



**THE LAW REFORM COMMISSION
OF WESTERN AUSTRALIA**

Project No 82

**Financial Protection in the Building
and Construction Industry**

DISCUSSION PAPER

DECEMBER 1995

The Law Reform Commission of Western Australia was established by the *Law Reform Commission Act 1972*.

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Preface

The Commission has been asked to consider what changes to the law, if any (other than contractors' liens and charges), should be adopted for the protection of the interest of subcontractors, workers and others in the building and construction industry in receiving payment for work done or materials supplied.

The Commission has not formed a final view on the issues raised in this discussion paper and welcomes the comments of those interested in the topic. It would help the Commission if views were supported by reasons.

The Commission requests that comments be sent to it by 1 March 1996.

Unless advised to the contrary, the Commission will assume that comments received are not confidential and that commentators agree to the Commission quoting from or referring to their comments, in whole or part, and to the comments being attributed to them in its final report. Since the process of law reform is essentially public, copies of submissions made to the Commission will usually be made available on request to any person or organisation. However, if you would like all or any part of your submission or comment to be treated as confidential, please indicate this in your submission or comments. Any request for a copy of a submission marked "confidential" will be determined in accordance with the *Freedom of Information Act 1992*.

The research material on which this paper is based can be studied at the Commission's office by anyone wishing to do so.

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Table of Abbreviations

Alberta Report	Alberta Joint Government/Industry Task Force on Builders' Liens: <i>Builders' Liens: Towards Greater Assurance of Payment</i> (1989)
AS 2124-1992	Standards Association of Australia <i>General Conditions of Contract</i>
BISCOA	The Building Industry Specialist Contractors Organisation of Australia
BISCOA (Qld)	The Building Industry Specialist Contractors Organisation of Australia - Queensland <i>Response to the Queensland Government November 1991 Green Paper: Security of Payment for Subcontractors in the Building and Construction Industry</i> (1992)
BISCOA (SA)	The Building Industry Specialist Contractors Organisation of Australia -South Australia <i>Comment on the Report of the Ministerial Working Party on Insolvency in the Building Industry - December 1990</i>
CIDA Report	Construction Industry Development Agency <i>Security of Payment</i> (Final Report 1994)
Dorter and Sharkey	J B Dorter and J J A Sharkey <i>Building and Construction Contracts In Australia: Law and Practice</i> (2nd ed 1990 looseleaf service)
Ettinger	L P Ettinger <i>Trusts in the Construction Industry</i> (1989) 27 Alberta LR 390
JCC-C 1994 T	The Royal Australian Institute of Architects; Master Builders Australia, Incorporated; The Building Owners and Managers Association of Australia Limited <i>Building Works Contract - JCC-C 1994</i>
Macklem and Bristow	D N Macklem QC and D I Bristow QC <i>Construction, Builders' and Mechanics' Liens in Canada</i> (6th ed 1990 looseleaf service)
Newfoundland Report	Newfoundland Law Reform Commission <i>Report on the Mechanics' Lien Act: Certain Substantive Issues</i> (1990)
NPWC 3	National Public Works Conference <i>General Conditions of Contract NPWC Edition 3</i> (1981)
NSW Issues Paper	Business and Consumer Affairs Agency <i>Issues Paper on Financial Protection for Building Subcontractors</i> (1991)

Queensland Government DP	Queensland Government <i>Security of Payment for Subcontractors in the Building & Construction Industry</i> (1991)
SA Select Committee	Select Committee of the [South Australian] House of Assembly <i>Report of the Select Committee of the House of Assembly on the Operation of the Worker's Liens Act 1893</i> (1990)
SA Working party	<i>Report of the [South Australian] Ministerial Working Party on Insolvency in the Building Industry</i> (1990)
Smith Report	C H Smith QC <i>Report of the Inquiry into the Building Industry of Western Australia 1973-1974</i>
SCGA Report	Legislative Council Standing Committee on Government Agencies Fifteenth Report <i>Review of the Builders' and Painters' Registration Boards</i> (V 011, 1987)
VSLRC Report	Victorian Statute Law Revision Committee Report on <i>Proposals for Contractors Liens Legislation and Alternative Methods of Securing Payments for Subcontractors</i> (1975)

Abbreviations of statutes

Alta	(Alberta) <i>Builders' Lien Act RSA 1980 c B-12</i>
BC	(British Columbia) <i>Builders Lien Act RSBC 1979 c 40</i>
Man	(Manitoba) <i>Builders' Liens Act RSM 1987 c B91</i>
Ont	(Ontario) <i>Construction Lien Act RSO 1990 c C.30</i>

Chapter 1

INTRODUCTION

1. TERMS OF REFERENCE

1.1 The Commission has been asked:

"To recommend what changes to the law, if any (other than contractors' liens and charges), should be adopted for the protection of the interest of subcontractors, workers and others in the building and construction industry in receiving payment for work done or materials supplied."

1.2 The terms of reference are broad and cover a wide range of persons engaged in the building and construction industry, including builders and head contractors. Because of the structure of the industry¹ owners and builders employ relatively few people in an employer/employee relationship. Normally most of the work is carried out by independent subcontractors. Subcontractors may also supply material as part of their contract or they may supply materials alone. The terms of reference extend to "workers ...in the building industry" and, for the purpose of the project, the Commission has construed "workers" as meaning employees of both the head contractor and subcontractors.

1.3 The genesis of the reference is contained in the Commission's recommendations in paragraph 78 of its report on *Contractors' Liens*² that:

- "(a) legislation providing for the registration of contractors' liens should not be introduced;
- (b) legislation providing for the creation of contractors' charges should not be introduced;
- (c) alternative proposals be examined by the Government for the protection of those engaged in the building and construction industries."

It is alternative proposals for protection that are now examined by the Commission.³

¹ Paras 1.5-1.7 below.

² Project No 54 (1974). See also para 1.18 below.

³ The project was given to the Commission following representations to the then Premier by employees and contractors in the building industry: Media statement of the Attorney General 8.5.1985. A Discussion

2. CONSULTATIONS

1.4 In August 1995 the Commission wrote to a number of organisations or associations with an interest in the terms of reference seeking preliminary submissions. The Commission, by means of an advertisement in *The West Australian*, also invited preliminary submissions from persons interested. Twenty four preliminary submissions have been received.⁴ The Commission gratefully acknowledges the help of those who have made preliminary submissions or have otherwise assisted the Commission.

3. THE STRUCTURE OF THE BUILDING AND CONSTRUCTION INDUSTRY

1.5 The structure of the building and construction industry has changed since the early 1950s and with it the contractual relationships of persons working in the industry.⁵ Where once much of the construction work was performed by employees of the builder, now the builder or head contractor normally carries out very little of the work with its employees.⁶ Instead the various works required to construct a building, whether a residence, office or industrial building, or to complete a civil project are subcontracted out to persons who may in former times have been employees of the builder. Bricklayers, carpenters, plumbers, plasterers, electricians and other suppliers of services and materials are now usually independent subcontractors. The following reasons have been suggested for this development by the Industry Commission -

- * A firm relying on its own labour force is geographically restricted.
- * An intermittent workload causes difficulties in maintaining a permanent workforce.
- * It is not viable to maintain a workforce containing all the specialists that might be required from time to time.

Paper was not issued earlier because other projects had a higher priority and work on the project was suspended for a period of time.

⁴ The names of those who made a preliminary submission are listed in Appendix I.

⁵ According to the Smith Report at 8 subcontracting first began to emerge in the early 1950s when home building was buoyant and flourished between 1965 and 1971 when building activity expanded greatly.

⁶ Head contractors typically employ only about 10% of on-site labour; Industry Commission, *Construction Costs of Major Projects* (Report No 8, 1991) 23.

- * A contractor with a small permanent workforce can concentrate on management and needs less working capital.⁷

Subcontracting also allows for greater specialisation in skills and equipment.

1.6 On large projects many subcontractors in turn subcontract to others to carry out part of their responsibilities. The contractual relationships in the project may therefore take the form of a pyramid with many of the people involved having no contractual relationship with the builder or head contractor at all. In effect, the modern builder has ceased to be a builder in the traditional sense and has instead become a project manager or organizer in return for a percentage of the construction price.

1.7 Because of the way finance for construction projects is organized before building commences it is unusual for an owner to become insolvent during the course of the work though payment may be held up for a long period of time. More commonly, it is the builder who gets into financial difficulties in which event the subcontractors stand to lose their money if the builder goes into liquidation. As each stage of the building is completed the owner (or the owner's financier) makes a progress payment to the builder. Ideally, this money should be used to pay the builder's subcontractors with the balance retained for its profits and costs. However, a builder in financial difficulties may not pay the subcontractors on time and of course if the builder goes into liquidation it can be expected that subcontractors will lose their money or part of it. Payments received by a head contractor might also be used to meet payments on other projects or to reduce an overdraft facility. A similar situation might occur down the contractual chain.

4. CAUSES OF DIFFICULTIES

1.8 Research for the Royal Commission into Productivity in the Building Industry in New South Wales suggests that the industry is marked by undercapitalisation of head contractors and subcontractors with a high level of dependence on borrowed funds.⁸ A reliable cash flow is therefore very important to those in the contractual chain. Too often, however, money paid:

⁷ Ibid.

⁸ Queensland Government DP 11-13.

"...to a contractor on one contract is siphoned off to pay creditors of another contract or used to invest in other projects.

"There have been occasions when a builder will enter into a contract where a loss is certain for the sole purpose of having a cash flow to cover past debts in anticipation of staying in business long enough to obtain a profitable contract before his insolvency becomes known."⁹

Another cause of difficulty is the existence of the chain of contracts linking the owner, head contractor, subcontractors, employees and material suppliers. This chain of contracts is itself risky, with those at the end of the chain bearing the greatest risk. Two associations who made preliminary submissions to the Commission pointed out that in some instances "...contractors have gone into liquidation within hours of receiving progress claims on a project without any distribution to sub-contractors and if the sub-contractor is paid [the subcontractor is] often required to forfeit the payment by the liquidator".¹⁰

1.9 Another difficulty drawn to the Commission's attention in a preliminary submission is that, despite contractual terms requiring payments to be made within 30 days of receipt of a progress claim, payments can be delayed for as long as 90 or 120 days. This may be because the head contractor is surviving on the money due to the subcontractor. If possible, the only effective redress the subcontractor has is to increase its price to cover the cost of providing credit to the head contractor. The submission also stated that retention funds¹¹ were being allocated to other projects and, consequently, that security of those funds is placed at risk.

1.10 A preliminary submission to the Commission also suggested that disputes (which may sometimes be spurious) as to the standard of work or materials are used to delay payments to subcontractors so that the head contractor continues to have the use of the money until it is paid to the subcontractor and may even refuse to make payments to contractors. While legal proceedings in the courts, such as the Small Disputes Division of the Local Court, can be used to deal with such disputes, it was claimed that these are unsatisfactory not only because of the expense and delay involved but also because the presiding officers do not have expertise in the contractual structure of the building and construction industry or construction methods or

⁹ Id 15: comments of the Queensland Insolvency Practitioners' Association.

¹⁰ The Master Plumbers & Mechanical Services Association of Western Australia; The Master Painters Decorators & Signwriters' Association of Western Australia.

¹¹ These are funds retained by the owner or head contractor to ensure proper performance of the contract. They may be used to complete the works if a contractor will not perform work, abandons the work or becomes insolvent.

standards. Some of the reforms proposed in Chapter 3 might discourage spurious disputes. Apart from these possible reforms, the Commission does not intend to address the general difficulties of the use of court proceedings to deal with disputes in the building and construction industry because it has ramifications beyond the scope of this project. In any case, alternatives to court proceedings, for example alternative dispute resolution procedures such as arbitration and mediation, are available and are presently used to settle disputes.

5. THE CONTRACTUAL RELATIONSHIPS

1.11 In the event of the head contractor's insolvency, its subcontractors rank as unsecured creditors.¹² That is, their right is merely one in common with other creditors to lodge a claim in the bankruptcy. When the assets of the bankrupt have been realized, the subcontractor receives a dividend generally based on the quantum of its debt so far as the general assets extend on an equality with other creditors.

1.12 A subcontractor cannot generally bypass the head contractor and have recourse against the owner because there is no privity of contract¹³ between the subcontractor and the owner¹⁴ unless the contract between the head contractor and the owner confers a benefit on the subcontractor.¹⁵ The *Property Law Act 1969*¹⁶ provides that where a contract expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract, the contract is enforceable by that person. All defences that would have been available to the defendant in an action to enforce the contract are available.¹⁷ However, it is not a defence to show that there is no privity of contract between the owner and the

¹² *Pritchett & Gold & Electrical Power Storage Co Ltd v Currie* [1916] 2 Ch 515.

¹³ The doctrine of privity of contract provides that only those who are parties to a contract may sue or be sued on it. As a result of the case of *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107 the status of the privity doctrine in Australia is in a state of flux. If the view of three of the members of the majority prevails, the common law will provide a means of enforcing a contractual benefit notwithstanding lack of privity and lack of consideration on the part of the beneficiary: see generally J W Carter and D J Harland *Contract Law In Australia* (2nd ed 1991) 317-320.

¹⁴ *A Vigers Sons & Co Ltd v Swindell* [1939] 3 All ER 590.

¹⁵ *In re Holte; ex parte Gray* (1888) 58 LJQB 5.

