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1. **Introduction**

The Final Report of the Inquiry into Construction Industry Insolvency in NSW chaired by Mr Bruce Collins QC (the Report) was released by the State Government in late January 2013. The objective of the Inquiry was to consider ways in which the incidence of contractor insolvency, and its impact on other industry participants, could be reduced.

The report is over 400 pages long and sets out 44 recommendations, with a particular focus on strengthening the rights of subcontractors and suppliers. If adopted, many of the proposed reforms could have a significant impact on the construction industry. The purpose of this paper is to consider the major recommendations and their implications for the industry.

We have grouped the recommendations in the Report thematically by dividing them into five key areas of reform:

(a) establishment of a new, consolidated regulatory regime;
(b) a requirement for a Construction Trust;
(c) implementation of prompt payment procedures down the contractual chain;
(d) new obligations in relation to Government contracts; and
(e) amendments to broaden the application of the *Building and Construction Industry Security of Payment Act 1999* (NSW) (the SOP Act).

On releasing the Report, the NSW Government also released three Consultation Summary Papers designed to assist in focusing consideration of the recommendations contained in the Report. The Consultation Summary Papers cover:

- licensing of commercial builders;
- statutory construction trusts; and
- changes to the SOP Act.

Interested parties have until 21 February 2013 to make written submissions in response to the recommendations contained in the Report.
2. **A new regulatory regime for the construction industry**

2.1 **The current regulatory regime**

Presently, the licensing regime for builders in NSW is essentially limited to licensing of builders in the context of the *Home Building Act 1999* (NSW).1 The licensing and other regulatory functions in relation to the construction industry are currently shared between a number of different agencies. These include:

(a) NSW Fair Trading;
(b) NSW Building Professionals Board;
(c) NSW Planning Self Insurance Corporation (NSW Home Warranty Insurance Fund);
(d) Long Service Corporation;
(e) NSW Public Works;
(f) NSW Government Procurement;
(g) Home Building Advisory Council; and
(h) WorkCover Building Industry Co-ordination Committee.

2.2 **The NSW Building and Construction Commission**

The Report proposes the establishment of an autonomous statutory authority called the "NSW Building and Construction Commission" (the Commission).2 The Report states that the proposed Commission "is the only way through which appropriate reforms may be instituted, implemented and monitored".3

The Commission would perform the following functions:

(a) consolidate the functions that currently exist in other government agencies, departments, boards and instrumentalities;

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1 There are certain other licensing requirements beyond the home building sector for specialist trades which form part of the construction industry.

2 Recommendation 1, page 351 Report.

3 Page 351 of the Report.
(b) provide a specialised division that deals with all administrative oversight, regulatory and operational responsibilities relating to the NSW Home Building Act 1989; 4

(c) assume sole responsibility for the control and regulation of all aspects of the building and construction industry, including discipline, complaints and standards; 5 and

(d) be responsible for the development of standard financial and accounting requirements applicable to all builders and contractors in NSW, and will have the power to conduct spot audits and require the production of relevant financial information from building contractors and construction contractors in certain circumstances. 6

2.3 A licensing system for contractors and subcontractors

The Report proposes the establishment of a licensing system that will require all builders and construction contractors operating in the commercial building sector in NSW to hold a graduated licence category according to the net financial backing they are able to demonstrate. 7 Contractors would be restricted to the category of project value for which they have demonstrated financial backing and licenced accreditation. The licensing system would be established and administered by the Commission.

It is not clear how this new licensing system is intended to interact with the National Occupational Licensing Authority (NOLA). 8 NOLA is a current COAG initiative towards removing inconsistent licensing regulations in the various jurisdictions by introducing common licensing standards in a number of fields. However, it is not yet known precisely when it will come into force in respect of building licensing (though current predictions suggest that building may be incorporated in national licensing scheme sometime in 2014).

Some related occupations (such as electrical occupations) may be subject to a national licensing scheme as early as 2013. The first wave of occupations scheduled to commence in 2013 will include property occupations (excluding conveyancers and valuers), electrical

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8 The Report merely notes the existence of the national occupational licensing initiative at page 353, while the Consultation Summary Paper on Licensing of Commercial Builders prepared by the NSW Department of Finance and Services states that the NSW Government will take the NOLA initiative into account when assessing the Report's recommendations in this respect.
occupations, plumbing, gas fitting and air-conditioning and refrigeration occupations. Building occupations will be transferred in the second wave which was anticipated to be in 2014. However, there have been not been any announcements yet in relation to specifically when this will occur.

