.

- Maximum sum insured and deductible levels.

- Insurance policy coverage required.

- Historical losses.

- Claims cost analysis using available historical data.

At this stage the Insurer's obligations would be nominated to include:

- Competitive pricing (if available); and
- Superior claims handling/reporting.

A successful Insurer response would require underwriting submissions which would translate basic information into a quality marketing document which can be presented to both local and overseas Insurers as a qualitative document detailing the following critical information:

(ii) Financial assessment of the extent of the risk (exposure to the Insurer);
(iii) Risk management initiatives introduced to assist in reducing losses; and
(iv) Proposed structure of insurance programme (ie limits, deductibles etc).

It is for these reasons that this Consultancy recommends the further research and analysis of historical data.

8.7 Questions Outlined in the Brief

Set out below are a number of questions on insurance that the Brief invited this Consultancy to consider.

8.7.1 How appropriate is insurance as a vehicle to address security of payment considering it addresses the symptoms, rather than the causes of the problem?

Clearly insurance is not the optimal vehicle to address security of payment because it addresses the symptoms, rather than the causes of the problem. Further, insurance comes with a direct cost to the Building and Construction Industry for which there is no corresponding benefit.

Insurance should be viewed as a mechanism of "last resort", ie it is creating a pool of funds from which Subcontractors can be paid. Other procedures outlined throughout this Consultancy can be used to reduce the overall financial exposure of Subcontractors. Accordingly this, in turn, reduces the need for insurance and limits the extent of the risk which needs to be covered.

8.7.2 Is there a realistically competitive insurance market for such schemes?

The Insurance Industry is not prepared to support voluntary insurance schemes for defaulting Head Contractors in the Building and Construction Industry. Further, it appears that the Insurers currently treat the Building and Construction Industry with a degree of scepticism.

A competitive insurance market will only eventuate if there is to be a universal mandatory scheme with policies able to be competitively priced.
To ensure there is a competitive insurance market the Construction Industry needs to take immediate and constructive action to improve its overall risk management. The other recommended procedures outlined in this Consultancy would aid in this process.

8.7.3 Is Universality (with resultant standard premiums) more cost effective than individual premium rates to each policy holder (surety bonds)?

This Consultancy's expectation is that universal insurance premiums will be more cost effective than individual premium rates. This view is premised on the basic principle of indemnity insurance whereby insurance is applied and enforced universally, ie that the losses of the unfortunate few should be paid for by the contributions of many.

The results of the additional research recommended on Head Contractor insolvencies would aid in quantifying the size of the problem and the potential risk and hence, the relative costs of these alternative approaches.

Consideration should also be given to the industry participants' reaction to the two alternatives. Those Head Contractors who have sound financial backing will not want a universal insurance premium which does not attribute any value to their own low risk profile.

8.7.4 How can universality be achieved on government or private sector projects?

Universality will only be achieved with thorough legislative measures. The requirement of the Head Contractor to take out appropriate insurance should be included in a standard form building contract, such as AS2124-1992, with appropriate legislation providing that such a contract (in its unamended form) is mandatory for all industry participants to adopt.

9.1 Recommendations

- As with Insurance, this Consultancy recommends that further research be undertaken to obtain empirical data to quantify the number and overall impact of Head Contractor insolvencies on Subcontractors in the Building and Construction Industry. The results of the research are needed before the concept of Mutual Funds providing security for Subcontractor payments is able to be fully considered.

- However, it is the recommendation of this Consultancy that if the concept of Mutual Funds is adopted, then the Mutual Fund should be used only for the purpose of reimbursing Subcontractors on the default of Head Contractors due to insolvency.

- As with Insurance, if Mutual Funds are to be used to protect all Subcontractors then there must exist a universal approach. Universality can only be achieved through legislation. However, in the interim, before such a legislative approach is adopted, all standard form building contracts should make provision for all Head Contractors to commit to a Mutual Fund to cover against its default in payment to Subcontractors due to insolvency.

- The Building and Construction Industry participants rely on the receipt of progress payments throughout the duration of the contract. Given our earlier recommendation that proof of payment mechanisms should exist in all standard building contracts, we would contend that at any one time there would be only one payment outstanding to the Subcontractors. Further, with amendment to Section 556 of the Corporations Law, the Subcontractors would receive a priority for their unsecured claims to $10,000 with the balance of the claim ranking as unsecured. Accordingly, the appropriate level of fund cover would need to be determined after taking into account that at the time of the default (ie insolvency) of a Head Contractor the maximum exposure to any Insurer would be one payment (either progress or final) less the priority afforded to Subcontractors.

9.2 Background

Mutual Funds are similar in concept to insurance in that they provide security to the Subcontractors in the event of the insolvency of the Head Contractor. The key difference to insurance is the way in which the monies to cover the "Insured" party are obtained and subsequently retained.

With insurance the premium monies are paid to the insurance company, either directly or through an insurance broker and they are then retained by the Insurer. The premiums are not generally reduced in subsequent years, but may increase if the risk of the individual Insured party increases or there are adverse claims experiences. When a Head Contractor defaults, then a payout to the Subcontractors results.

With Mutual Funds, monies are paid into a fund pursuant to a set percentage amount of say the project contract value and form part of a pool of funds within a Mutual Fund. The monies are retained and invested by the fund. The monies continue to exist as "fund monies" and accordingly, from year to year, there may be a reduction in the amount that is required to be contributed by the participants as the balance remaining in the fund will continue to subsist until it, or some part of it, is required to be paid out.

However, in practice Mutual Funds share a common problem, ie "underfunding". Underfunding occurs as a result of the Mutual Fund paying out amounts which exceed the balance of funds at a given time. Due to the subjective nature of Mutual Funds, ie trying to assess the future payouts for a given year, the funds retained may be inadequate and accordingly defeat the purpose for which they were established in the first place.