¹⁶ S 11(2).

¹⁷ Each person named as a party to the contract must be joined as a party to the action: *Property Law Act 1969* s 11(2)(b). This means that although a subcontractor may be seeking to recover from the owner, the head contractor should be joined as a party to the action. This might provide a means of ensuring that the owner is not required to pay twice for the same work: once to the head contractor and secondly to the subcontractor.

subcontractor or that no consideration moved from the subcontractor to the owner.¹⁸ Some standard form contracts, such as AS 2124-1992, provide for the owner to pay a subcontractor, usually a nominated subcontractor, money due to the head contractor in particular circumstances.¹⁹ While this standard form contract is used, for example, by the Building Management Authority, the Commission understands that the power to make direct payments is not often exercised.

1.13 One avenue open to a head contractor or subcontractor who suffers a loss as a result of default in payment is an action under the Commonwealth *Trade Practices Act 1974* or *Fair Trading Act 1987*. *The Trade Practices Act 1974* (Cth) provides that a corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.²⁰ A contravention of the prohibition renders the corporation or person liable to an action for damages by any party that has suffered a loss.²¹ Intention to mislead or deceive is not an element of the prohibition.²² If a director or financier of a developer makes a misleading statement to a head contractor or subcontractor about the financial viability of the developer, the director or the financier may be liable to the head contractor or the subcontractor for any loss suffered as a result of that statement.²³

1.14 A head contractor or subcontractor who suffers loss as a result of a default in payment by a company may also be able to recover the sum lost from a director of the company. Under the *Corporations Law* individual directors are under a statutory duty to prevent insolvent trading by their company. If they fail to do so they are liable to a civil penalty and are personally liable to pay compensation to a creditor of the company. A director is liable if at the time the company incurs a debt -

* he is a director of the company;

* the company is insolvent or becomes insolvent by incurring the debt;

¹⁸ *Westralian Farmers Co-Operative Ltd v Southern Meat Packers Ltd* [1981] WAR 241. See J Longo 'Privity and the Property Law Act: *Westralian Farmers Co-Operative Ltd v Southem Meat Packers Ltd*' (1983) 15 *UWAL Rev* 411.

¹⁹ See para 3.59 below.

²⁰ S 52. S 10(1) of the *Fair Trading Act 1987* is in the same terms but is not confined to a corporation and applies to a person.

²¹ *Trade Practices Act 1974* (Cth) s 82; *Fair Trading Act 1987* s 79.

²² *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216, 223, 228.

²³ See eg *Menhaden Pty Ltd v Citibank NA* (1984) 55 ALR 709.

- * there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.²⁴

The creditor may proceed in a court of competent jurisdiction to recover from the director, as a debt due to the creditor, an amount equal to the amount of the loss or damage in certain circumstances.²⁵ These circumstances are that the company is being wound up and that the company's liquidator gives written consent to the commencement of proceedings.²⁶ The court may also give leave to commence proceedings.²⁷ Depending on the circumstances and documentation, it may be difficult to prove that conduct that was misleading or deceptive as required by the *Trade Practices Act 1974* (Cth) occurred or that, under the *Corporations Law*, directors failed to prevent insolvent trading by their company.

6. LIENS AND CHARGES

1.15 The position of a creditor will be stronger where he has a lien or charge over assets of the insolvent debtor. At common law a lien arises in favour of a person who does work on movable goods and relates only to those goods. In the absence of a contractual provision, a person who does work on land or a building does not have a lien on the land for the work done or the materials supplied in the course of the work.²⁸ Some contracts may even provide that as soon as materials are brought on to the building site they become the property of the owner of the land. Such a provision is designed to prevent materials passing to the receiver or trustee in the event of insolvency of the head contractor or its subcontractors. In other cases, whether or not property in the materials has passed to the head contractor or builder will depend on the intention of the parties.²⁹

1.16 In those jurisdictions where liens exist for the protection of persons in the building industry,³⁰ they have been created by statute and are commonly known as contractors' liens. Legislation which allows for a contractor's lien provides that such a lien is registrable over the

²⁴ *Corporations Law* s 588G(I). For a discussion of these criteria see generally H A J Ford and R P Austin, *Principles of Corporations Law* (7th ed, 1995) 20.600-20.640. Statutory defences available to a director are discussed at 20.650.

²⁵ *Corporations Law* s 588M(3).

²⁶ *Ibid* s 588R(I).

²⁷ *Ibid* s 588T.

²⁸ 3 *Halsbury's Laws of Australia* para 65-642.

²⁹ *Dorter and Sharkey* 5.600.

³⁰ For example, Ontario (Ont s 14); Alberta (Alta s 4); British Columbia (BC s 4).

land upon which the building works are carried out. Once registered it operates as an encumbrance against that land. Subject to limitations imposed by the enabling statute, a lien holder is entitled to sell the land over which the lien is registered and apply the proceeds in satisfaction of the debt secured by the lien, having regard to any other encumbrances registered before the lien.

1.17 At common law a charge operates as an encumbrance against money payable by one person to another in favour of a third person. In the absence of a contractual provision, a subcontractor who does work on a building project has no right to a charge in its favour over money owing to the head contractor under the head contract. As in the case of liens, in those jurisdictions where charges in favour of subcontractors exist, they have been created by statute.³¹ Because of the weak bargaining position of subcontractors contracts in this State do not normally provide protection for subcontractors by means of either a lien or a charge.

1.18 In 1974 the Commission recommended that legislation providing for liens should not be introduced because "the registration of a lien against land may be detrimental to an owner who is in no way at fault" by inhibiting the owner's right to transfer or mortgage his land.³² It also recommended that legislation providing for charges should not be introduced because it "would not materially assist subcontractors and would tend to create more difficulties than it seeks to solve".³³ The Commission stated that one possible difficulty was that charges legislation could make it harder for a contractor to finance a building project in its early stages because until a progress payment became due under the contract the contractor had to rely on its own resources. Commonly a contractor borrowed money secured by a floating charge over money to become payable under the contract. However, as a subcontractor's charge would take precedence over such a lender's security, "banks and finance companies would probably be reluctant to lend money to any contractors but those of considerable substance".³⁴

³¹ In Queensland, the *Subcontractors' Charges Act 1974* (Qld) provides for this type of charge. See also *Worker's Liens Act 1893* (SA) s 7.

³² Law Reform Commission of Western Australia Report on *Contractors' Liens* (Project No 54 1974) para 35.

³³ *Ibid* para 57.

³⁴ *Ibid* para 41. For other difficulties see paras 43-56.

7. DEVELOPMENTS ELSEWHERE

1.19 The problems faced by subcontractors and employees are by no means unique to Western Australia and have been addressed in other jurisdictions in Australia and in Canada and the United States of America. In Australia, there have recently been inquiries in this area in New South Wales,³⁵ South Australia³⁶ and Queensland.³⁷ The matter has also been examined at the federal level by the Construction Industry Development Agency.³⁸ Statutory protection for subcontractors of one form or another has been provided in all states of the United States of America and in all common law Canadian provinces. A number of reforms adopted or proposed in these jurisdictions are discussed in Chapter 3.

³⁵ New South Wales Business and Consumer Affairs Agency *Issues Paper on Financial Protection for Building Subcontractors* (1991).

³⁶ *Report of the Select Committee of the House of Assembly on the operation of the Worker's Liens Act 1893* (1990) and *Report of the Ministerial Working Party on Insolvency in the Building Industry* (1990).

³⁷ Queensland Government Discussion Paper *Security of Payment for Subcontractors in the Building & Construction Industry* (1991).

³⁸ *Security of Payment Final Report* (1994).

Chapter 2

SHOULD SPECIAL PROVISION BE MADE FOR THOSE IN THE BUILDING AND CONSTRUCTION INDUSTRY?

2.1 At present the payment of head contractors and subcontractors is not regulated by legislation. The terms and conditions of payment are subject to negotiation between the parties in a free market. The retention of this unregulated position might be justified by basic societal values such as freedom of individual action and minimization of government interference or coercion. It might also be justified by the intrinsic advantages claimed to be offered by a well-functioning competitive marketplace, such as -

- * the market's tendency to minimize economic waste by allowing for continuous individual balancing, through contractual relationships, of economic costs and benefits by participants in projects;
- * the "carrot and stick" incentive the market provides for greater production efficiency; and
- * the incentives it provides for innovation, including innovations in the means of financing projects.

2.2 On the other hand, regulation might be justified on the following grounds -

- * The assumption that the "best" or most efficient allocation is achieved by free market forces rests in part upon an assumption that there is a "proper" allocation of bargaining power among the parties affected. Where the existing division of such bargaining power is "unequal" in this sense, it may be thought that regulation is justified in order to achieve a better balance. For various reasons, subcontractors have apparently been unable to deal with the problem of protecting payments due to them by making appropriate arrangements¹ with builders or head contractors which will protect them.

¹ Such as negotiating a clause in their contract under which the owner holds a proportion of the retention monies on trust for the head contractor as trustee for the subcontractors.

Other forms of protection are -

1. An unconditional undertaking. Cl 5 of Standards Association of Australia Subcontract Conditions AS 2545-1993 requires the head contractor to put up as security for payment

Competition within the building industry is often fierce and subcontractors are loath to do anything which would jeopardize their chances of getting contracts. The Queensland Government DP concluded:

"While extreme 'rationalists' would argue that company failures are the product of the inefficient being removed from the market-place, this does not recognise that well established and highly regarded subcontractors can often be forced into insolvency because of the failure or default of another party in the contractual chain. This market failure occurs because there is a lack of certainty of arrangements, an ability to shift risk to parties without giving them a premium for accepting it use of less than competitive tendering systems, an imbalance of bargaining power, an imperfect information for some parties and the use of legal processes that can be slow, costly and inappropriate to settlement of disputes.

It is easy to say that if subcontractors are aware of these shortcomings they should not enter into contracts. However, given the already existing imbalance of power, the reality is that they have no option, unless of course they were to collude in contravention of the *Trade Practices Act*."²

In the context of this inquiry, a better balance between the parties to a project might be achieved by providing statutorily that the system of payment of subcontractors should be based on a fiduciary relationship rather than a contractual one³ or providing protection by means of implied contract conditions.⁴

- * Unscrupulous head contractors and subcontractors distort the operation of the market place. For example, some head contractors and subcontractors, operating as a corporation, become insolvent leaving behind a trail of bad debts only to recommence business as another corporation. At present the law does

an unconditional undertaking by a bank or insurance company to pay a certain amount in the event that the head contractor fails to pay the subcontractor.

2. A Romalpa clause (named after the case *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676 in which a clause of this kind was considered by the English Court of Appeal). This type of clause provides that ownership of materials does not pass from the supplier to the contractor until the supplier has been paid in full for the materials. If the contractor becomes insolvent before the supplier has been paid, the supplier still owns the materials unless they have become a part of the improvement. Its use is becoming more common in Western Australia but mainly by suppliers of very expensive items of plant.

² Paras 1.17 and 1.18.

³ Paras 3.2-3.8 below.

⁴ Paras 3.59-3.71 below.

not prevent insolvent head contractors and subcontractors from operating a new corporate entity. As the Alberta Report points out:

"Contractors and subcontractors, who have little or no aversion to operating in this manner, can bid and take jobs without due regard to the profitability of the job since they live on cash flow instead of the job's profit margin. The argument sometimes made, that competition by such contractors and subcontractors is good for the consumer is specious at best. There is already significant competition in all parts of the construction industry and margins are not unreasonably high. Those contractors and subcontractors who are indifferent about the solvency of their corporate entity transfer real costs to subtrades who remain unpaid and to consumers who are left with incomplete work."⁵

The problem of unscrupulous head contractors will be ameliorated to some extent by proposed changes to the *Builders' Registration Act 1939* which will give the Builders' Registration Board power to ban builders who have failed from setting up business under a different name.⁶ It will not, however, address the problem of unscrupulous subcontractors.

- * There are deficiencies in the information available to those in the industry. In an industry with a pyramid structure, regulation of the payment system is justified because those low in the structure do not know enough about the ability of those above them to meet their financial obligations or the consequences of their financial failure. However, the CIDA Report contains a number of recommendations to improve the regulation of corporations and the information available to head contractors and subcontractors. One such recommendation is that the Australian Securities Commission database be expanded to record relevant historical information on both companies and directors and to provide ready public access to that information.⁷ It also recommended that when the Australian Construction Industry Pre-Qualification Criteria for Contractors and Subcontractors is reviewed, consideration be given to the inclusion within the Financial Capacity Criteria

⁵ Alberta Report 20.

⁶ Media Statement Minister for Fair Trading 22 August 1995.