2.4 Introduction of new financial information requirements

The proposed licensing reforms are intended to work alongside other recommendations, including the introduction of mandatory requirements for financial backing and net tangible asset thresholds, similar to those that operate in Queensland. The Queensland licensing system, administered through the Queensland Building Services Authority Act 1991, sets limits on the value of building work that a contractor can be engaged to work on. Builders are therefore licensed according to their net tangible assets, which in turn limits the value of the work they are entitled to undertake.

The introduction of a new licensing system, similar to that in Queensland, is likely to have a significant impact on contractors in two important ways.

First, contractors, irrespective of the type of licence being applied for, will be obliged to disclose significant financial information on the date of application. The type of information required to be provided may include the net tangible assets held by the applicant, a financial audit report, and professional indemnity insurance requirements.

Second, in addition to requirements to disclose financial information at the date of a licence application or renewal, the Report proposes that contractors may be subject to audits at other times for the purpose of evaluating their ongoing financial health. The Queensland Building Services Authority (QBSA) has the right to reassess a licensee's financial situation in a number of prescribed circumstances, for example, where the QBSA has reasonable grounds for concern that the licensee no longer satisfies the financial requirements for its class of licence.

Although the extent of the proposed ongoing financial information monitoring by the Commission is yet to be determined, such a regime is likely to impose significant administrative burdens on contractors.

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9 Page 353 of the Report.
Further consideration of issues likely to be encountered if a licensing regime similar to that of the QBSA was adopted in NSW are discussed in a recent report published in November 2012 by the Transport, Housing and Local Government Committee of the Queensland Parliament.11

### 2.5 The Education Committee

The Report proposes the establishment of an Education Committee to conduct programs which develop skills in the building and construction industry, including but not limited to, financial education and administrative skills.12 The Report proposes that the Education Committee could draw on the knowledge and expertise of representatives from the Office of Small Business Commissioner, the Housing Industry Association, the Master Builders Association, the Institution of Arbitrators and Mediators Australia and the Department of Education and Communities.

### 3. The Construction Trust

The Report proposes the establishment of a statutory construction trust (Construction Trust) for all projects valued at $1 million or more. The Inquiry proposes that the Construction Trust would be established through appropriate amendments to the SOP Act.

Where a project requires a Construction Trust, any payment made by a principal, head contractor or subcontractor, in respect of, or on account of, work and materials carried out by the head contractor, subcontractor or supplier (as the case may be), will be subject to a trust for the purpose of paying subcontractors and suppliers down the contractual chain. This trust will arise immediately on receipt of the moneys by the trustee.

#### 3.1 Essential features of a Construction Trust

Some essential features of the Construction Trust (as proposed to apply in NSW) are set out below. The Report recommends that NSW adopt the form of Construction Trust currently used in Maryland with slight modifications from the Ontario and British Columbia versions of the Construction Trust. For those who are interested in the form of the statutory provision giving rise to the trust, some comparative provisions examined by the Inquiry are set out in Appendix A.

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The form of Construction Trust proposed by the Inquiry include the following features:

(a) payments from the principal to the head contractor (and from the head contractor to the subcontractor and suppliers cascading downwards), will be considered trust property, and should be paid into, and retained in, a separate and segregated "Construction Trust” bank account (the Trust Account). The Trust Account will replace any other bank account used for the purpose of receiving or paying out money related to the project works;

(b) before making a payment out of the Trust Account to a subcontractor, the head contractor (or other trustee as the case may be) must submit a certificate stating the amount due and payable to the subcontractor (or other beneficiary) and that the amount is to be paid out of the Trust Account; and

(c) once money has been paid into the Trust Account, each beneficiary claiming to be entitled to payment of money out of the Trust Account is entitled to call upon the trustee to provide up-to-date details in the form of copies of the current account balances.

3.2 Power of trustee to invest trust funds in authorised investments

The Report proposes that the head contractor (or other trustee as the case may be) be entitled to invest trust funds into an authorised investment consistent with the relevant provisions of the Trustee Act 1925 (NSW) (Trustee Act).

Section 14 of the Trustee Act provides trustees with the power to invest trust funds consistently with duties set out in section14A, including the duty to review the performance of trust investments at least once in each year. Matters to which the trustee is to have regard in exercising the power of investment are set out in s14C.

The Trustee Regulations 2010 (NSW) provide further guidance as to the types of investments which trustees might reasonably consider appropriate for the investment of trust funds. These include:13

(a) any public funds or Government stock or Government securities of the Commonwealth or any State,

(b) any debentures or securities guaranteed by the Government of New South Wales,

(c) any debentures or securities:

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13 Trustee Regulations 2010 (NSW), cl 4.
issued by a public or local authority, or a statutory body representing the Crown, constituted by or under any law of the Commonwealth, or of any State or Territory; and

(ii) guaranteed by the Commonwealth, any State or the Northern Territory;

(d) any debentures or securities issued by the Northern Territory and guaranteed by the Commonwealth;

(e) interest-bearing deposits in a bank; and

(f) any deposit with, withdrawable shares in, or loan of money to, an authorised deposit-taking institution.