This Consultancy has reviewed the Housing Guarantee Fund ("HGF") in detail, specifically concentrating on how such a concept could be adapted to provide appropriate coverage for Subcontractors in securing their payments. The HGF was a form of Mutual Fund.

9.3 Housing Guarantee Fund ("HGF")

The HGF existed under the following Acts ("the Acts") of the Victorian Parliament:

- *The House Contracts Guarantee Act* 1987; and
- *The House Contracts Guarantee Act (Further Amendment) Act* 1990.

The objectives of the Acts were to:

- Provide security to home owners by establishing the HGF; and

- Provide security to home owners by increasing the contractual requirements to be included in home building contracts.

Under these Victorian Acts, the HGF existed in various forms from 1 May 1988 until 30 April 1996. The HGF has been replaced with a similar fund, the Domestic Building Scheme.

The HGF comprised a pool of funds which were sourced from the following contributions:

- **Builder registrations**

  Under the relevant Regulations each builder was required to be registered and pay an annual fee, which varied depending on the balance of funds within the HGF. In 1996 the annual registration fee was $180.

- **Job registration**

  Pursuant to the Regulations, every job undertaken by a builder had to be registered and a registration fee was to accompany the registration. The registration fee was dependant upon the nature of the job with fees ranging from $135 to $280 for jobs in the private sector and up to $450 for jobs in the public sector. This cost was in turn passed onto the Principal via the building contract.

The HGF was simply a guarantee to the building owner and his successors in title "of the performance of the builder's obligations under the Domestic Building Works Contract". The liability of the fund was to make good loss or damage suffered by the building owner or his successor in title on account of:

- The failure of the builder to fulfil its obligations under the contract; or

- In any case, a defect caused by bad workmanship during the guarantee period. The guarantee period was seven (7) years.

Basically, there was a limit to the liability of the HGF, which was capped at $40,000 and a claim could be made on the fund only where the value of the work performed was greater than $3,000.

The scheme worked with difficulty and was abandoned recently as part of the reform of the system governing the Victorian Building and Construction Industry.

The reform was initiated with the proclamation of the Building Act in 1993. This Legislation restructured the method for obtaining an approval of building permits by permitting issue by private building surveyors. It also created compulsory professional indemnity and public liability insurance for building practitioners.

Significantly, the insurance was underwritten by a limited number of some four (4) private Insurers. These Insurers were not interested in considering involvement in the Scheme until it was compulsory for the whole industry and backed by legislation.

In May 1996 the Domestic Building Contracts and Tribunal Act was introduced as an extension of the Building Act to cover the domestic building environment simultaneously replacing the Housing Guarantee Fund.
The Housing Guarantee Fund applied to all domestic work commenced prior to 1 May 1996. From that date, the Domestic Building Contracts and Tribunal Act applied.

Under the new Legislation, there is imposed a requirement for a warranty pursuant to the Domestic Building Contracts Act, minimum terms and conditions in domestic building contracts together with a statutory implied warranty as to the standard of workmanship.

Under the Building Act there is professional indemnity insurance cover for builders and service providers, together with a limited range of public liability cover for demolition contractors and some classes of builders, depending on the type of structure.

This Consultancy contends that the Victorian HGF and the Domestic Building Scheme comprise elements of a Mutual Fund Insurance scheme (albeit that they protect the building owner by providing security in the event of builder default) which could be considered as a principle for creation to protect Subcontractors against Head Contractor default.

9.4 How a Similar Mutual Fund Scheme Would Operate

9.4.1 What Event?

It is the recommendation of this Consultancy that the only event that the fund be used to recompense Subcontractors for a Head Contractor default should be on the insolvency of the Head Contractor.

9.4.2 Which Subcontractors?

If the concept of a Mutual Fund for Subcontractors for the purpose of reimbursing Subcontractors on the default of Head Contractors due to insolvency is to be adopted and implemented, the issue that immediately presents itself is which Subcontractors in a construction and building project are to receive recompense for losses incurred.

It is the recommendation of this Consultancy that the funds should only be used to recompense those Subcontractors who have privity of contract with the Head Contractor immediately above them in the contractual chain. We concede that it is clear that a priority given to the Subcontractor contracting with the Contractor immediately above them in the contractual chain may mean that other Subcontractors down the subcontracting chain could be prejudiced. As such, it is the recommendation of this Consultancy that each Subcontractor should have a pro forma building contract in writing to be able to take advantage of funds contained within the Mutual Fund.

A benefit of granting recompense to Subcontractors if they have privity of contract is that it may encourage them to more readily enter into written contracts, which may reinforce a cultural change in the industry.

9.4.3 Which Building Contracts are to be Covered?

In order to bring some uniformity into the Building and Construction Industry, it is the recommendation of this Consultancy that there be back to back standard form contracts in existence, such as AS2124-1992, for each principal contract and each subcontract thereunder.

9.4.4 Who to Fund?

As with Insurance, the Head Contractor should be the party who contributes to the fund for the benefit of the Subcontractors. The Principal would be the party who ultimately bares the cost of funding the fee, but with the benefit of the knowledge that it would not be subject to "double" and/or duress payments for work which has already been paid to the Head Contractor, but which has not been passed to the Subcontractor. Anecdotal evidence suggests that the Subcontractor will not complete a construction project if it has not been paid.

9.4.5 What to Fund?

The fee required to fund the scheme can be significantly reduced if the potential risk of the occurrence and the financial exposure of Head Contractor insolvency is minimised. We believe by enacting on the recommendations contained within this Consultancy that the risk and financial exposure of insolvency of the Head Contractor will be reduced to a level where the potential risk of occurrence will be minimal and hence, the cost of the fee should not be prohibitive.