⁷ CIDA Report 8. This recommendation was endorsed by the CIDA Board as recommendation 3.

of detailed relevant information on the corporate history of directors and key management personnel.⁸

- * The legal relationships between the parties to large construction projects are complex with many of those providing services on credit having no contractual relationship with the ultimate source of funding, the owner or its financier. The ordinary contractual remedies are inadequate to deal with the complex interrelated claims involved in the typical construction project. As the Newfoundland Law Reform Commission points out:

"Notwithstanding the interconnected nature of this chain, relying solely on notions of contractual privity the parties at each level have payment and performance claims only against the parties in the construction pyramid immediately above or below them. However, parties may be greatly affected, indeed placed seriously at risk, by the actions of persons within the chain other than those with whom they have contractual relationships. If, for example, the owner refuses to pay for the work done on his premises, those at the bottom of the construction pyramid, who, in fact have done most of the work, have no contractual claim against him."⁹

- * Subcontractors have a special role in the building and construction industry. At present very few head contractors perform much of the actual building work. Subcontractors carry out most of the construction work in both the house building sector and the construction industry. The subcontractor has by its work and materials made a major contribution to improving the value of the owner's land and the services and materials once supplied lose their separate identity and become part of the land,¹⁰ yet the subcontractor might not be paid for months after the completion of the contract.
- * Alternatives to regulation are unsatisfactory. For example, there are problems in subcontractors taking unilateral steps, such as obtaining credit insurance, to protect themselves. The Building Industry Specialist Contractors Organisation of Australia (BISCOA) has informed the Commission that credit insurance is commercially available, but at 3% of the subcontract price it is felt by

⁸ Ibid 9. This recommendation was endorsed by the CIDA Board as recommendation 4.

⁹ Newfoundland Report 1.

¹⁰ This argument also applies to others who have contributed to the project such as those who provide finance, legal advice, design or other services.

members to be too expensive as their margin of profit on most jobs is so small in comparison. The Housing Industry Association developed a credit indemnity scheme which offered an insurance-type protection for its subcontractor members but the scheme has foundered.¹¹ It has also been suggested to the Commission that in an industry "rife with unethical and unconscionable behaviour" subcontractors are generally fearful of using existing legal remedies for fear of not being considered for the next project.¹²

2.3 The Commission welcomes comment on whether the law should be amended to regulate the payment of head contractors, subcontractors, workers and others in the building and construction industry, particularly when the payment of unsecured creditors in other industries is unregulated. Various approaches to regulation are examined in the following chapter. In particular, the Commission welcomes assessments of the direct impact of regulation, and particular forms of regulation, on the efficiency of the industry and any side effects or indirect effects regulation might have on the industry and its consumers.

¹¹ Para 3.73 below.

¹² The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia.

Chapter 3

POSSIBLE APPROACHES TO REFORM

1. INTRODUCTION

3.1 The problem of providing financial protection for building head contractors and subcontractors exists elsewhere in Australia and overseas and a number of different ways of dealing with it have been adopted or proposed. There are broadly speaking two main approaches-

- (a) preventing losses arising in the first place, and
- (b) providing some sort of salvage mechanism once a loss has occurred.

The following nine forms of protection, which do not involve contractors' liens and charges, are discussed below -

- * creation of statutory trusts in favour of head contractors or subcontractors;
- * payment bonding of head contractors;
- * managed contracts with direct payment so that the builder would merely be a manager and the owner would be liable for paying all the other persons who work on the building project;
- * covenanting;
- * statutory implied conditions for protection of head contractors and subcontractors to be included in contracts;
- * the establishment of a statutory credit indemnity insurance scheme;
- * a "stop notice" procedure;
- * a holdback fund; and

* grading of building contractors under a licensing scheme.

While anyone of these could be used to provide protection for subcontractors not all are appropriate in providing protection for head contractors.

2. STATUTORY TRUST

(a) Introduction

3.2 In Canada, a number of provinces have legislation which provides that all sums received by a head contractor or subcontractor ("the trustee") on account of their contract price are trust funds in their hands for the benefit of their subcontractors, workers and suppliers ("the beneficiaries").¹ The effect of a statutory trust is to transform what would otherwise be a debtor-creditor relationship into a fiduciary one. Failure to pay a debt is no longer merely a breach of contract, but a potential breach of trust. If the builder goes into liquidation the moneys are protected from the liquidator and preserved for the beneficiaries of the trust.² Such provisions usually augment contractors' liens,³ but they can operate independently of them.

3.3 Until the beneficiaries of a trust are paid for work done or materials supplied, the trustee may not appropriate trust moneys for its own use except as permitted by the trust provisions of the Act. In Ontario, the legislation goes further and provides that moneys in the hands of the owner for the purpose of the project are trust moneys. This is done by providing that where sums payable to a contractor by the owner become payable on the certificate of a person named in the contract, upon the issuance of the certificate, an amount equal to the sums so certified which is in the owner's hands or which subsequently comes into the owner's hands⁴ shall be a trust fund for the benefit of the contractor.⁵

¹ There are trusts in Alberta, British Columbia, Manitoba, New Brunswick, Ontario and Saskatchewan: Macklem and Bristow, Table of Concordant Statutes C6 -C9.

² For example, see *Canadian Commercial Bank v Simmons Drilling Ltd* (1989) 62 DLR (4th) 243 which concerned a statutory trust under Saskatchewan's *Builders' Lien Act 1984*.

³ It has also been recommended that trust provisions augmenting lien legislation be introduced in Newfoundland: Newfoundland Report 111.

⁴ For example, where a payment is made to the owner by its financier.

⁵ Ont s 7(2). This legislation also provides that all sums received by an owner which are to be used in financing a project, including purchasing land and payment of prior encumbrances, constitute, subject to payment of the purchase price of the land and payment of prior encumbrances, a trust fund for the benefit

3.4 In the case of a head contractor or subcontractor, the trust arises when the contract moneys are received by them. Usually this is when the moneys are in their hands but it can arise when moneys are owing to the contractor on account of the contract price even though they have not been paid to the contractor.⁶ As a result if, for example, moneys owing to a contractor under a contract for the project are paid into court, the moneys are deemed to be impressed with the trust and must be held for the benefit of the beneficiaries.⁷ It also means, for example, that moneys received from the owner by the trustee in bankruptcy of the head contractor on account of the contract price are subject to the statutory trust and are not property of the bankrupt which is divisible among its creditors until the beneficiaries under the trust are paid.⁸

3.5 The trust only applies to moneys received on account of the contract price. It therefore does not apply to moneys received by, for example, an owner from a head contractor for damages for breach of contract.⁹

3.6 In Australia, the SA Select Committee concluded that the industry should consider including provisions setting up trust accounts in standard building contracts.¹⁰ Some standard building contracts contain trust clauses relating to some payments. In *KBH Constructions Pty Ltd v Lidco Aluminium Products Pty Ltd and others*¹¹ the Supreme Court of New South Wales held that a clause under which the interest of the builder in the amount retained was "fiduciary as trustee",¹² presupposes the existence of trust property and required the property to be held on trust. The decision made it clear that contractors who hold retention moneys governed by such a clause do not have an unfettered right to use them. In England, it has been held that a similar clause impresses the retention monies with a trust which remains valid notwithstanding the head contractor's insolvency and thus the subcontractor's interest in those monies is protected.¹³

of the contractor. Until those persons are paid, the owner cannot appropriate any part of the trust to its own use: *ibid* s 7(1).

⁶ Macklem and Bristow 9-21.

⁷ *Ibid* 9-21 to 9-22.

⁸ *Ibid* 9-23 to 9-24.

⁹ *Ibid* 9-27.

¹⁰ SA Select Committee 6.

¹¹ (unreported) 27 June 1990.

¹² SCJCCA 1985 (clause 10.24.05).

¹³ *Re Arthur Sanders Ltd* (1981) 17 BLR 125.

3.7 While the parties to a contract could include provisions setting up trust accounts they rarely do so. They are not, for example, contained in standard form contracts such as AS 2124-1992 which is used by the Building Management Authority for government building contracts.

3.8 A statutory trust has the following advantages -

1. It provides a means of ensuring that a head contractor and subcontractors are paid for their services and for materials supplied while keeping contract moneys within the control of the parties to the project.
2. Because the moneys are held in trust, they cannot be seized or frozen by a receiver or liquidator of the trustee.¹⁴
3. A wider range of remedies is available for a breach or possible breach of trust.¹⁵
4. It may result in a speedier resolution of disputes between, for example, a head contractor and a subcontractor, because generally the head contractor could not withdraw money from the trust fund until all the claims of the fund's beneficiaries had been met.
5. For the same reason, it may result in speedier payment of subcontractors.

It has the following disadvantages -

¹⁴ *Bankruptcy Act 1966* (Cth) s 116(2)(a).

¹⁵ Trustees are civilly liable to restore the trust funds and to make good any loss caused by a breach of trust. Other remedies are-

1. Proceedings to compel the trustee to perform its duty or protect the beneficial interest in the trust property.
2. Proceedings to remove a trustee and appoint a new trustee in its place.
3. An order that trust moneys be paid into court.
4. An injunction restraining a breach of trust
5. The appointment of a receiver of the trust property.
6. A personal action against a third party who has received trust property. The recipient of the property wrongly distributed may plead that it received the property in good faith and has so altered its position.
7. In certain circumstances, tracing or following the trust property into the hands of the person who received it.

1. It may not be simple to administer, particularly if every party (except those with no obligation to pay a subcontractor) in the contracting chain is required to act as a trustee of funds.¹⁶
2. There may be additional costs associated with administering the trust moneys. For example, there might be a requirement that trust accounts be audited annually.
3. Many contractors may not have the bookkeeping ability to comply with the strict accounting requirements of trust accounts.¹⁷
4. It is effective only to the extent that there is trust property available to meet the claims of beneficiaries:

"It does not guarantee payment where, for example, the contractor or subcontractor has underbid a job or where the right of set-off arises because of an incomplete or deficient job. In the situation of underbidding or of set-off, it is conceivable that a trust beneficiary will not be paid in full even though there has been no breach of trust anywhere in the chain. As long as a trustee pays all trust money he receives, he discharges his obligation even though his beneficiary is not paid in full."¹⁸

5. It affects the cash flow of a head contractor who might otherwise divert payments elsewhere while still being able to meet payments to subcontractors as they fall due.
6. Those higher up the contractual chain may attempt to evade a trust scheme by adopting a residence or domicile or obtaining finance outside the State. However, the State Parliament can enact laws having extra-territorial effect, that is, laws which affect persons, conduct or things outside the State, so long as the law has a sufficient connection with the State.¹⁹

¹⁶ Para 3.16 below.

¹⁷ This could, of course, be dealt with by a training scheme.

¹⁸ Ettinger 393.

¹⁹ See generally R D Lumb, *The Constitutions of the Australian States* (5th ed 1991) 86-89 and P H Lane, *An Introduction to the Australian Constitutions* (6th ed 1994) 209-210.

3.9 If statutory trusts were adopted, a number of issues would need to be addressed. These are discussed below.

(b) Should a trust attach to funds in the owner's hands?

3.10 One means of protecting the head contractor or others involved with a project is to provide that the owner is trustee of the moneys on account of the project for the benefit of the head contractor and for others involved with the project. Bringing the trust into existence at the earliest possible time preserves the funds within the construction chain. If the owner is not a trustee, the time at which the trust arises in relation to the head contractor or a subcontractor is important. In Canada, this is generally when contract moneys are "received" by the contractor. However, difficulties can arise during the time before the contractor obtains physical possession of the moneys. If the trust does not arise until contract moneys are received by the contractor, an attachment order by a third party served before the owner parts with the moneys can prevail over the trust.²⁰ On the other hand, moneys paid into court have been deemed to be impressed with a trust even though the contractor has not physically received them.²¹

3.11 To avoid these difficulties, where the owner intends to pay for the project in whole or part out of a pool of monies held by it, a trust could be created once amounts were "owing" to a contractor "whether or not due or payable"²² or became payable to a head contractor by the owner, for example, on a certificate of payment or on a certificate of substantial performance of the contract.²³

3.12 Part or all of the funds to pay the head contractor under the contract might, however, come from a financier and those funds might be secured by a mortgage or other security. The owner could be required to identify the source of those funds and a trust for the benefit of the head contractor and others involved in the project could apply to them at the time the financier was responsible for making a payment to the owner. That is, at the time the financier

²⁰ Macklem and Bristow 9-21. There is now a statutory reversal of this result in Manitoba: footnote 64 below.

²¹ Macklem and Bristow 9-22.

²² See Ont s 8(1).

²³ See Ont s 7(2)-(3).

was required to advance the funds to enable the owner to meet a progress or final payment to the head contractor, a trust would arise in relation to the funds.²⁴

3.13 This approach was recommended in the Alberta Report.²⁵ It also recommended that the owner should be a trustee of the following funds:

- "(c) subject to a prior claim against the rents, any funds derived by the owner from rental of the land in respect of which the improvement is being made;
- (d) any funds received by an owner from other owners that are to be used for payment of the improvement;
- (e) where there is a sale by the owner of the owner's interest or estate in the land in respect of which the improvement is being made, the funds that are equal to an amount that is the positive difference, if any, between
 - (i) the value of the consideration received by the owner as a result of the sale, and
 - (ii) the reasonable expenses arising from the sale and any amount paid by the owner to discharge any prior registered encumbrance;²⁶
- (f) any funds that are received by the owner for the owner's minerals or the owner's interest in minerals produced from the land on which the work took place or the materials were furnished, where
 - (i) work is done or materials are furnished with respect to the recovery of the minerals, and
 - (ii) money is owing for that work or those materials by the owner to the person who did the work or furnished the materials;
- (g) money paid by a landlord to a tenant as a leasehold inducement or a tenant's leasehold improvement allowance; and
- (h) any proceeds of insurance that are paid to the owner by reason of damage to, or destruction of, the improvement."²⁷

²⁴ In Ontario all amounts received by an owner that are to be used in the financing of the project constitute a trust fund for the benefit of the head contractor: Ont s 7(1). A similar trust arises where an amount becomes payable by the owner on a certificate of payment (Ont s 7(2)) or where substantial performance of a contract has been certified: Ont s 7(3). See also Man s 5(1)-(2).