However, it should be noted that investing in one of the specified forms of investment will not in and of itself mean that the trustee has complied with the duties and requirements placed on it under section 14A of the Trustee Act.\(^{14}\)

Upon payment of all moneys found or agreed to be due and payable to the subcontractors and suppliers, the head contractor would be entitled to retain the income earned upon the investment of the Trust Account.

### 3.3 Obligations of the trustee under a Construction Trust

The Report proposes that the contractor, as trustee, be subject to a number of requirements and restrictions in relation to the money held in the Trust Account. These include that the trustee:

(a) be required to open a Trust Account for the purpose of receiving money from a principal, head contractor or subcontractor that in whole or part contains money for work performed by downstream subcontractors or suppliers;

(b) must, before making any payment out of the Trust Account to a subcontractor, submit a certificate to the bank stating the amount due and payable to a particular subcontractor and that the amount is to be paid out of the trust account;\(^{15}\)

(c) may only withdraw money from the Trust Account to pay itself once all subcontractors and suppliers have been paid what is due and payable to them for work performed on the project;\(^{16}\)

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\(^{14}\) Trustee Act, s14DB(2).

\(^{15}\) Recommendation 9, page 356 of the Report.

\(^{16}\) Recommendation 9, page 356 of the Report.
may elect to deposit trust funds into an authorised investment;¹⁷

may retain any interest earned on the trust funds from the date they were deposited into the Trust Account until the date of payment out to the subcontractors;¹⁸

is obliged to maintain accounts and records regarding payments in and out of the Trust Account, and the purposes of such payments.¹⁹

3.4 Rights of subcontractors as beneficiaries of a Construction Trust

The Report proposes that the sub-contractor, as beneficiary, have certain rights in relation to a Construction Trust. These include that the sub-contractor:

(a) may request information from the contractor regarding payments made into the trust by the principal, and payments out of the account to any subcontractor, including reasons for non-payment or retention;²⁰

(b) may inspect the accounts of the trust referred to above;²¹ and

(c) may upon insolvency of the contractor (trustee), make an application to the Supreme Court of NSW for the appointment of a new trustee.²²

3.5 Application of a Construction Trust in the event of a payment dispute

In the event of a dispute as to what is due and payable in relation to a particular payment claim, the Construction Trust is designed to work in tandem with existing dispute resolution schemes under the SOP Act.

The head contractor will therefore be obliged to pay the amount not in dispute out of the Trust Account. The subcontractor should then make an application for adjudication in relation to the disputed amount under the SOP Act.

It should be noted that the Report also recommends that the SOP Act become a mandatory form of payment dispute resolution prior to parties being able to go to arbitration or litigation in the event of a dispute.²³

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²¹ Recommendation 15, page 359 of the Report.
3.6 Breach of a Construction Trust

Payment by a trustee of itself prior to ensuring that all subcontractors have been paid will constitute a breach of the Construction Trust. However, the Report goes considerably further than this and proposes that in the event of a breach of the Construction Trust third parties with knowledge of the breach of trust will also be liable.\(^\text{24}\)

Consistent with other proposed reforms which place the SOP Act at the centre of the progress payment regime, there will be no breach of trust for any payment out of the Trust Account which is made in accordance with, and on the basis of, a SOP Act adjudication. This is the case even if it is later determined by a court, arbitral tribunal or by expert determination, that the amount owing to the subcontractor or supplier is more or less than the adjudicated sum paid out.\(^\text{25}\) Therefore, a trustee will always be protected, provided it pays out of the Trust Account amounts which have been the subject of a SOP Act adjudication.

4. Prompt payment procedures

The Report makes a number of amendments to the SOP Act to promote cash flow, and protect moneys owed to subcontractors in the event of a contractor's insolvency. In relation to the management of progress payment claims (payment claims) the Report proposes three amendments which are set out below.

4.1 The contractor must provide the principal with a statutory declaration

The contractor is obliged to provide to a principal a statutory declaration stating that the subcontractor has been paid what is due and payable to them, before any money will be paid.\(^\text{26}\)

To address the common situation where statutory declarations are ignored, sworn in the knowledge that their contents are false, or circumstances where the declarant is under pressure from the contractor, the Report proposes that:

(a) the NSW Department of Finances and Services be empowered to prosecute offences against section 25 and section 25A of the Oaths Act; \(^\text{27}\) and

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\(^{24}\) Recommendation 12, page 358 of the Report.