Through the effective use of the proof of payment approaches previously mentioned and with appropriate consensual dispute resolution mechanisms, then Subcontractors should receive progress payments throughout the duration of the building contract. Accordingly, a Subcontractor's risk of non payment would be limited to two (2) aspects of financial exposure:

- amounts due for work performed since the last progress payment; or
- the final progress payment.

Therefore, the risk of non payment by a Head Contractor would effectively be limited to one payment within the contract. If the recommendation for Subcontractors to receive a priority pursuant to an amendment to Section 556 of the Corporations Law is enacted, then we would contend that the financial exposure would be limited to a reduced percentage of the total subcontract value. This represents a substantial reduction to the risk of covering the full subcontract value without increasing the financial exposure of the Subcontractors.

Therefore this Consultancy recommends that the sum to be insured be the next net payment due as:

- proof of payment procedures should ensure that prior payments have been made by the Head Contractor and also that the Principal is withholding progress payments until proof of payment procedures have been complied with; and

- the next payment due should be net of any priority claim.

9.4.6 How to Fund?

The Mutual Fund could be funded by a levy or premium based upon a percentage of the value of the building contract, which would be non-refundable.

The Mutual Fund concept could also envisage that the final progress payment of the contract or a sum constituting the retention could be compulsorily nominated (by legislation) to be paid into a Mutual Fund.

The Mutual Fund could then manage the final progress payment under the contract to Subcontractors and manage the retention factors under the contract to ensure the pre-requirements are met and the final retention element of the contract is paid to the Head Contractor and/or Subcontractors.

A Mutual Fund pool comprising final progress payments and/or retentions would amount to a substantial investment. Such a Fund would be capable of generating substantial income in its own right even if invested for very short terms.

A useful illustration exists in Victoria in the form of the Solicitors' Guarantee Fund which has been in operation for many years. This is a pool of money held at any time by Victorian solicitors which is invested, but simultaneously freely accessible to meet solicitors trust account draw down requirements.

Even though these funds are strictly "at call", there is unlikely to be a situation where all the money is required at the one time, meaning at any time there is a substantial sum of money in the residual pool at any time which generates income in its own right.

The attraction of this type of Mutual Fund would be that it generates income or constitutes a growing fund without anyone having to pay a "levy" or "premium".

A further attraction of this type of Mutual Fund would be its self-funding element which (subject to some costs to the Principal and the Head Contractor) may remove the imposition of the premium cost experienced by one of the parties in the chain with respect to an insurance scheme.
There are costs and disadvantages associated with this concept of a Mutual Fund. Currently, many Principals pay the Head Contractor the whole of the contract price on completion of construction and the warranty retention factor is covered by the

provision of a bank guarantee by the Head Contractor to the Principal pending compliance with time and quality elements under the warranty provisions of the building contract. Under a Mutual Fund scheme, the builder may be saved the bank guarantee cost, but loses the use of the money with respect to the final payment.

In other cases where a retention factor prevails, those monies are held by the Principal who has the benefit of income from those funds pending the Head Contractor's compliance with the warranty, time and quality provisions.

Insufficient data exists to quantify the loss to the Head Contractor and the Principal in the foregoing examples if the proposed final progress payment or the retention monies were paid to the Mutual Fund.

9.4.7 Further Research

As was previously mentioned with respect to Insurance, further research needs to be undertaken to obtain empirical data to quantify the number and overall impact of Head Contractor insolvencies on Subcontractors in the Building and Construction Industry. Without providing empirical data it is difficult to appreciate the size of the problem and hence, the size of the potential risk.

Further research needs to be undertaken on Head Contractor defaults due to insolvency in the past five to ten years to determine the following critical factors in the Building and Construction Industry:

- The average number of Head Contractor insolvencies each year;
- The average loss that Subcontractors have incurred from defaulting Head Contractors;
- What is the nature of the loss for the Subcontractor (ie personal exertion, material, profits etc); and
- In which sector(s) of the industry, if any, is the Head Contractor becoming insolvent with the greatest frequency.

Through using such historical data, an estimate would be able to be made as to potential future losses by applying varying deductible and aggregate deductible scenarios to measure their likely impact on the level of funding required.

Similar research to that detailed at Section 8.6 will need to be undertaken in relation to the concept of Mutual Fund Insurance.

10.1 Recommendations

- Prequalification is the process used by one party in the contractual chain to assess the capacity of another party in the chain to successfully complete a project. This assessment involves consideration of financial, technical and management capacity.

- For prequalification to be effective it must involve the verification, review and assessment of current financial and non-financial information by appropriately skilled and competent assessors.

- The ability of prequalification to prevent or protect against non-payment or slow-payment is limited.

- Whilst prequalification will not prevent financial failure of a Contractor, a thorough and rigorous prequalification process should help to identify and evaluate the risk of such failure.

- This Consultancy does not recommend that a prequalification process be mandated, although we recommend and encourage its utilisation on a voluntary basis.

- Guidelines should be available through relevant professional and trade associations on the appropriate format of such prequalification including guidance as to appropriate benchmarks to assist users to evaluate the particular prequalification criteria.

- It should be the responsibility of the evaluating party to assess and determine whether prequalification has been met and to subsequently engage the Contractor.

- The extent of the procedures undertaken by the Principal should adequately address the risk of failure of the Head Contractor.

- For projects above $5 million the prequalification process should be undertaken by the Principal on the Head Contractor.

- No additional reduction of the risk exposure will be obtained by the Subcontractor undertaking his own prequalification process for projects above $5 million where the Principal has completed such a review.