In Ontario the owner discharges its obligations under the trust when it pays the amount certified for payment to the contractor: Ont s 7(2), (4) and 10.

²⁵ Alberta Report 11.

²⁶ See Ont s 9(1).

²⁷ Alberta Report 11-12. In provinces where the statute creates a trust out of funds received by a contractor, the courts have gone further, to recognise that money still in the hands of the owner may be held on trust. They have done so on the basis of constructive receipt on the ground that "...once moneys are actually owed, although not yet due and payable by an owner to a general contractor, the funds are constructively received by the contractor": Macklem and Bristow 9-5.

(c) Who should act as the trustee?

3.14 In the Canadian Provinces with trust schemes, the trustee is one of the participants in the construction project. If this approach were adopted, the trustee could by writing appoint a person, including a trustee corporation, to be the trustee in its place.²⁸ That trustee might, of course, require the payment of fees and expenses. An alternative would be to create a government body to act as trustee or to appoint a government body such as the Builders' Registration Board or the Public Trustee as the trustee. The use of a government body was rejected by the Smith Report in 1974 because it would be an "administrative nightmare".²⁹ However, in comments on the Queensland Government DP, BISCOA(Qld) favoured a single statutory trust for cash retentions held by a government body and funded from interest earned on the moneys held in trust.³⁰ It considered that this approach had a number of advantages including that there would be -

- * no question of the funds being misappropriated; and
- * fewer spurious disputes than if the funds were held by the builder.

3.15 In the house building industry, if funds in the hands of owners were subject to a trust, making the owner a trustee of funds for a project could present difficulties because many owners would be private individuals who were building their residence. It might be considered to be overly onerous to require them to act as a trustee and take responsibility for the disbursement of funds, particularly if that involved disbursing funds to subcontractors and not just to the head contractor.³¹ They could, of course, appoint a trustee in their place but they might have to pay the trustee's fees and expenses. In this part of the industry it might therefore be preferable to limit the trust obligations to making payments to the builder. Once the funds were received by the builder, the builder would be the trustee in relation to subcontractors.

²⁸ *Trustees Act 1962 s 7(1).*

²⁹ Para 7.36.

³⁰ BISCOA (Qld) 14-15.

³¹ The trust legislation in Ontario does not apply to a "home buyer": Ont s 7(1).

(d) Should there be a single trustee?

3.16 If the trustee were one of the participants in the construction project, rather than a government body, there could be a single trustee or each participant who is under an obligation to pay a contractor (including possibly an owner) could be a trustee. The first approach has been proposed in New South Wales where it has been suggested that the head contractor should be the trustee. The NSW Issues Paper suggested that legislation should be enacted to make mandatory trust clauses in favour of subcontractors:³²

"The trust clause would be inserted in every subcontractor contract and would be to the effect that the main contractor hold all monies received from the owner in respect of subcontractor work in the trust for the subcontractor. The definition of 'subcontractor' should be wider than currently generally accepted by industry and cover all who are not in direct contractual nexus with the project owners for example, professionals who provide service to the main contractor rather than as a principal in contract with the owner."³³

Under this approach, the trustee, whether the owner or head contractor, holds the project funds in trust for all those who contribute to the project even if there is no privity of contract with the owner or the head contractor. The trustee would pay all those involved with the project out of the trust moneys. If the head contractor were the single trustee, it would pay subcontractors out of the trust money and when they had been paid all moneys due, the balance could be transferred to the contractor's own account.³⁴ Under the second approach ("the Canadian approach"), which has been adopted in a number of Canadian Provinces³⁵ and proposed in Alberta,³⁶ each participant in the construction project, including possibly the owner, which holds or receives a payment on account of the contract holds those moneys as a trustee. Generally, the head contractors and subcontractors would make payments from the trust monies to their subcontractors and could transfer the balance to their account once their obligations had been met.³⁷

³² The trust would be reinforced by substantial pecuniary penalties. Compliance with the legislation would be supervised by the NSW Building Services Corporation which could prosecute for breaches of the legislation.

³³ 9.9.

³⁴ For other circumstances in which the trustee might obtain money from the fund see paras 3.23-3.27 below.

³⁵ See, for example, BC s 2(1); Man s 4(1)-(2) and Ont s 8.

³⁶ Alberta Report 11-13.

³⁷ For other circumstances in which the trustee might obtain money from the fund see paras 3.23-3.27 below.

(e) For whom should the trustee hold the funds in trust?

3.17 If the Canadian approach were adopted, each trustee could be required to hold funds in trust only for those with which it had contracted directly (known as the "privity of trust" approach)³⁸ or for all those down the chain from it.³⁹ The arguments for adopting the privity of trust approach are -

1. It is simple. The trustee knows that the beneficiaries are those with which it has contractual privity.
2. It maintains an orderly flow of funds down the chain.⁴⁰

According to Ettinger, its main disadvantage is:

"...rigidity in that a sub-subcontractor or supplier way down the chain has limited ability to bring an action to enforce a trust further up the chain or attach moneys further up the chain. Instead the sub-subcontractor or supplier must wait for funds to 'trickle down'. If a link in the chain is bankrupt or insolvent before receiving trust funds, those further down must wait for a trustee in bankruptcy or receiver to be appointed and then run the risk of having to fight with the trustee in bankruptcy or receiver over what funds are subject to the trust. Also, in the event a link in the chain fails to take action to enforce the trust of which he is a beneficiary, others down the chain may face difficulties in bringing an action to enforce a trust of which they are not beneficiaries. Either they may not be permitted to enforce a trust of which they are not beneficiaries or the court may find itself standing on its head and straining the facts in order to find privity of contract where none really exists."⁴¹

3.18 Rejection of the privity of trust approach and adoption of the approach in which trust funds are held for all those down the chain has the advantage that those further down the chain have greater protection because they can obtain trust money directly when there is a problem with a contractor higher in the chain or they can attempt to prevent a breach of trust. However, if more than one participant in the construction project is required to act as a trustee two problems need to be addressed -

³⁸ This approach has prevailed in Manitoba, Saskatchewan and Ontario (Ettinger 408-411) and has been proposed in Alberta: Alberta Report 39.

³⁹ This approach has been adopted in New Brunswick and British Columbia: Ettinger 411-412.

⁴⁰ Ettinger 416.

⁴¹ Ibid.

- * Should moneys received by one subcontractor be held in trust for those in the chain below another subcontractor? If the moneys received by one subcontractor were trust funds for those claiming under other subcontractors it would be difficult to identify all the beneficiaries and to sort out the priorities. In Canada the problem of identifying beneficiaries has been dealt with by holding that a claimant:

"...cannot claim against moneys received by a collateral subcontractor who has received moneys from the head contractor for to do so would result in the workmen, materialmen and subcontractors of that collateral subcontractor being denied payment of moneys which are properly theirs. To put it perhaps in a colloquial way the claims...may be made vertically but not laterally."⁴²

- * How does the trustee discharge its obligations to the beneficiaries? In Canada this problem has been dealt with by holding that a trustee's obligations to the beneficiaries are fully discharged when the trustee has fully paid the parties with whom it contracted.⁴³ This means, for example, that an unpaid supplier of a subcontractor is not entitled to be paid from any contract moneys in the hands of the head contractor if the head contractor has already paid the subcontractor all moneys due and owing to it. When the trust is insolvent, the trustee can discharge its obligations to the beneficiaries by distributing the funds on a pro rata basis.⁴⁴

3.19 Irrespective of the approach adopted problems can arise in determining whether a particular person is a beneficiary of the trust.⁴⁵ For example, in the absence of an express statutory provision, it has been held in Canada that a person who merely rents equipment to be used on a project is not a beneficiary of the trust.⁴⁶

⁴² *Cronkhite Supply Ltd v Workers' Compensation Board et al; Fidelity Insurance Co of Canada, Third Party* (1978) 91 DLR (3d) 423, 432.

⁴³ See Ettinger 412.

⁴⁴ Para 3.29 below.

⁴⁵ See generally Macklem and Bristow 9-12 to 9-18.

⁴⁶ Macklem and Bristow 9-12. In all provinces, it has now been expressly provided that these persons are beneficiaries of the various trust funds: *ibid*.

(f) Should the trustee be required to keep a separate trust account?

3.20 One limitation on the effectiveness of a trust scheme is that unless there is a requirement for a separate trust account⁴⁷ (and the trustee complies with it) the trust funds could become mixed with other money and therefore be unidentifiable. According to Ettinger a requirement for a separate trust account will:

"...effectively eliminate a problem in [Canadian Provinces] where a contractor pays trust money into his general account and his bank takes the money to cover the contractor's previous indebtedness to the bank. As long as the bank did not have notice, actual or constructive, that the funds were subject to a trust, the bank is entitled to the moneys."⁴⁸

3.21 One consequence of a requirement for a separate trust account is that it should discourage practices such as paying past accounts or financing new projects with payments for a current project. However, as Ettinger points out:

"The requirement of a separate trust account may seem onerous to those contractors and subcontractors who rely on the ability to borrow funds using accounts receivable as collateral. This is less of a problem than it appears for two reasons: 1) if the bank is lending money on the basis of accounts receivable, it is already taking into account the customer's accounts payable and basically the trust obligations are the accounts payable, and 2) if the money is lent for the purpose of paying trust beneficiaries, the customer is able to repay the bank from trust funds without committing a breach of trust."⁴⁹

⁴⁷ In a number of cases in England dealing with a trust for retention moneys under standard form contracts it has been held –

1. As the contractor was to be treated as a fiduciary in relation to retention moneys, it was under a duty to set the retention moneys aside in a separate account: *Wates Construction (London) Ltd v Frantham Property Limited* (Unreported) referred to in F Fitzpatrick 'Retention Funds in Building Contracts' [1991] *New LJ* 1007, 1007. A mandatory order can be made by a court requiring the contractor to set aside as a separate trust fund a sum equal to that part of the sum certified in any interim certificate by an architect as being retention money: *Rayack Construction Ltd v Lampeter Meat Co Ltd* (1979) 12 BLR 34, 38.
2. In the case of a **solvent** contractor, the equitable maxim that equity looks on that as done which ought to be done can come to the aid of a subcontractor and the contractor is deemed to have held retention moneys on trust: *Re Arthur Sanders Limited* (1981) 17 BLR 125, 136.
3. The effect of **insolvency** is that if the fund has not been set aside, no injunction will be ordered to constitute it and the maxim of equity looking on that as done which ought to be done will not apply: *Re Jartay Developments Ltd* (1982) 22 BLR 134, 136.

⁴⁸ Ettinger 398. Many cases in Canada deal with the question of whether or not the bank was aware of the nature of the funds. A statutory trust itself does not constitute notice of a trust: Macklem and Bristow 9-28. If a bank is aware that the funds are trust funds, the bank is a participant in a breach of trust which makes it liable to the beneficiaries. In any case, the trustee is in breach of the trust for failing to preserve trust assets. If the trustee is a corporation, its officers and directors who are its operating mind will be personally liable: *ibid* 9-50 to 9-51.

⁴⁹ Ettinger 428. As to the second point see para 3.25 below.

(g) Should there be a consolidated trust account?

3.22 If a trust account separate from the trustee's general account were required, the trustee could be allowed to keep a consolidated trust account, that is, one account into which all trust moneys in respect of all projects should be deposited. It may, however, be preferable to require the trustee to keep a separate trust for each project. In Canada it has been held that if accounts have been mingled so that a number of subcontractors from different projects can trace moneys to that one mingled account, they are all on an equal footing and are entitled to payment out of the account rateably. If, however, the moneys are clearly identifiable and traceable to one of the projects, the recovered sum is deemed to be impressed with a trust in favour of the subcontractors of that project.⁵⁰

(h) When should the trustee be entitled to receive or use funds held in trust?

3.23 The simplest option is to provide that a trustee who is the head contractor or a subcontractor is entitled to the balance of the trust funds when the project is completed, so long as all obligations to subcontractors have been met.⁵¹ Another option is to allow such a trustee to receive or use funds held in trust where the trust account balance exceeds the moneys owing to the beneficiaries of the trust. This would enable the trustee to withdraw funds to meet its own overheads or profit. To provide otherwise could cause financial hardship to trustees, particularly on projects which extended over a lengthy period of time.

3.24 In some circumstances the owner, head contractor or subcontractor might pay for materials, service, labour or rented equipment for the project out of its own funds. In these cases it might be argued that it is fair to provide that a withdrawal from the trust fund of an amount equal to the sum paid does not constitute a breach of trust.⁵²

3.25 In other cases a trustee might meet its obligations to contractors and others out of borrowed money. For example, a contractor who wished to pay its subcontractors, but which had not received sufficient money from the owner at the time to do so, might obtain a loan or

⁵⁰ Macklem and Bristow 9-15.

⁵¹ In this case, the trustee would receive the balance of the fund including any interest which had accrued on the money held in the trust fund.

⁵² This is the case, for example, in Ontario: Ont s 11(1).

an overdraft facility from a financial institution to pay the subcontractors, the expectation would be that the debt would be repaid once the owner eventually paid the contractor. In these circumstances it is reasonable that, once a payment of funds for the trustee is received from the owner, trust moneys should be used by the trustee to discharge the loan to the extent that the lender's money was used by the trustee to pay in whole or part for work done,⁵³ particularly as it does not reduce the funds flowing down the chain.