\(^{25}\) Recommendation 17, page 360 of the Report.

\(^{26}\) Recommendation 21, page 361 of the Report.

\(^{27}\) Recommendation 22, page 362 of the Report.
it be an offence under the Act to endeavour to circumvent the operation of section 24 and section 25A of the Oaths Act by “renegotiating” the terms of payment.  

4.2 The principal must pay the contractor within 15 days of receipt of the payment claim

The principal must pay the contractor within 15 days of receipt of a payment claim. Any contractual or non-contractual stipulation contrary to this prompt payment provision, will be void and of no effect.

In the event the principal fails to pay within 15 days, it is guilty of an offence, under the SOP Act and subject to penalty rates of interest on the amount of the progress payment claim.

In the event of a dispute between the principal and the contractor regarding whole or part of the payment claim,

(a) the principal is not obliged to pay the amount in dispute within the 15 day period; and

(b) if the dispute cannot be resolved by the principal and contractor amongst themselves, and a claim is taken to the SOP Act, the amount determined by the adjudicator shall be paid by the principal directly into the Construction trust.

4.3 The contractor must pay the subcontractor within 28 days of receipt of the payment claim

The contractor must pay the subcontractor within 28 days of receipt of a payment claim. Any contractual or non-contractual stipulation contrary to this prompt payment provision will be void and of no effect.

In the event the principal fails to pay within 28 days, then:

(a) the contractor is guilty of an offence under the SOP Act and subject to penalty rates of interest on the amount of the payment claim; and

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the subcontractor will have the option to suspend work until payment is made, and this suspension will be deemed not to be a breach of the contract.\(^\text{34}\)

In the event of a dispute between the contractor and the subcontractor regarding whole or part of the payment claim:

(a) the principal is not obliged to pay the amount in dispute within the 28 day period;\(^\text{35}\)

(b) if the dispute cannot be resolved by the principal and contractor amongst themselves, and a claim is taken to the SOP Act, the amount determined by the adjudicator shall be paid by the principal directly into the Construction trust.\(^\text{36}\)

4.4 An example of operation of prompt payment provisions

The following example is intended to illustrate how the prompt payment provisions and the Construction Trust might operate were the recommendations accepted.

For the purposes of the example, assume that:

(a) a subcontractor’s progress payment claim for $2.5m is received by the head contractor on 30 June 2013 and that claim therefore has to be paid by 28 July 2013;

(b) having received and reviewed the claim, the head contractor certifies that the full amount of $2.5m is due and payable;

(c) the head contractor in turn submits a payment claim for $3m to the principal which is received on 5 July 2013 and therefore is payable by 20 July 2013;

(d) having received and reviewed the claim, the principal issues a payment schedule certifying that the amount of $2m is due and payable, but disputes the remaining $1m;

(e) the principal pays the amount not in dispute of $2m into the head contractor’s Trust Account on 18 July 2013 (thereby within the 15 day period);

(f) as the head contractor owes the subcontractor $2.5m but has only $2m in its Trust Account, the head contractor will need to find another $0.5m of its own funds to pay the Subcontractor by 28 July 2013;

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\(^{34}\) Recommendation 26, page 368 of the Report.


\(^{36}\) Recommendation 33, page 367 of the Report.
on receipt of the payment schedule from the principal, the head contractor makes an adjudication application under the SOP Act in respect of the disputed $1m;

in the adjudication determination (which will only be issued well after the 28 day payment period has expired), it is determined that $800,000 of the disputed $1m is due and payable;

the principal must then deposit the amount of $800,000 determined by the adjudicator in the head contractor's Trust Account.

5. Retention Sums

The Report proposes that retention sums be held in a Construction Trust. Therefore, retention sums could only be paid out in accordance with:

(a) any relevant certificate;
(b) agreement between the parties;
(c) SOP Act determinations; or
(d) a decision of a court of competent jurisdiction, an arbiter or expert opinion (as applicable).  

The Report notes that this proposed reform may have an effect on the ability of head contractors seeking finance for securities to provide to principals. Because it is to be held in trust, the retention sums would not be able to be considered by a bank as the fully unencumbered property of the head contractor when assessing balance sheets for provision of a bank guarantee to the principal.

The entitlement to interest on retention sums will follow the resolution of competing claims.