- For projects below $5 million prequalification is not a cost effective mechanism. The procedures undertaken by the Principal will be reduced in line with their reduced financial exposure. From the Subcontractor's perspective the level of financial information available in respect of smaller Head Contractors will limit the effectiveness of prequalification.

- If the problem of security of payment has not diminished in the future, we believe that consideration should be given to compulsorily implementing a prequalification process with appropriate benchmarks that must be achieved before a contract can be awarded to any particular Contractor.

10.2 Background

Prequalification is to be considered as a tool to enhance the financial self-protection of Building and Construction Industry participants, particularly as a means to improve the security of payment to Subcontractors.

Given prequalification can address a range of business attributes it is relevant to clarify what is meant by prequalification and prequalification criteria ("PQC").

Prequalification is the process used to assess the capacity of a Head Contractor or Subcontractor to successfully complete a project. As shown below prequalification can occur at several levels in the construction chain.

Typically, prequalification occurs predominantly at the Principal to Head Contractor level and to a lesser extent between Head Contractors and Subcontractors. Head Contractors also informally consider the ability of the Principal to successfully finance a project.

This Consultancy also considers an expansion of the prequalification process whereby Subcontractors undertake prequalification on the Head Contractor as a means for their own self protection.

Prequalification can occur on a project specific basis or as part of a pre-registration process to attain "eligible tenderer" status. Typically with pre-registration there is a tiered approach based upon areas of activity and for various project value ranges.

PQC are the tools used to assess the capacity of a Head Contractor or Subcontractor. PQC are not restricted to financial measurements. The NPWC have agreed that PQC should include an assessment of financial, technical and management capacity. The NPWC also recommends that the Head Contractor's past payment performance to Subcontractors be considered and we concur with these observations.
The Construction Industry Development Agency ("CIDA") developed a framework of PQC for the construction industry. CIDA suggested that PQC be considered under the following main categories:

- technical capacity;
- financial capacity;
- quality assurance;
- time performance;
- occupational health and safety;
- human resource management; and
- skill formation.

These categories represent a more detailed analysis of the aspects recommended by the NPWC.

Generally, the CIDA guidelines do not provide benchmarks or other mechanisms to assess minimum acceptable levels of Contractor performance in each of the specified areas. Rather, the CIDA PQC is a framework of information requirements which the Head Contractor and Subcontractor should provide to the Principal to enable the Principal to form its own assessment. Some minimum requirements are inherent within the CIDA PQC such as the requirement to provide audited financial statements for Contractors in the over $5 million project category.

The most important phase of the prequalification process is the review and assessment of the PQC to form a conclusion on the capabilities of the prospective Head Contractor or Subcontractor. The extent of the review procedures undertaken should be based on the risk to the party undertaking the prequalification. Typically, the key element in assessing potential financial exposure is the significance of the project value to the party undertaking the review. The key elements to a successful prequalification assessment are:

(i) The information reviewed is verifiable, current and up-to-date;

(ii) The extent of the verification of the PQC information provided by the Head Contractor or Subcontractor is adequate for the potential risk; and

(iii) The assessment is undertaken by appropriately skilled and competent people; both technical and financial.

This prequalification assessment process may be undertaken internally with verification of information through external references and other credit sources or outsourced either partially or wholly to appropriately skilled advisers.

10.3 Current Practice

10.3.1 Within Australia

It is relevant to consider the current prequalification practises at each level in the contractual chain.

- **By Principal on Head Contractor**

  - ***Public Sector***

    The major public sector Principals either have formal prequalification processes in place or are in the process of developing and implementing such systems. Generally, the prequalification processes tend to be built around the CIDA guidelines although the specifics of each system varies on a State by State basis and within Government organisations within the same State.

    Most public sector Principals operate a pre-registration system whereby Head Contractors are registered to "eligible tenderer" status. These pre-registrations systems are normally tiered based upon areas of activity and for various ranges of project value. Consequently, the tiers adopted depend upon the relative needs of that Government department and its construction projects.

    The public sector Principals adopt various approaches to the prequalification assessment process. The assessment processes are focused towards addressing the technical, financial and managerial capacity of the Head Contractor. Often other factors are taken into consideration such as compliance with Code of Practice guidelines and enhancing the capabilities of localised business and industry. Some Principals, such as New South Wales Department of Public Works and Services, are working towards systems which award work to those Head Contractors who display commitment to continuous improvement and best practice initiatives. The Australian Capital Territory Works and Commercial Services prequalification system focuses predominantly on Quality Assurance ("QA") on the basis that QA certification is effectively equivalent to prequalification.

    Within the public sector the prequalification assessment process often draws on external information sources or utilises external sources with appropriate skills to undertake part or all of the prequalification assessment. In the Northern Territory, Head Contractors must be accredited by Contractor Accreditation Limited ("CAL"), an industry-based private organisation that undertakes what is effectively a prequalification assessment process.

  - ***Private Sector***

Prequalification by Principals on Head Contractors also occurs in the private sector although typically this is on a project specific basis. Companies and investors such as Coles Myer Limited and Colonial Mutual adopt such an approach for their major projects. The Head Contractor will often be subject to several levels of prequalification scrutiny not only from the Principal but also from the project financier. This prequalification assessment will be an intensive process and usually addresses the technical, financial and managerial capability of the Head Contractor. For smaller projects the prequalification processes conducted by the private sector are less formalised.

- **By Principal on Subcontractor**

  It is unusual to find direct prequalification by Principals on Subcontractors in either the public or private sectors. It is occasionally found in the public sector indirectly through the Principal requiring the Head Contractor to evaluate Subcontractors.