3.26 A final circumstance in which a trustee might be allowed to appropriate trust funds is where the head contractor or a subcontractor is liable to pay the trustee money for outstanding debts, claims or damages either -

- (i) unrelated to the project; or
- (ii) only when related to the project.⁵⁴

That is, a trustee could be allowed to set-off against trust funds due to the head contractor or a subcontractor any counterclaim it may have against the contractor either in relation to the project or to any project.⁵⁵ If there will be a deficiency as a result of the set-off, the question arises as to who is to bear the loss. For example, if the head contractor defaults the loss will need to be borne by either the owner or, if the owner is permitted to set-off the head contractor's damages against the amount owing to it, the subcontractors. If the owner's liability is to be no more than the contract price it will be the subcontractors who bear the loss.⁵⁶

3.27 If a contractor or subcontractor abandoned a contract relating to the project, the costs of completion of the project or damages resulting from delayed completion might increase the

⁵³ S 11(2) of Ont provides, for example:

"Subject to Part IV, where a trustee pays in whole or in part for the supply of services or materials to an improvement out of money that is loaned to the trustee, trust funds may be applied to discharge the loan to the extent that the lender's money was so used by the trustee, and the application of trust money does not constitute a breach of trust."

See also Man s 6(1) which allows trust money to be applied to discharge a loan to the extent that the lender's money is used to meet obligations in relation to the project. The trustee must actually elect to make repayment to the lender and the whole of the money so repaid must be used for the project to which the trust relates: Macklem and Bristow 9-31.

⁵⁴ In Ontario, the set-off may apply to debts, claims or damages whether or not related to the project: Ont s 12.

⁵⁵ For the position in a number of Canadian Provinces see Ettinger 405-406. In Manitoba the owner discharges its obligations under the trust when it pays the contractor "all sums justly owed to him in respect of the performance of the contract" but it is required to see that "provisions for the payment of other affected beneficiaries of the trust has been made": Man 5(3).

⁵⁶ This is the position which has usually prevailed in Canada: Ettinger 407.

cost of the project to the owner. A set-off by the owner of any increased costs would decrease the funds flowing down the construction chain though it might be insufficient to recover the total loss. It might be argued that it is unfair to allow the owner's right of set-off to be used to deny payment to an unpaid subcontractor because those further down the contractual chain from the defaulter should not suffer a loss as a result of the increased costs of the project when they had no say in the choice of the defaulting party as a participant in the project. The owner's choice of a head contractor should not be a risk assumed by a subcontractor. The owner's right to set-off could therefore be limited to the balance of the fund after the sums due to the beneficiaries of the trust had been met, but it could insure against any loss it might suffer or protect itself by demanding a performance bond from the head contractor.

(i) How should trust funds be distributed to beneficiaries?

3.28 The timing of payments by a trustee to the beneficiaries is important. It would be influenced, however, by whether a trustee should be required to maintain an even hand, for example, by a rule as to the distribution of trust funds which required that the beneficiaries be paid on a pro rata basis. In Canada, a trustee is not required to maintain an even hand among the beneficiaries, at least where the claims of the beneficiaries do not exceed the amount available for distribution.⁵⁷ The reason for this is that:

"...contractors must be able to pay their subcontractors and suppliers as the work proceeds and not be in breach of the trust even if some beneficiaries end up not being paid in full. As long as the contractor has paid out all the trust funds to trust beneficiaries, he will have discharged his trust obligations. The alternative would be for the contractor to withhold payment from all beneficiaries until the end of construction when he could be sure of ascertaining all the beneficiaries and their *pro rata* portion. This would be a commercially unacceptable impediment to the flow of funds, and one would assume, contrary to the intent of the legislation."⁵⁸

Adoption of a different rule in Western Australia would involve a significant departure from existing practice which often involves the making of progress payments as a project proceeds to completion and not a single payment when a project is completed or when a subcontractor completes its work.

⁵⁷ See Ettinger 403-405. See Ont s 10.

⁵⁸ Ettinger 404.

(j) How should trust funds be distributed to beneficiaries if the trust fund is insolvent?

3.29 Cases may arise in which the trust fund is in fact insolvent⁵⁹ so that there are insufficient funds to satisfy the claims of the beneficiaries of the trust. In these cases, the fairest approach would be to require that the trust fund be distributed amongst its beneficiaries on a pro rata basis. This would also be consistent with rules of equity under which impartiality between the beneficiaries is the guiding principle.⁶⁰ It is a logical, just and workable rule.⁶¹ If this approach were not adopted, the Commission welcomes comments on what rules should apply to the distribution of trust funds if the fund is insolvent.

(k) Priority as between trust beneficiaries and a judgment creditor who has obtained an attachment order

3.30 If the owner were not the trustee of funds for a project, debts owing or accruing from a third party (such as an owner) to a defendant (such as a contractor or subcontractor) against whom any person has obtained a judgment or order for the recovery or payment of money may be attached to meet the judgment or order.⁶² If the trust did not come into being until the contract money for a project was received by the contractor⁶³ from the owner, the effect of the attachment order might be that the money would never actually be received by the contractor. That is, the trust would never attach to the contract money. It might be argued that it is inconsistent with the policy of a trust scheme to give a judgment creditor a greater right against the garnishee (for example, the owner) than it would have against the contractor which was indebted to it and that if the contractor's right of disposal of contract moneys is subject to a trust, the right of a judgment creditor to the moneys should also be so restricted.⁶⁴ The

⁵⁹ See *Guarantee Trust Co of Canada v Beaumont* [1967] 1 OR 479 (CA) referred to in Macklem and Bristow 9-52.3 in which it was held that a trust fund must be distributed rateably "...once the builder had abandoned the project ...because, although he had not been formally declared bankrupt, he was in fact insolvent."

⁶⁰ R P Meagher QC and W M C Gummow *Jacobs' Law of Trusts in Australia* (5th ed 1986) para 1901. See also Ettinger 404.

⁶¹ Unlike the *Clayton's case* rule which allocates funds in an account on a "first in - first out" basis: see *Re Eastern Capital Futures Ltd (in liquidation)* [1989] BCLC 371 and *Re Ontario Securities Commission and Greymac Credit Corporation* (1986) 30 DLR (4th) 1.

⁶² *Supreme Court Act 1935* s 126(1); *Local Courts Act 1904* s 145.

⁶³ Or one of the others in the contractual chain.

⁶⁴ In Manitoba, for example, trust money is protected from attachment. Man s 6(2) provides:

"Where money owing to a contractor or sub-contractor in respect of the contract price under a contract or sub-contract would, if paid to the contractor or sub-contractor, be subject to a trust... the money is not subject to garnishment under The *Garnishment Act*."

attachment order would still apply to money the trustee was entitled to receive from the trust once its obligations to beneficiaries of the trust had been satisfied.⁶⁵

(l) Priority as between trust beneficiaries and an assignee of an account

3.31 One practice is for a contractor⁶⁶ who borrows money or has a line of credit with a supplier to make an assignment of present or future accounts as security for the loan or line of credit. However, to allow assignees of contract moneys to retain those moneys free of the trust would provide an opportunity to defeat the policy of the trust provision. It is also inconsistent with the general policy of trust schemes which is to keep contract money within the construction chain. For these reasons, it might be argued that an assignee should take money subject to any trust which would attach to those moneys in the hands of the assignor.⁶⁷

(m) Information and training as to trust obligations

3.32 For a trust scheme to be effective, it is important that those responsible for handling trust funds have at least a basic knowledge and understanding of the obligations of a trustee. It might therefore be desirable to develop a training course dealing with the obligations and requirements for maintaining and operating a trust account. So far as builders are concerned, registration as a builder could be conditional on passing a test demonstrating an elementary understanding of trust obligations and requirements. Others in the industry, such as subcontractors, who handled trust funds could also be required to obtain a licence, by passing the test, before being able to operate in the industry.

(n) Should a breach of trust be sufficient reason to suspend or revoke the registration of a builder?

3.33 One means of increasing the effectiveness of a trust scheme would be to make failure to comply with a trust scheme a ground for disciplinary action against a builder. To be fully effective it would be necessary for the revocation of the registration of a corporate builder to apply also to those who were directors of the corporation at the time so that another

⁶⁵ See para 3.23 above.

⁶⁶ Or one of the others in the contractual chain.

⁶⁷ In Manitoba Man s 6(3) provides that no assignment by a contractor or subcontractor of any moneys due or to become due on account of the contract price is valid as against any trust created under the Act. Where a right to payment of moneys which are subject to a trust is assigned, the moneys received by the assignee are subject to the trust and the assignee is the trustee: Man s6(4).

corporation with one of those persons as a director could not obtain registration. Otherwise, the disreputable could "hide behind an ever-shifting corporate veil."⁶⁸

(o) Should a special limitation period, say 12 months, be provided for the enforcement of the trust scheme?⁶⁹

3.34 Under the existing law no specific limitation periods apply to actions against trustees: the appropriate limitation period is that which would have applied if the defendant had not been a trustee.⁷⁰ As the scheme would confer a special privilege, it might be reasonable to require those who benefit from the scheme to make a claim promptly, say within 12 months of the completion, abandonment or other discharge of the contract. A special limitation period could be justified because, unlike other types of trust, a breach is likely to be discovered quickly. If a beneficiary is not paid under the trust he will be aware of it within a short period of time of the breach of trust.

(p) Who should be liable for a breach of trust?

3.35 Another means of increasing the effectiveness of a trust scheme would be to require every director, officer, employee, agent or other person having effective control of a corporation who might be responsible for a breach of trust to be liable for the breach.⁷¹ Such a requirement⁷² would have the effect of lifting the corporate veil and ensuring that those who are in effective control of the corporation are personally liable for breaches of trust.⁷³

⁶⁸ Ettinger 428.

⁶⁹ Such a period was recommended in the Newfoundland Report: 103-106. In Manitoba, a short limitation period of only 180 days after the date upon which the person bringing the action first became aware of the breach of trust is provided: *Man s 8*.

⁷⁰ *Limitation Act 1935 s 47*. See Law Reform Commission of Western Australia Discussion Paper on *Limitation and Notice of Actions* (Project No 36 Part II 1992) paras 4.67-4.71 and the discussion of the effect of fraud at paras 5.35-5.40.

⁷¹ For a detailed discussion of the personal and proprietary remedies for a breach of trust see H A J Ford and W A Lee, *Principles of the Law of Trusts* (2nd ed, 1990) 725-772.

⁷² See the Newfoundland Report 96-97 and Ont s 13(1) which provides:

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

(a) every director or officer of a corporation; and

(b) 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."

⁷³ It might, however, be necessary to extend s 75 of the *Trustees Act 1962* to such persons. It provides that trustees who are personally liable for a breach of trust may be relieved of liability by the Supreme Court either wholly or partly if they have acted "honestly and reasonably".

(q) Disputes relating to trust money

3.36 At present, any person who has an interest in any trust property and is aggrieved by any act, omission or decision of a trustee in the exercise of any power conferred by the *Trustees Act 1962* may apply to the Supreme Court to review the act, omission or decision or to give directions in respect of any apprehended act, omission or decision.⁷⁴ The Commission suggests that, should provision be made for a statutory trust, a similar power be provided to allow disputes with respect to the trust to be dealt with by the Supreme Court.

3.37 Apart from such a power, a person dissatisfied with the conduct of a trustee could apply for the appointment of a new trustee.⁷⁵ The Supreme Court may make an order appointing a new trustee in substitution for a trustee who "has... misconducted himself in the administration of the trust".⁷⁶ The Court may also appoint a receiver of trust property "where that is necessary for the well-being of the trust."⁷⁷

(r) Criminal offence

3.38 To provide greater protection for trust moneys, apart from the civil remedies for breach of a trust, it could be made an offence for every person upon whom a trust is imposed knowingly to appropriate or convert any part of any trust moneys to his own use or any use not authorised by the trust.⁷⁸ It could also apply to every director or officer of a corporation who knowingly assented to or acquiesced in any such offence by the corporation. Reliance could, however, be placed on the *Criminal Code* which provides that it is a crime for any person, with intent to defraud, by deceit or any fraudulent means to cause a detriment, pecuniary or otherwise, to any person.⁷⁹ However, the proposed offence would be easier to prove because it would not require proof of an intent to defraud.

⁷⁴ *Trustees Act 1962* s 94(1).

⁷⁵ *Ibid* s 77(1).

⁷⁶ *Ibid* s 77(2)(b).

⁷⁷ H A J Ford and W A Lee, *Principles of the Law of Trusts* (2nd ed 1990) 776.

⁷⁸ Such an offence is provided in Provinces in Canada: see, eg, BC s 2(2); Man s 7.

⁷⁹ S 409(1)(d).

3. PAYMENT BONDING OR GUARANTEES

(a) Introduction

3.39 Under a payment bonding or guarantee scheme, a head contractor is required to obtain a bond from an insurance company or bank guaranteeing the payment of all subcontractors and employees.⁸⁰ Payment bonding is used in many States of the United States of America though its purpose may be to provide protection for those higher up in the contractual chain because suppliers, subcontractors and employees have a right to place a lien over a construction project. To avoid this, it is in the interests of owners to ensure that those with a right to a lien are paid by requiring head contractors and subcontractors to provide bonds for the payment of their creditors and employees. Payment bonds could, however, be used to protect the financial interests of subcontractors.