6. Changes to the SOP Act

Beyond consequential amendments to put in place the recommendations described above (such as the Construction Trust), the Report also proposes a number of specific amendments to the SOP Act. These are set out below:

(a) The Report proposes the removal of:

37 Recommendation 18, page 360 of the Report.
38 Page 212 of the Report.
(i) the requirement under section 13(2)(c) of the SOP Act for a payment claim to be endorsed before it comes within the SOP Act;\(^\text{40}\) and

(ii) the right of a claimant to choose its own adjudicator (we note that the SOP Act currently only permits a claimant to choose its Authorised Nominating Authority, which in turn nominates an adjudicator).\(^\text{41}\)

(b) The Report proposes the expansion of the adjudicators powers to include the ability to:

(i) determine on an interim basis disputes concerning bank guarantees;

(ii) resolve disputes concerning the entitlement to retention sums;

(iii) resolve disputes in the home building sector in respect of projects valued at greater than $1 million; and

(iv) issue a final certificate after hearing both sides to a dispute involving sums less than $40,000.\(^\text{42}\)

(c) The Report proposes the introduction of:

(i) a requirement that subcontractors who dispute an amount owing to it in relation to a progress payment claim must, at first instance, make a claim through the SOP Act, before referring to arbitration or court proceedings;\(^\text{43}\)

(ii) training requirements for qualified adjudicators who exercise functions under the SOP Act;\(^\text{44}\) and

(iii) extended time limits to respond to adjudication applications.\(^\text{45}\)

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\(^{40}\) Recommendation 38, page 389 of the Report.

\(^{41}\) Recommendation 39, page 369 of the Report.


\(^{44}\) Recommendation 40, page 370 of the Report.

7. **Government Contracts**

In relation to Government contracts, the Report proposes the introduction of mandatory requirements for the Government to:

(a) re-evaluate its order of priorities in the tender process;\(^{46}\)

(b) utilise project bank accounts;\(^{47}\)

(c) conduct financial checks on a rolling basis;\(^{48}\) and

(d) where the contract has a project value of greater than $10 million, include a form of dispute prevention and dispute resolution in the contract.\(^{49}\)

8. **Transition period**

The Report proposes that following passage through Parliament, the legislative reforms will be subject to a two year transition period.\(^{50}\) The Report states that this period is so that "those participating in the industry may bring their house into order and begin to treat moneys which are not really theirs as if they were the entitlement of others".\(^{51}\)

Beyond that, the Report does not provide any detail of how the transitional provisions might apply. In particular, it is not clear as to which contracts the proposed reforms would apply to; for example, would the reforms apply to all contracts entered into after the date of the amendments or would there be a period during which existing projects might be required to transition into the various payment and trust reforms. Many major construction projects have a life of considerably longer than the two year transition period and thus a large number of projects are likely to be affected in this way.

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\(^{48}\) Recommendation 41, page 369 of the Report.

\(^{49}\) Recommendation 37, page 369 of the Report.

\(^{50}\) Recommendation 44, page 373 of the Report. In addition, it is proposed that they will be subject to an advisory and education program, and set out in the form of an Exposure draft.

\(^{51}\) Page 315 of the Report.
Appendix A: examples of Construction Trust legislative provisions from other jurisdictions

The Maryland Construction Trust Legislation

Real Property Code Ann, Title 9. Statutory Liens on Real Property: Subtitle 2: Trust relations in the Construction Industry provides as follows:

"Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by a subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for the purposes of paying those subcontractors".

The Ontario Construction Trust Legislation

Section 8(1) of the Ontario Construction Lien Act R.S.O. 1990, c.30 (the Ontario Act) provides:

"All amounts, 

- owing to a contractor or subcontractor, whether or not due or payable; or 
- received by a contractor or subcontractor, 

on account of the contract or subcontract price of an improvement constitute a trust fund for the benefit of the subcontractors and other persons who have supplied services or materials to the improvement who are owed amounts by the contractor or subcontractor".

Section 8(2) of the Ontario Act, makes plain, that the cascading trust applies to suppliers as well as contractors and subcontractors. It states:

"Obligations as Trustee

The contractor or subcontractor is the trustee of the trust fund created by subsection (1) and the contractor or subcontractor shall not appropriate or convert any part of the fund to the contractor's or subcontractors own use or to any use inconsistent with the trust until all subcontractors and other persons who supply services or materials to the improvement are paid all amounts related to the improvement owed to them by the contractor or subcontractor".

In addition, to ensure that Corporations will be liable for the misapplication of trust funds, section 13(1) of the Ontario Act provides:

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

1) every director or officer of a corporation; and

2) any person, including an employee or agent of the corporation, who has effective control of a corporation or its relevant activities who assents to, or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation is liable for the breach of trust."