- **By Head Contractor on Principal**

  Prior to seeking appointment for any significant project the Head Contractor will typically undertake an elementary assessment to ensure that the Principal has the capacity to fund the project under consideration.

- **By Head Contractor on Subcontractor**

  Formalised prequalification systems do not readily exist between Head Contractors and Subcontractors in Australia. However, in practice, Head Contractors do assess informally the technical and managerial capacity of a Subcontractor to complete a project. Such assessment is generally based on past performance and general industry knowledge of the Subcontractor's work performance. Often the Head Contractor will work with a core group of Subcontractors whom they know are adequately skilled and technically competent.

- **By Subcontractor on Head Contractor**

  No formal prequalification processes are currently undertaken by Subcontractors on Head Contractors. However, often Subcontractors will undertake a similar informal process to that which the Head Contractor undertakes on them. The Subcontractor will assess any Head Contractor based upon past experiences from working for that Head Contractor and from general industry knowledge on the Head Contractor. That is, if the Subcontractors were paid on the last project, then the Head Contractor will be satisfactory to work for on the proposed project. The level of this informal review may vary when the work is much more competitive.

10.3.2 Overseas - Singapore

In Singapore, a pre-registration system operates for all Contractors providing construction services to the public sector. This pre-registration system is a prequalification process which is similar to the approach taken by Australian public sector Principals. The Singapore prequalification assessment takes into consideration the following factors:

- track record and performance;
- financial capacity;
- personnel resources;
- company status; and
- plant and equipment.

Singapore operates a tiered registration system based upon areas of activity and for specific project values. As part of the prequalification assessment Contractors must have achieved the following:

- operate through a corporate structure;
- paid up capital of at least 10% of the relevant financial grade; and
- net capital worth of at least 10% of the relevant financial grade.

10.3.3 Summary of CIDA Prequalification Criteria (1995 Version)

The 1995 CIDA criteria are summarised as follows:

Head Contractors

- Apply to all contracts where the tender value exceeds $5 million

- The prequalification criteria used to assess contractors encompass the following main criteria:

  - technical capacity;
  - financial capacity;
  - quality assurance;
  - time performance;
  - occupational health and safety;
  - human resource management; and
  - skills formation.

- Technical capacity covers the provision of information on:

  - past performance and experience;
  - management and administration capabilities;
  - labour and equipment;
  - Subcontractors and consultants; and
  - innovative capability.

- Financial capacity covers the provision of information including:

  - background and organisational details;
  - audited financial statements;
  - audited cashflow forecast;
  - quarterly management accounts;
  - directors statement;
  - borrowings;
  - work in progress;
  - off balance sheet information; and
  - adherence to specific financial ratios are not mandated.

Subcontractors

- Apply for all subcontracts in excess of $100,000 but possibly may not utilise all elements unless subcontract exceeds $250,000.

- Areas covered are the same as for Head Contractors although the level of information required is reduced.

- Technical capacity covers the provision of information on:

  - background and organisational details;
  - insurance and registration;
  - past performance and experience; and
  - labour.

- Financial capacity covers the provision of information including:

  - audited financial statements where available or other financial reports or references;
  - financial references from past clients; and
  - turnover information for the last two years and current year projection.

Smaller Projects

- Designed for smaller projects which fall below the $5 million Head Contractor cut-off. All elements may not be utilised unless the tender value exceeds $250,000.

- Areas covered are the same as for Head Contractors ,although the level of information required is reduced.

- Information required for the purposes of technical and financial capacity is similar to that required for the Subcontractors version.

Consultants

- Covers the requirements for consultancies in excess of $250,000.

10.4 Sources of Information

Prequalification will only be effective where current information is available, particularly in relation to financial prequalification criteria.

Current and historical financial information is available from two sources:

- Internally, provided by the Contractor being assessed; and
- Externally, from third party agencies.

10.4.1 Internal Sources of Information

Information provided by Head Contractors themselves will vary in quality and its veracity will need to be independently evaluated from time to time. However, internally provided information should be current and not historical and should be able to be provided on a timely basis.

Principals, in seeking to prequalify Head Contractors, are able to demand provision of current (and accurate) financial information due to their economic position in the contractual chain. Head Contractors will provide such information as is necessary in order to prequalify. Also, there should be no difficulty in arranging for an independent evaluation of the financial information provided by Head Contractors themselves.

The main limitation to such information will be the degree of sophistication of the Head Contractor's reporting systems. Larger Head Contractors will readily be able to provide up-to-date management accounts and cash flow projections. However, reporting by smaller Head Contractors may be limited to year end accounts produced to fulfill statutory and taxation requirements with no focus on future cash flow projections.

10.4.2 External Sources of Information

For the purposes of the prequalification assessment process the information available from the following independent external sources requires further consideration:

(a) Australian Securities Commission; and
(b) External credit reference agencies.

For each of these sources the following aspects have been considered:

(i) Extent of information;
(ii) Reliability/currency of information;
(iii) Ease of access; and
(iv) Cost to access.

- ***Australian Securities Commission***

  Relevant information which can readily be obtained by all members of the public for a nominal cost through Australian Securities Commission ("ASC") is as follows:

  - basic information on the company and its directors;
  - financial information as contained in the company's annual return;
  - information on whether the company is subject to any administration process;
  - details of registered charges both current and discharged; and
  - details of persons disqualified from acting as directors.

  Information available from the ASC is only relevant for those Contractors who operate through a corporate structure.

  The currency of information available through the ASC depends somewhat on whether the company has lodged the required information within the timeframes specified. However, more importantly, with the recent introduction of the new Corporations Law Simplification Act the extent of the financial information and accounting requirements vary based on the size of the company.