3.40 A payment bonding scheme could also apply to owners so that they could be required to obtain a bond to protect the head contractor. At least one of the standard form contracts⁸¹ provides an option for the owner to provide security to the contractor. This contract provides for the security to be in various forms including a bond or an unconditional undertaking given by an approved financial institution or insurance company.⁸² In some areas of the industry, such as the home building industry which does not involve a tender process, this might be considered to be unnecessary because generally finance for the project will be secured before a project proceeds and the head contractor can require that proof of the approval of the finance be provided before work commences.⁸³

3.41 This is not the case where the head contractor is required to tender for a project. For this reason, payment bonding might be considered to be desirable in this area. An alternative approach would be to require the owner to provide a statement of adequate project funding arrangements when a tender is called. Such a recommendation was made in the CIDA Report.⁸⁴ The CIDA Board did not endorse this recommendation in precisely these terms. It recommended that an owner should be under an obligation to provide tenderers with a

⁸⁰ That is for work and materials supplied, not damages for loss of a contract or other more remote losses.

⁸¹ AS 2124-1992 cl 5.2.

⁸² Ibid cl 5.3.

⁸³ Such proof might be in the form of an undertaking by a financial institution that it will advance the funds for the project. If the funds are to come from the owner's own resources, proof can be sought of the existence of those funds, for example, in the form of bank statements.

⁸⁴ Recommendation 5.

statement of how it proposes to fund the project.⁸⁵ The statement would be provided by an officer of the company who was in a position to know the facts of the statement. It also recommended that the Code of Tendering (Interim Australian Standard AS 4120) be amended to "...accommodate the obligation for the client to provide tenderers with a statement of how it proposes to fund the project."⁸⁶ So far as standard contracts are concerned, it recommended that consideration be given to inclusion in the contracts of:

- "• a provision that the principal be required to provide evidence of adequate project funding, as a pre-condition to commencement of work under the contract; and
- of a warranty as to the principal's capacity to pay the contract sum."⁸⁷

3.42 Payment bonds have the following advantages -

1. They do not interfere with the way the parties wish to organize the building project or with the flow of cash down the pyramid to subcontractors.
2. They are simple to administer if there is one bond covering all those involved with the construction project. They might not be as simple to administer if each person in the contractual chain⁸⁸ were required to enter into a bond.

3.43 On the other hand, they have the following disadvantages -

1. The premium may be substantial⁸⁹ and in addition the insurance company may demand an indemnity from the owner or head contractor secured by a charge over its assets. This may have the effect of driving smaller builders from the industry or excluding them from some parts of the industry. Those that did not have the money "up front" for the premium would also be prevented from undertaking projects.

⁸⁵ Recommendation 5.

⁸⁶ Recommendation 6.

⁸⁷ Recommendation 7.

⁸⁸ Para 3.45 below.

⁸⁹ According to the Queensland Government DP 61 based on the experience in the USA, the premium could be between 1% and 2% of the project sum. Builders who are more financially, technically and managerially competent might obtain insurance at more competitive rates than less competent builders.

2. Insurance companies might in effect operate as de facto licensors since inability to obtain a bond would disqualify a builder from operating.⁹⁰ This might, however, lead to a more stable industry by eliminating those that are a poor risk.
3. The costs of a bonding scheme would add to the costs borne by head contractors, which no doubt would be passed on in higher contract prices.
4. The Queensland Government DP suggests that "phantom policies" might be provided.⁹¹ To prevent this "...the fundamental terms of such policies would need to be set out in the legislation, or alternatively, certain policies could be approved by the builders' licensing authority."⁹²
5. Subcontractors whose claims were resisted after an owner or head contractor had defaulted "...would find themselves in a dispute with an insurance company of considerable size and stake in the precedents set by any judgments...[T]his does not auger well for the chances of small subcontractors in insisting on payment by the insurer."⁹³ One way of dealing with this problem would be to provide for a special tribunal, such as the Commercial Tribunal, to deal with claims made by the subcontractor against the surety.

3.44 If payment bonds were adopted a number of issues would need to be addressed. These are discussed below.

(b) Who should be required to obtain a bond?

3.45 If payment bonding were introduced, there could be one bond obtained by the owner or head contractor covering all contractors regardless of the participant's position in the project's contractual chain or every intermediate person in the contracting chain with

⁹⁰ In the USA underwriters conduct stringent assessments of builders prior to underwriting their projects: Queensland Government DP 60.

⁹¹ Queensland Government DP 60.

⁹² Ibid.

⁹³ Ibid 61. According to the Newfoundland Report 31 payment bonding can result in lengthy and unsatisfactory litigation.

obligations to others could be required to obtain a separate bond.⁹⁴ A separate bond may be the best approach because a surety issues its bond following an investigation and evaluation of the obligee's financial position. It would be unreasonable to require the surety to bear the burden of guaranteeing the financial soundness of remote participants in the project whose existence was unknown to the surety when it issued the bond and over which the owner or head contractor had no power of selection or control. As the Law Reform Commission of British Columbia pointed out, to require the surety to guarantee not only the debts of the owner or head contractor but also others down the chain:

"...would make the degree of risk of the guarantor difficult to estimate, it would make it more difficult for a contractor to obtain a guarantee and it might result in the realization of the fear... That the bonding companies would, as to certain projects, exercise a power of veto over subcontractors. This is because the contractor would not merely be exercising his right to prefer subcontractors who can obtain bonding to those who cannot, but because the contractor might not himself be able to obtain bonding unless his subcontractors were approved by the surety."⁹⁵

(c) Would it be necessary to nominate a single insurer as the construction industry project insurer?

3.46 The Queensland Government DP suggests that it may be necessary to nominate⁹⁶ a single insurer as the construction industry project insurer due to the size of the premium pool and the extent of the risk.⁹⁷ Inquiries by the Victorian Statute Law Revision Committee in 1975 indicated that insurance companies did not want to engage in payment bonding because of the "cost liability factor".⁹⁸ Banks also were unlikely to be willing or able to undertake payment bonding.⁹⁹

(d) Limiting the amount of the payout on a claim

3.47 One means of reducing the cost of the scheme would be to restrict the insured proportion of the subcontractors' claims to sums less than 100%, say 80%. As the Queensland Government DP points out:¹⁰⁰

⁹⁴ That is, the right to sue on the payment bond could be limited to those in contractual privity with either the head contractor or a subcontractor who obtained a payment bond.

⁹⁵ Report on *Debtor Creditor Relationships: Part 2 Mechanics' Lien Act: Improvements on Land* (1972) 74.

⁹⁶ The nomination could be reviewed periodically to ensure that the service being offered was competitive.

⁹⁷ 60.

⁹⁸ VSLRC Report para 54.

⁹⁹ Id para 56.

¹⁰⁰ 60.

"An 80% limit would certainly reduce the cost to the builder of providing the insurance cover, but....effectively denies to the subcontractor any cover for his profit component. It would be possible, although one would think rather inefficient, for subcontractors to take top-up cover for themselves. 80% would probably allow subcontractors to pay staff and suppliers and keep operating in all but the most marginal of cases."

(e) Should an excess, say of \$500-\$1000, be provided?

3.48 Another means of reducing the cost of the scheme would be to impose an excess of say \$500-\$1,000 on claims. Otherwise, the cost of administering claims for less than this amount would reduce the viability of the scheme.

(f) Notification of default in an insurance policy

3.49 One possible difficulty with a payment bonding or guarantee scheme is that an owner, head contractor or subcontractor might default in its insurance policy. If this occurred, the insurance company could be required to notify the Builders' Registration Board, the owner, head contractor and subcontractors. This would enable those who needed to take steps to protect their own interests to do so.

(g) Time limitations on claims

3.50 Unless otherwise provided, the time limit on a claim under a bond or guarantee would be twenty years if a deed¹⁰¹ or six years if a simple contract.¹⁰² To provide some protection for sureties against claims by unknown remote subcontractors if there was only one bond covering all subcontractors, a special time limit on the period within which a subcontractor could take action on a bond, for example, within six months of the final settlement or abandonment of the head contract could be provided.

(h) Distribution of proceeds

3.51 In some cases the proceeds of a bond may be insufficient to satisfy all claims. It would be more equitable if all claimants received payment of the bond proceeds on a pro rata basis.

¹⁰¹ *Limitation Act 1935* s 38(1)(e)(i).

¹⁰² *Ibid* s 38(1)(c)(v).

(i) Inspection of a bond

3.52 Those interested in a bond might wish to have details of its contents. This could be done by giving all interested parties a right to inspect a bond at the owner's or head contractor's business address or the head contractor's site office (if it has one).

4. MANAGED CONTRACTS WITH DIRECT PAYMENT

3.53 Another approach is to require the participants in a building project to enter into a contractual relationship which more accurately reflects modern building practice by which most builders have become little more than project managers. In the mid 1970's a number of substantial buildings were constructed on that basis, usually by insurance companies and other large businesses who wanted to avoid any embarrassment which might arise if the builder collapsed. Under this arrangement, the builder by the terms of the contract acted purely as a manager for a percentage of the contract price and the owner paid the subcontractors direct, there being direct contracts between the owner and the individual contractors.¹⁰³ However, it seems to be only possible to organize a project in this fashion if the owner is a large commercial organization able to handle the accounting side of the project. Even then it might not want the high degree of involvement that is required by such a scheme. It would be particularly unsuitable for the home building industry. One way of avoiding the direct involvement is through a covenanting scheme which is discussed under in the following heading.

3.54 According to the Queensland Government DP:

"Even where progress payments pass through the manager's hands, managed contracts offer a better protection for 'subcontractors' because the work is identified in relatively small lump sum packages and is progressively paid for on an audited cost-incurred basis, with the manager receiving his/her fee proportionally. The risk to the subcontractor of the manager's default/insolvency can be completely eliminated by a system of direct payment upon certification by the manager."¹⁰⁴

¹⁰³ Strictly, it would be a misnomer to call them "subcontractors".

¹⁰⁴ Queensland Government DP 32.

3.55 Possible difficulties with this approach are -

1. There could be disputes between the builder and the owner on the quality of the work of a subcontractor and the right of the subcontractor to payment.
2. A subcontractor might approach the owner directly where there is a dispute between it and the builder as to the quality of the work and the right of the subcontractor to payment.
3. The fact that there was no contract between the subcontractor and the builder could make it difficult for the builder to maintain the quality of work.
4. It provides no protection if the owner becomes insolvent.

3.56 The use of managed contracts was examined in the CIDA Report. It recommended that where a project manager is acting as agent for a disclosed principal and holds identifiable certified funds due to trade contractors, suppliers or consultants, those funds should be held in a common identifiable trust account in a financial institution.¹⁰⁵ It also recommended that the main contract and the trade, supply and consultant contracts should clearly identify with whom the trade contractor, supplier and consultant is in contract and whether the construction manager is an agent for a disclosed or undisclosed principal.¹⁰⁶

5. COVENANTING

3.57 A covenanting system attempts to alleviate the late payment or nonpayment of subcontractors by having payments normally paid to a head contractor paid to a covenanting agency,¹⁰⁷ which then disperses this money to the head contractor and subcontractors. The head contractor does not handle any payments to subcontractors.

3.58 Covenanting has the advantage that it assures prompt payments to subcontractors. It has the following disadvantages -

¹⁰⁵ Recommendation 33. This recommendation was endorsed by the CIDA Board as recommendation 31.

¹⁰⁶ Recommendation 34. This recommendation was endorsed by the CIDA Board as recommendation 32.

¹⁰⁷ It would, of course, be necessary to ensure that there were agencies, such as insurance companies, that would be interested in operating as a covenanting agency.

1. The covenanting agency would charge a premium that would be passed on to either the owner or those receiving the payments.
2. The system would be complex. The head contractor might be required to submit a more detailed tender than is customary in the building industry showing the portions of the contract to be performed by subcontractors. When lodging claims for progress payments with the covenanting agency the head contractor would need to segregate the claim to show the amounts owing to it and to subcontractors.

6. IMPLIED CONDITIONS

(a) Introduction

3.59 At present, protection for payments to subcontractors is provided in some standard form contracts.¹⁰⁸ For example, clause 10.5 of AS 2124-1992 provides protection for "Nominated Subcontractors":¹⁰⁹

"In respect of Nominated Subcontract Work performed by a Nominated Subcontractor, the Principal shall make payment directly to the Nominated Subcontractor. Except where the Contractor has accepted an assignment of the benefit of a prior contract made between the Principal and a Nominated Subcontractor-

- (a) such payment shall be made on behalf of the Contractor; and
- (b) if the Contractor reasonably requests the Principal in writing not to make a payment to the Nominated Subcontractor, the Principal shall withhold payment but under no circumstances, including bankruptcy or winding up of the Contractor, shall payment be made to the Contractor.

The Principal as stakeholder shall hold retention moneys and security provided by a Nominated Subcontractor and shall disburse or apply the retention moneys or security as jointly requested by the Contractor and the subcontractor or in accordance with the decision of an arbitrator or Court."

¹⁰⁸ Examples of standard form contracts are AS 2124-1992 (prepared by the Standards Association of Australia), NPWC 3 (prepared by the National Public Works Conference) and JCC-C 1994 (prepared by the Joint Contracts Committee). Most standard form contracts have companion subcontracts which contain like conditions for the same matters. Special conditions may, however, be incorporated in contracts and subcontracts. Non-standard contracts are also used.