  For proprietary companies these requirements depend upon whether the company is classified as "small" or "large". Under the current Corporations Law a proprietary company will be classified as small if it satisfies at least two of the following criteria:

- less than 50 employees at the end of the financial year;
- gross operating revenue for the financial year of less than $10 million; and
- gross assets of less than $5 million at the end of the financial year.

For small proprietary companies there is no longer any requirement under the Corporations Law to prepare financial statements and no financial information is required to be disclosed in the company's annual return. In contrast, large proprietary companies are required to lodge audited financial statements with the ASC by no later than four months after their year end, subject to certain transitional concessions. 'Grandfathering' provisions apply which allow formerly audited large proprietary companies to not lodge their accounts with the ASC.

Overall, the information available through the ASC is largely dated and historic. Therefore, its value in predicting future performance is somewhat limited. Furthermore, limited financial information is only available in respect of small proprietary companies and previously audited large proprietary companies.

- ***External Credit Reference Agencies***

There are several organisations offering independent credit reference reports. Various levels of report can be obtained and the costs are typically below $250 per report. Anybody can utilise these services with the only advantage of any group approach being a potential fee reduction of up to 50%.

The information which is typically contained in a credit reference report includes:

- company background and operating structure;
- director information including other failed directorships and past court actions against the directors' individually;
- financial information;
- banking details;
- details of registered charges;
- details of any court actions;
- trade reference records; and
- risk assessment based on the above information.

The sources used by the credit reference agencies ("CRAs") to compile these reports include:

- interviews of company officials;
- ASC records;
- court records;
- interviews of trade suppliers; and
- other credit reference sources.

Typically, CRAs will update their information sources as part of the service of

providing a report so that it takes into consideration all current information. The ability of CRAs to provide on comprehensive reports, particularly for smaller Contractors, depends somewhat on the extent of co-operation and information provided by the Contractor itself and its suppliers.

This often means that information for smaller companies/businesses is not very detailed, except for noting any judgements effected against the company/business.

10.5 An Effective Prequalification Process

10.5.1 Current Practice

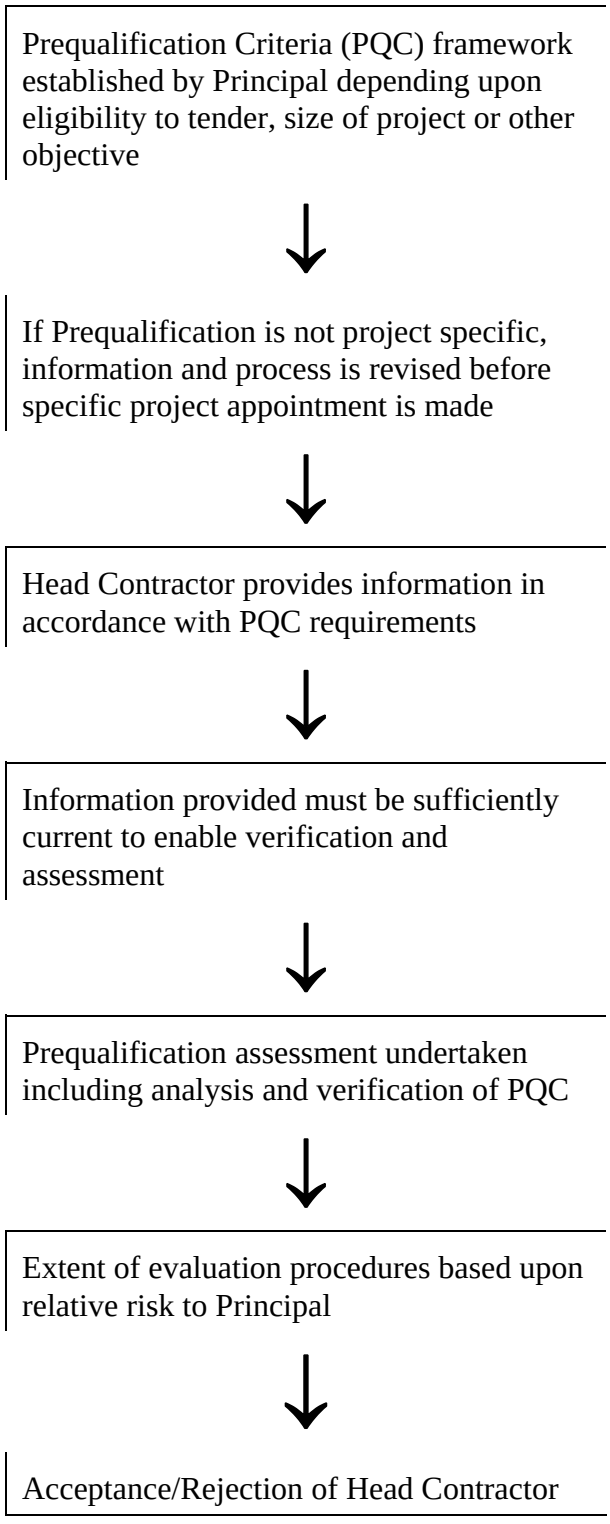
No empirical evidence is readily available to establish the effectiveness of the existing prequalification practices undertaken within the Building and Construction Industry in Australia. However, research has been undertaken which generally supports that in organisations with an appropriately structured risk assessment and risk management system the organisation's exposure to those risks is reduced.

Overall, the only level at which a full prequalification process is currently occurring in the construction chain is between the Principal and the Head Contractor predominantly in the public sector. Realistically, this is most likely due to both the relative financial exposure of the Principal and the ability of it to command the information required to undertake such a process.

Given the lack of empirical evidence upon which to base a risk assessment the selection of an "optimal" prequalification system must inevitably be based on a subjective assessment of relative risk. In this context it is more appropriate to focus on the fundamental aspects of a sound prequalification process rather than specific financial benchmarks. Where necessary, financial benchmarks based on our understanding of the industry, have been used to describe the prequalification process. Before universal implementation these benchmarks they should be further tested against appropriate empirical evidence.

10.5.2 Typical Prequalification Process

The following chart sets out a typical process for a prequalification methodology:



For the purpose of describing the fundamentals of a sound prequalification process, this Consultancy focuses on minimum acceptable levels which Contractors should

achieve before they are considered for a project. Clearly, prequalification systems which focus on awarding projects to top performers in the Building and Construction Industry and those with mature QA systems should highlight Contractors who more than fulfil these basic requirements.

10.5.3 When to Apply Prequalification

Given the potential range of project values and associated risks within the Australian Construction Industry it is logical to consider a tiered approach. Based on CIDA guidelines and taking into consideration the typical financial reporting systems of smaller and larger Contractors, appropriate tiers could be as follows:

Project Value:

< $250,000
$250,001 - $1,000,000
$1,000,001 - $5,000,000
$5,000,001 - $10,000,000
>$10,000,000

Public sector Principals may need to dissect these categories further to fulfil their own requirements. These project value ranges are utilised in the chart at page 128, which describes a prequalification system and which takes into consideration the key elements of the prequalification process.

Generally, compliance with CIDA PQC guidelines will provide the Principal with sufficient information to undertake a prequalification assessment. However the requirement for the audit of cashflow forecasts has been excluded as it is considered unlikely that Statutory Auditors will be willing to sign off on such future projections without significant qualification to their opinions. Furthermore, although CIDA requires audited financial statements for Head Contractor values above $5 million this expectation may be unrealistic given Head Contractors operating between $5 to $10 million may not be required under the Corporations Law to have audited accounts. There is no legal requirement under the Corporations Law for an audit or even preparation of accounts for those corporate Contractors who are classified as a "small" proprietary company.

10.5.4 How to Apply Prequalification

The prequalification assessment involves two aspects:

(i) the overall assessment of the technical, financial and managerial capabilities of the Contractor; and

(ii) the extent of verification and testing of this assessment.

CIDA have not recommended adherence to certain specific ratios. However, CIDA suggests that regard may be given to the following ratios as part of the financial analysis:

(a) total current assets as a percentage of total tangible current liabilities;
(b) current assets as a percentage of current liabilities; and
(c) turnover as a multiple of net tangible assets.

This Consultancy concurs with the CIDA approach of not mandating achievement of certain ratios because of the potential that reliance on ratios alone will not provide a prudent risk assessment. The overall assessment process needs to take into consideration all of the aspects outlined in the CIDA PQC to form an overall opinion on the adequacy of the Contractor's financial, technical and managerial capacity.

From a financial perspective this Consultancy believes that particular consideration should be given to the following aspects:

(a) turnover;
(b) capital backing or net asset backing; and
(c) working capital.

These three aspects give an indication of the overall financial ability of the Contractor to successfully complete a project on the size under consideration. Indicative measures could be as follows:

Turnover:	Average annual turnover for the last 3 years equivalent to 75% of the current project value.
Capital Backing:	The Contractor must be able to demonstrate that it has access to adequate capital backing to complete the project. It is difficult to specify a minimum level of capital backing and any requirement needs to take into consideration the current low levels of capital backing in the Construction Industry. Clearly, the Contractor should not have a deficiency of net tangible assets. As a minimum the Contractor should have capital backing or net tangible assets equivalent to 25% of the project value.

Working Capital: The Contractor must be able to demonstrate it has access to sufficient working capital to complete the project. This should include a positive ratio of current assets to current liabilities.

While we do not believe that benchmarks should be mandated, we suggest that best practice guidelines could be established in order that industry participants have a financial yardstick to measure themselves against and levels at which to aim.

Best practice guidelines will need to be the subject of separate survey and study due to the fragmented nature of the Building and Construction Industry. Also, there may need to be a stepped approach due to the current under-capitalised nature of the industry and the need to avoid disproportionate costs (particularly at the lower end of the industry) in comparison to the apparent benefits that may be achieved.

10.5.5 Extent of Verification

- ***By Principal on Head Contractor***

The extent of the verification process should be relative to the risk to the Principal of the Head Contractor failing to complete the project. Using CIDA guidelines as an indication for projects below $250,000 reliance on past references is probably an adequate procedure. For projects between $250,000 and $5,000,000 the extent of verification depends somewhat on the general perceptions/performance of the Head Contractor as indicated by the PQC information. Whilst for projects above $5 million an in-depth assessment should be undertaken.

It appears that most of the qualification processes currently in operation in both the private and public sectors within Australia if stringently and thoroughly applied should address the fundamentals outlined above.

The following table summarises the PQC that may be applied to Head Contractors by Principals.

- **Summary of Prequalification Criteria to be Applied to Head Contractors by Principals**

Project Value	PQC Information	Prequalification Assessment		
		Are audited accounts mandatory?	Minimum Financial Requirements	Verification Process
< $250,000	3 references from Principal/clients and Subcontractors	N	Turnover: 75% of project value NTA: 25% of project value CA: CL>1	Check of references
$250,001- $1,000,000	CIDA PQC for smaller projects	N	Turnover: 75% of project value NTA: 25% of project value CA: CL>1	Limited assessment - review of PQC
$1,000,001 - $5,000,000	CIDA PQC for smaller projects	N	Turnover: 75% of project value NTA: 25% of project value CA: CL>1	Limited assessment - review of PQC
$5,000,001 - $10,000,000	CIDA PQC for $5M+ contracts except for audit requirements	N	Turnover: 75% of project value NTA: 25% of project value CA: CL>1	Full assessment and verification of PQC
> $10,000,000	CIDA PQC for $5M+ contracts except for audit sign off on cashflow	Y	Turnover: 75% of project value NTA: 25% of project value CA: CL>1	Full assessment and verification of PQC

- ***By Principal on Subcontractor***

  It is uncommon for such verification to be undertaken.