¹⁰⁹ A Nominated Subcontractor is a subcontractor to whom the head contractor is directed by the owner's representative, the Superintendent, to subcontract nominated work.

3.60 One approach to reform involves providing statutorily that certain conditions shall be implied in all contracts to provide protection for head contractors or subcontractors. Implied conditions are not novel in the building industry where the *Home Building Contracts Act 1991* contains a number of implied conditions.¹¹⁰ The following paragraphs contain a discussion of a number of clauses which could statutorily be made implied conditions.

(b) "Proof of payment" clauses

3.61 AS 2124-1992 provides protection for subcontractors by means of a proof of payment clause. Clause 43 of this standard contract provides:

- "(a) Before the Principal makes each payment to the Contractor, the Superintendent may, not less than 5 days before a Payment Certificate is due, in writing request the Contractor -
- (i) to give the Superintendent a statutory declaration by the Contractor or, where the Contractor is a corporation, by a representative of the Contractor who is in a position to know the facts declared, that all workers who have at any time been employed by the Contractor on work under the Contract have at the date of the request been paid all moneys due and payable to them in respect of their employment on the work under the contract; and
 - (ii) to provide documentary evidence to the Superintendent that at the date of the request all workers who have been employed by a subcontractor of the Contractor have been paid all moneys due and payable to them in respect of their employment on the work under the Contract.
- (b) Not earlier than 14 days after the Contractor has made each claim for payment under Clause 42.1, and before the Principal makes that payment to the Contractor, the Contractor shall give to the Superintendent a statutory declaration by the Contractor or, where the Contractor is a corporation, by a representative of the Contractor who is in a position to know the facts declared, that all subcontractors have been paid all moneys due and payable to them in respect of work under the Contract.
- (c) If the Contractor fails -
- (i) within five days after a request by the Superintendent under Clause 43(a), to provide the statutory declaration, or the documentary evidence (as the case may be) required pursuant to Clause 43; or
 - (ii) to comply with Clause 43(b),

¹¹⁰ S 9.

notwithstanding Clause 42.1, the Principal may withhold payment of moneys due to the Contractor until the statutory declaration or documentary evidence (as the case may be) is received by the Superintendent.

If the Contractor provides to the Superintendent satisfactory proof of the maximum amount due and payable to workers and subcontractors by the Contractor, the Principal shall not be entitled to withhold any amount in excess of the maximum amount.

At the written request of the Contractor and out of moneys payable to the Contractor, the Principal may on behalf of the Contractor make payments directly to any worker or subcontractor.

If any worker or subcontractor obtains a court order in respect of moneys referred to in Clause 43(a) or (b) and produces to the Principal the court order and a statutory declaration that it remains unpaid, the Principal may pay the amount of the order, and costs included in the order, to the worker or subcontractor and the amount paid shall be a debt due from the Contractor to the Principal.

After the making of a sequestration order or a winding up order in respect of the Contractor, the Principal shall not make any payment to a worker or subcontractor without the concurrence of the official receiver or trustee of the estate of the bankrupt or the liquidator as the case may be."

3.62 This clause may be contrasted with a "pay after paid" clause which provides that a head contractor's obligation to pay its subcontractors arises only when it has received payment from the owner or principal. "Pay after paid" clauses are of two general types: those that deal with the right to be paid ("pay if paid ") and those that deal with the time for payment ("pay when paid"). If the clause deals with the right to be paid, a subcontractor has no right to be paid for its work until, for example, the head contractor receives payment from the owner. However, if a "pay after paid" clause only stipulates the time for payment, for example, when the contractor receives payment from the owner under the head contract, it does not alter the head contractor's obligation to pay the subcontractor. If the timing provision fails, for example because of the insolvency of the owner, the head contractor would be under an obligation to pay the subcontractor within a reasonable time.¹¹¹ "Pay after paid" clauses have three unfair aspects. First, payment of the subcontractor is delayed until the head contractor receives a payment from the owner.¹¹² Secondly, the subcontractor bears the risk of the owner's liquidity even though it might not be reasonable to expect the subcontractor to inquire into the financial position of the owner, a participant in the project with which it has no contractual relationship. Nor could it reasonably be expected to take that risk into account in fixing the price for its

¹¹¹ See generally D S Jones, 'Structuring Contracts to Protect Against Insolvency' 21 *ACLN* 34, 47-48.

¹¹² According to D S Jones, 'Structuring Contracts to Protect Against Insolvency' 21 *ACLN* 34, 47 "...the clause is intended to protect the cashflow of the contractor during the course of building works."

portion of the work. In these circumstances it is more appropriate for the head contractor to bear the risk and, perhaps, insure against it. Thirdly, the payment may depend on a condition over which the subcontractor has no control. For example, in *Dunlop & Ranken Ltd v Hendall Steel Structures Ltd, Pitchers Ltd (Garnishees)*¹¹³ the court held that a payment did not have to be made where the contract provided for payment to be made on the receipt of an architect's certificate under the head contract but one certificate from the architect had not been issued.

3.63 One approach to reform is to require statutorily that all head contracts contain "proof of payment" clauses along the lines of clause 43 unless there was provision for direct payment along the lines of clause 10.5.¹¹⁴ As a corollary, "pay after paid" clauses could be declared void. The result of the statutory adoption of a clause along the lines of clause 43 is that a head contractor would have to pay subcontractors before they received payment from the owner.¹¹⁵ The head contractor would no longer have the use of those parts of progress payments payable to subcontractors during the period between when they were paid by the owner and when they paid the subcontractor. The head contractor would, therefore, bear the risk of each progress payment, a risk it could insure against, and fund payments to subcontractors before it obtained the progress payment from the owner. The CIDA Report recommends that all contracts contain "proof of payment" clauses.¹¹⁶ The CIDA Report also concluded that proof of payment clauses in existing standard form contracts were inadequate. It therefore recommended that industry contract committees be asked to include an appropriate proof of payment clause in all head contracts based on the principles of:

- "• written acknowledgement by the entity lower in the chain that payment has been received; and
- that the entity has made due payments including wages and workers statutory entitlements. "¹¹⁷

¹¹³ [1957] 1 WLR 1102.

¹¹⁴ The subcontractor's right could be enforced under s 11(2) of the *Property Law Act 1969*; see fn 17 in Ch 1.

¹¹⁵ The CIDA Report (at 30) recommends that paid if paid clauses should not be used and that signatories to the Construction Industry In-principle Reform and Development Agreement should ensure that conditions of tender prohibit the use of such clauses. No recommendation was made with regard to "pay when paid" clauses (31). These recommendations were endorsed by the CIDA Board as recommendations 17 and 18.

¹¹⁶ CIDA Report recommendation 16. This recommendation was endorsed by the CIDA Board as recommendation 15.

¹¹⁷ Ibid.

3.64 It has been suggested to the Commission that proof of payment clauses in some government contracts are not effective because builders swear false declarations with some impunity.¹¹⁸ This type of fraud would clearly need to be addressed. One means of curtailing it might be to require that the statutory declaration be accompanied by receipts for payments to the subcontractors.

3.65 A difficulty with a proof of payment provision is the need to provide a mechanism for dealing with disputes over the subcontractor's right to payment. Three possible approaches suggested by the Queensland Government DP are:

- " (a) the proof of payment clause could provide for builders to produce to the principal either a receipt or (where there is a dispute over a subcontractor's right to be paid) a notice specifying the amount otherwise payable to that subcontractor. That amount could then be withheld by the principal¹¹⁹ until such time as the dispute is resolved.
- (b) Alternatively, the builder's full progress claim could be paid with the amount specified in the notice becoming trust money in the builder's hands. When the dispute is resolved the order could provide for the trust's disposal.
- (c) Legislation and the contract could authorise the principal to pay disputed amount to a third party stakeholder (eg the licensing authority, the adjudicator) or into court, where proceedings had commenced."¹²⁰

(c) Proof of funding

3.66 Another means of protecting subcontractors, and head contractors, is by means of an implied condition which required the owner to provide proof of project funding prior to the commencement of work. In this context, the CIDA Report recommended that the industry contract committees consider including in the standard contracts a clause to the effect that -

- * the principal be required to provide evidence of adequate project funding; and
- * a warranty as to its capacity to pay the contract sum.¹²¹

¹¹⁸ The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia. Western Power, which has a proof of payment clause in its General Conditions of Contract similar to cl 43 of AS 2124-1992, said that the clause was "largely ineffective". It pointed out that the clause provides no security if the contractor is prepared to make a false declaration.

¹¹⁹ Cl 10.5 of AS 2124-1992 (para 3.59 above) provides for the Principal to act as a stakeholder of retention moneys.

¹²⁰ Queensland Government DP 32.

(d) Romalpa clause

3.67 Another type of clause which could be made an implied condition is a "Romalpa" clause.¹²² This type of clause ensures that property in goods and materials supplied but not yet incorporated into a building does not pass to the owner until the contractor is paid. This means, for example, that if the head contractor terminates a contract because the owner has become insolvent, the contractor can obtain all goods and materials which have not been incorporated into the building. Those that have been incorporated cannot be obtained because, having become part of the land and property, they will have passed to the owner. In effect, the Romalpa clause provides security for the unpaid price of goods sold.

(e) Assignment of progress payments

3.68 Where the funds for a project come not from the owner but its financier the head contractor usually receives progress payments from the owner, not the financier. As the owner usually only receives these funds from the financier on production of progress certificates, the head contractor will not receive these funds if the owner becomes insolvent between the time when the funds have been advanced by the financier and the time when they are passed on to the head contractor. One means of protecting the head contractor against loss in this situation is an implied condition providing for direct payment from the financier to the head contractor upon receipt of the progress certificate by the financier. As with proof of payment clauses it would be necessary to provide a mechanism for dealing with disputes over the head contractor's right to payment.¹²³

(f) Payment of liquidated damages

3.69 The CIDA Report drew attention to abuses of a provision in contracts relating to the payment of liquidated damages. It said that head contractors were requiring subcontractors to pay the total amount of liquidated damages payable by the head contractor under the head contract even though a subcontractor may have been only partially responsible for the delay which caused the damages to be incurred.¹²⁴ To prevent this abuse from occurring, the Report

¹²¹ CIDA Report recommendation 7. This recommendation was endorsed by the CIDA Board as recommendation 7.

¹²² See the analysis of such a clause by Goff LJ in *Clough Mill Ltd v Martin* [1985] 1 WLR 111, 117-118.

¹²³ See para 3.65 above.

¹²⁴ CIDA Report 36.

recommended that standard form contracts should incorporate the principle that "no party in the contractual process should be liable for more than the cost of the consequences of its actions".¹²⁵

(g) Suspension of works

3.70 At present some standard contracts provide for the suspension of the works because of an act or omission of the owner.¹²⁶ Such clauses limit a head contractor's liability should it ultimately become necessary to terminate a contract because of a default by the owner. To ensure that such protection was provided, the CIDA Report recommended that all contracts should contain a right to suspend the work for failure to make payment, with a further right to terminate the contract if nonpayment continued.¹²⁷

(h) Retention funds

3.71 A number of those who made a preliminary submission to the Commission suggested that retention funds should be held in trust.¹²⁸ Otherwise these funds could be allocated to other accounts or projects. At least one of the standard form contracts provides for retention funds to be held in a joint account.¹²⁹ The CIDA Report pointed out that subcontractors consider retention money to be unsatisfactory because it ties up cash flow and the money may be lost if the contractor becomes insolvent. The CIDA Board recommended that, except where government departments or agencies are involved, all contracts should contain:

"...a provision that the party holding security in the form of cash or retention moneys establish a common identifiable account in a financial institution into which security must be paid, and held in trust, in the absence of other mechanisms for payment of security in the event of insolvency."¹³⁰

¹²⁵ Ibid recommendation 24. This recommendation was endorsed by the CIDA Board as recommendation 23.

¹²⁶ See eg AS 2124-1992 cl 34.1.

¹²⁷ CIDA Report recommendation 25. This recommendation was endorsed by the CIDA Board as recommendation 24.

¹²⁸ Air Conditioning & Mechanical Contractors' Association of Western Australia; The Australian Institute of Building; Architectural Aluminium Fabricators Association of Western Australia; The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia.

¹²⁹ AS 2124-1992 cl 5.9.

¹³⁰ Recommendation 30.

This would prevent funds being lost on the contractor's insolvency. It would not, of course, overcome the subcontractor's concern that part of their cash flow is tied up. To overcome this problem, it has been suggested to the Commission that a subcontractor should be entitled to provide a bank guarantee in lieu of a cash retention. If a subcontractor has insufficient assets, the bank may require the subcontractor to maintain an equivalent sum to the guarantee with the bank. The subcontractor can therefore earn interest on the sum and it is not at risk if the head contractor becomes insolvent.

7. INSURANCE APPROACH

3.72 At present it is possible for a head contractor or a subcontractor to protect itself with credit indemnity insurance. However, the premiums may be too high in relation to the profit margins.¹³¹ This may be because profit margins in the building industry have diminished through highly competitive tendering. On the other hand it may be that contractors insure only the risky jobs and the premiums are geared to this fact.

3.73 As mentioned earlier,¹³² the Housing Industry Association developed a credit indemnity scheme to, protect member subcontractors against the insolvency of contractors. However, the cover provided under the scheme has ceased because the premium, which was included in the subscription for subcontractor members, was inadequate to meet claims on the fund.