- ***By Head Contractor on Principal***

  Clearly, for significant projects Head Contractors undertake their own assessment of the ability of the Principal to successfully finance the project. For the purpose of this Consultancy it is not considered necessary to further enhance this process.

- ***By Head Contractor on Subcontractor***

  Ideally, the prequalification process undertaken by the Head Contractor on Subcontractors should mirror that undertaken by the Principal on the Head Contractor. Obviously, the process would be scaled down for the relative risk although the overall principles outlined above for the Principal to Subcontractor prequalification could still be utilised. This approach would be consistent with CIDA guidelines although it does not appear to currently be occurring in the Australian Construction Industry.

- ***By Subcontractor on Head Contractor***

  In practice market forces will determine to the extent of the prequalification process which the Subcontractor can require of the Head Contractor. Without legislation or other means which compel the Head Contractor to provide information to the Subcontractor it is unlikely that the Subcontractor will be able to obtain any in depth information directly from the Head Contractor. One of the prime concerns of the Head Contractor will be the potential disclosure of profit sensitive information which may effect the relationship between the Head Contractor and the Subcontractor.

  Any prequalification process undertaken by the Subcontractor will therefore need to be predominantly based on external information sources. The two prime sources of this information will be the ASC and external credit reference reports.

10.6 Who Should do the Prequalification?

Prequalification processes vary depending on the financial exposure of the participants. The relative risk, and therefore the prequalification procedures will differ for smaller and larger construction projects. To account for this factor this Consultancy considers projects in two categories; below and above $5 million. This cut-off has been selected based upon CIDA guidelines as an indication of the level at which the Head Contractor will have a mature reporting system.

For a given project the Head Contractor is potentially subject to prequalification from both the Principal and the Subcontractor. The relative value of these prequalification processes must be considered in the context of the protection it affords to the Subcontractor.

10.6.1 For Project Values Above $5 million

This Consultancy confirms that for substantial projects in both the public and private sector a rigorous prequalification process will normally be undertaken before a Principal appoints a Head Contractor.

From the Subcontractor perspective in practice no formal prequalification of Head Contractors occurs. Without legislative requirements, market forces will limit the Subcontractor's prequalification to the information available through external sources such as the ASC and credit reference agencies.

Given the detailed procedures being undertaken by the Principal, the overall value of the Subcontractor conducting more limited prequalification procedures needs to be seriously considered. If a stringent prequalification assessment is undertaken by the Principal the risk of Head Contractor failure is addressed through this process. The more limited procedures which the Subcontractors can undertake will not offer any additional protection against the risk.

In summary, the key element to the prequalification process should be the review undertaken by the Principal on the Head Contractor. Clearly, the Principal is in a far stronger position than a Subcontractor to require the co-operation of the Head Contractor. Furthermore, the Principal is more likely to have access to the technical and financial skills necessary to complete the prequalification assessment.

In the public sector, compliance with appropriate prequalification policies should be adequate.

We do not believe that a prequalification process should be mandated in the private sector, although its utilisation on a voluntary basis is recommended.

Rather than prescribing the specific format of the prequalification required, we believe that guidelines should be issued by and be made available from relevant professional and trade associations on:

- general requirements for prequalification;
- format of prequalification; and
- appropriate benchmarks.

Guidelines on appropriate prequalification systems could be developed from existing CIDA PQC guidelines.

10.6.2 For Project Values Below $5 million

For smaller projects the prequalification procedures undertaken by the Principal will be reduced based upon the reduced financial exposure. However, the smaller project may still be significant for the Subcontractor. This means it is not effective to rely on the prequalification undertaken by the Principal.

This Consultancy considers that for smaller projects prequalification undertaken by

the Subcontractor will not be an effective risk management tool. The smaller Subcontractors will have difficulty in understanding the financial assessment. Even if an external agency provides a prequalification report to the Subcontractor the information on which the report is based is likely to be limited as under the Corporations Law "small" proprietary companies are no longer required to prepare statutory financial statements.

10.7 Typical Financial Checks by a Principal on a Head Contractor

We summarise some of the financial checking procedures which may be incorporated as part of the verification process adopted by a Principal:

(i) Review PQC for compliance with minimum financial requirements and assess adequacy of the Head Contractor in relation to:

- turnover;
- capital backing; and
- working capital.

(ii) Review PQC to assess the overall credit worthiness of the Head Contractor.

(iii) Review past work performance and conclude whether from a financial perspective the applicant has the ability to complete a project of the specified size.

(iv) Review documentation to support to legal operating structure of the Head Contractor.

(v) Confirm corporate Head Contractor details with the ASC and obtain information on:

- last annual return;
- registered charges against the company;
- ensure company is not under administration; and
- ensure key principals on not listed as disqualified directors.

(vi) Confirm general financial position of contract with their financier and obtain a bank reference.

(vii) Confirm current financial position with the Statutory Auditor, where applicable.

(viii) Obtain comfort on whether Subcontractors and other creditors are being paid on a timely basis by:

- external credit reference checks; and
- direct contract to Subcontractors and suppliers.

(ix) Review other external sources for information on the contract

- external credit reference checks; and

- newspaper articles searches.

The external information from the ASC and other credit reference sources can be readily accessed by any Principal and the costs of such information are generally below $500.