3.74 The advantage of insurance schemes is that they do not interfere with the day to day running of the project and do not restrict the cash flow in any way. Also since each party insures itself against loss, the structure of the project would not be affected. In view of the apparent failure of voluntary schemes, a compulsory insurance pool would be required so that losses could be spread over everyone in the industry.¹³³ If a compulsory scheme were adopted, consideration would need to be given to how it should be administered, for example,

¹³¹ The SA Working Party at 13 suggested a scheme providing cover of up to \$40,000 in any one year for one licensee could be set up for an annual premium of about \$100.00 (plus stamp duty in SA of \$8.00). BISCOA(SA) at 7 criticised this suggestion because it would be inadequate in commercial developments.

¹³² Para 2.2 above.

¹³³ The SA Working Party at 13 recommended the adoption of trade indemnity insurance though it concluded that further investigation was required to determine if the scheme needed to be mandatory. BISCOA(SA) at 5 opposed a compulsory scheme of insurance because it would encourage bad practices in the industry. BISCOA(Qld) at 18 also opposed a mandatory scheme on the ground that it would be ineffective.

by a government department, a group representative of the industry or one or more insurance companies. Decisions would also have to be made as to -

1. Who would be covered: the head contractor as well as subcontractors.
2. The losses to be covered: profit as well as sums actually expended or debts incurred.

3.75 The Queensland Government DP suggests that there were at least two arguments against introducing a compulsory insurance pool. First, it is not appropriate to compel subcontractors who are capable of protecting their own interests, to participate in a scheme. Secondly, "...the capacity for fraud is monumental, given that it would be open to the parties to negotiate contracts incapable of being performed because at the end of the day that performance will be underwritten by a massive statutory insurance scheme."¹³⁴

8. STOP NOTICE

3.76 A stop notice is a statutory procedure by which a subcontractor can force undisbursed funds which the owner may owe to the builder under the head contract to be held for its own payment. It would not be necessary if a contract contained a proof of payment clause.¹³⁵ Upon the receipt of a bonded¹³⁶ stop notice, the owner (or its lender) is required to withhold sufficient funds from the head contractor to satisfy the claims of subcontractors. That is, the funds are held in a type of escrow account. They are released if the head contractor pays the subcontractor. If the head contractor is not able to make the payment, there are two ways in which the subcontractor can acquire his part of the escrow account. First, if the head contractor sues the owner, the owner may pay the amount due under the contract into court. All persons, including the subcontractor, entitled under the amount due under the contract are made parties to the action and the court may direct the payment and the amount due under the contract. Secondly, the subcontractor may sue the head contractor. The owner and all "other interested parties", so far as known, must be made parties to the action. The owner may pay into court the amount admitted to be due under the contract or sufficient to pay the sums

¹³⁴ Queensland Government DP 58.

¹³⁵ Paras 3.61-3.65 above.

¹³⁶ That is, an undertaking that the subcontractor will pay all costs that may be awarded against the owner or lender.

claimed. The court then determines who is lawfully entitled to payment. Irrespective of the means by which the claim is asserted, the owner is not liable for a greater amount than the amount due to the head contractor under the construction agreement. If the head contractor assigns its rights to the proceeds of the contract to a financial institution, that institution's right to the contract proceeds are subordinate to the rights of the subcontractor.

3.77 A stop notice has the following limitations -

1. A subcontractor has no right to the stop notice unless the head contractor is entitled to payment under the contract. The owner must therefore be indebted to the contractor under the contract at the time the stop notice is filed.
2. 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 right in relation to the owner's undisbursed contract funds.
3. It freezes only the undistributed contract funds in the hands of the owner at the time of the notice. The subcontractor must, therefore, file its notice with the owner before the owner disburses all the contract funds.
4. It may adversely affect the flow of funds from the owner to the builder which could have an unfortunate effect on the project because the owner may have to set aside funds needed to continue construction.

3.78 Several practical factors also limit the effectiveness of a stop notice:

"In many small construction contracts, only one or two payments are made by the owner 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 subcontractors 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 prerequisite to acquiring the subcontract. " ¹³⁷

3.79 An advantage of a statutory stop-notice scheme is that, regardless of the order the subcontractors follow in filing their stop-notices, all filing subcontractors share pro rata in the contract proceeds if such proceeds are insufficient to satisfy all claims, ¹³⁸ the owner not being liable for a greater amount than the amount contracted for with the head contractor.

9. HOLDBACK FUND

(a) Introduction

3.80 Under a holdback scheme the owner is required to retain a percentage of the contract price (say 10%) for a period of time after construction has been completed. ¹³⁹ Subcontractors may claim on this fund ¹⁴⁰ if they have not been paid by the head contractor. Claims which are met from the fund may be deducted from the amount ultimately due to the head contractor. Usually, if the owner fails to retain the holdback money, the claimants are entitled to a lien on the property to the extent of the amount of funds they would have received had the money been withheld. It was developed as a means of protecting those who had enhanced the value of a property yet in the absence of privity of contract with the owner had no direct claim against the owner.

3.81 It has the following disadvantages or has been criticised for the following reasons -

1. It restricts the ready flow of some funds along the construction chain and could cause cash flow problems for contractors and subcontractors who must finance the difference between what is received and must be paid, for example, for labour and materials.

¹³⁷ W L Smith and B S Hazard, 'Mississippi Law Governing Private Construction Contracts: Some Problems and Proposals' (1976) 47 *Mississippi LJ* 437, 456.

¹³⁸ Ibid 463.

¹³⁹ Such a scheme may also involve money being withheld at each level of the construction pyramid.

¹⁴⁰ According to the Alberta Report at 16:

"Although the rationale for a statutory holdback is to provide a sum of money which will be available to at least partially satisfy lien claimants, in fact it is not a specific pool of money but is rather a notional concept which only comes into being in the event that the owner decides to pay it into court in order to clear his title of liens."

2. It adds to the cost of a project. One survey in the United States of America indicated that prices could be reduced by an average of 3.2 percent if the holdback was eliminated.¹⁴¹
3. Undue reliance upon the holdback leads to poor business practices because proper credit checks are overlooked.

3.82 The percentage of the contract price retained is an important factor in the effectiveness of the scheme:

"The 10 percent retainage fund as used in Texas ...has been criticized as being too small a sum to provide adequate protection for subcontractors. Initially providing for a substantially higher percentage of retainage, however, might prove to be too heavy a burden on the prime contractor."¹⁴²

The Alberta Report also pointed out that higher statutory holdbacks cause difficulties:

"The reality, however, is that the statutory holdback of 15% causes a serious deficiency in the cash flow of contractors and subcontractors, which may contribute to insolvencies and business failures. That is, rather than being part of the solution, in some cases the statutory holdback is part of the problem."¹⁴³

The Alberta Report recommended that the statutory holdback be eliminated as part of a reform which involved the introduction of statutory trust provisions because it could be done without any significant loss of security for subcontractors.¹⁴⁴

3.83 If a holdback scheme were adopted, a number of issues would need to be addressed. These are discussed below.

(b) At what rate should the holdback be set?

3.84 Selection of the rate of the holdback involves balancing the interests of the protection of subcontractors with the interest of having contract moneys free to pay for work when

¹⁴¹ Newfoundland Report 29. Subsequently the USA Government eliminated the holdback from all of its projects for this reason: *ibid.*

¹⁴² W L Smith and B S Hazard, 'Mississippi Law Governing Private Construction Contracts: Some Problems and Proposals' (1976) 47 *Mississippi LJ* 437, 468.

¹⁴³ Alberta Report 16.

¹⁴⁴ *Ibid.*

completed. In Canada the rate varies between 7.5 percent (in Manitoba) and 20 percent (in New Brunswick and Prince Edward Island), the most common rate being 10 percent.¹⁴⁵ The trend in Canada has been towards lower rates.¹⁴⁶ One way of setting the rate would be to fix it at the prevailing margin of profit within the industry. This might ensure that the head contractor received sufficient funds to pay those who supplied services and materials to complete the project.

(c) When should holdback money be released?

3.85 The holdback money could be released -

- (a) On completion of the contract, that is, on the actual and final completion of all work on the project. This has the disadvantage that it can delay the downward flow of funds.
- (b) On substantial, not necessarily total, performance of the contract.¹⁴⁷ This approach promotes the expeditious downward flow of holdback money but leaves those who perform work after substantial performance, such as those involved in finishing work, at risk. These contractors can be protected by a "late trades holdback" which would provide protection for those who provide services or materials from the day of substantial performance until total completion of the project.¹⁴⁸
- (c) On the expiration of specific periods of time, for example, annually. This approach would be applicable to large projects, say those with a value in excess of \$20 million. Otherwise the holdback could amount to a large sum towards the end of the project even though the amount outstanding to subcontractors was small.

¹⁴⁵ Newfoundland Report 32-33.

¹⁴⁶ Ibid 34.

¹⁴⁷ In Newfoundland, for example, this is deemed to occur when specific criteria regarding use of the project and a percentage dollar value of the work remaining to be done has been satisfied: Newfoundland Report 36.

¹⁴⁸ See Newfoundland Report 55-58.

(d) Time limit on claims

3.86 A time limit could be imposed on claims being made on the holdback or late trades holdback following completion or substantial completion or abandonment of the project, as the case may be. In Canada it varies from 30 to 60 days.¹⁴⁹ The Newfoundland Report concluded that a period of 45 days achieved "an equitable balance between the interests of protection and the necessity of not hindering unduly the flow of finances down the chain."¹⁵⁰

(e) Setting aside the holdback money

3.87 If the owner is not required to set aside the holdback money in a separate fund, the amount representing the holdback might be lost if the owner became insolvent or bankrupt. To avoid this, the owner could be required to set aside the holdback money in a separate secure fund,¹⁵¹ perhaps a trust fund.¹⁵² Such a requirement would, of course, mean that the owner would incur additional cost either as a result of not having the use of the money or in having to borrow the money. Such costs would be offset to some extent if the owner were entitled to any interest earned by the money in the fund.

(f) Failure to retain holdback money

3.88 To be effective it would be necessary to provide some sanction for a failure by the owner to retain holdback money. As a subcontractor is not entitled to a lien on the owner's property,¹⁵³ this would not provide a remedy. An alternative remedy would be to make the owner liable to the subcontractor for any loss suffered by the subcontractor as a result of the owner's failure to retain holdback money. Where the action was successful and a judgment was obtained, the judgment could be enforced by execution against the owner's property.

¹⁴⁹ Newfoundland Report 62.

¹⁵⁰ Ibid 64-65.

¹⁵¹ Otherwise the owner could defer the cost of borrowing until such time as it was required to pay over the holdback.

¹⁵² This approach was adopted in Manitoba: Newfoundland Report 66-67.

¹⁵³ The usual remedy available where a holdback scheme operates: para 3.80 above.

10. GRADING OR LICENSING OF BUILDERS

3.89 The grading of builders by way of a licensing scheme was recommended by Mr C H Smith QC in his report *Inquiry into the Building Industry of Western Australia 1973-1974*.¹⁵⁴ As the industry is structured at present a builder with few assets of its own can satisfactorily build large office blocks and other developments involving large sums of money. Under the scheme proposed by Mr Smith, head contractors would be limited to contracting for work the value of which was in accordance with their skill, training and financial resources. At present, the Builders' Registration Board may require an applicant for registration under the *Builders' Registration Act 1939* to satisfy it that it has sufficient material and financial resources available to enable it to meet its financial obligations as and when they become due. It may refuse to register an applicant which fails to so satisfy it.¹⁵⁵ An objection to the grading of builders is that it could prove very difficult to develop effective criteria to grade builders. In Queensland it has been suggested that licence qualifications should emphasise bookkeeping and record management, financial skilling with particular emphasis on appropriate debt ratios, relevant technical experience, cost estimating, tender preparation and administration and other management skills.¹⁵⁶ In comments on the Queensland Government DP, BISCOA (Qld) at 10 suggested that there should be a graded registration system for both builders and subcontractors which would take into account their experience and capability, financial soundness and management skills. Using these criteria "... a system of points could be awarded for each category of the criteria and then quantum levels of work could be established, in which companies may operate and tender upon." However builders whatever their size are capable of trading imprudently and becoming insolvent. At the most, the scheme would appear to be merely ancillary to other measures for ensuring payment of subcontractors.

¹⁵⁴ Smith Report paras 7.26-7.28.

¹⁵⁵ *Builders' Registration Act 1939* ss 9A(2) and 10(2a). The SCGA Report at 41-42 recommends that these provisions be repealed because the information provided by an applicant soon becomes outdated.

¹⁵⁶ Queensland Government DP 16.

The SA Working party at 4 proposed that, as part of the licence requirements, participants in the industry should "demonstrate their understanding of the principles of risk management and the need to better manage their debtors."

The CIDA Report recommended that a set of common criteria to assess the character, financial and technical capacity of those seeking registration should be developed: CIDA Report 7. This recommendation was endorsed by the CIDA Board as recommendation 2.

3.90 In South Australia, the Ministerial Working Party recommended that applicants for builder's licences should meet certain prudential requirements, demonstrated by financial recourse to one or more of the following -

- * personal guarantees to a certain value covered by registered securities over specific assets;
- * bank guarantees to a certain value;¹⁵⁷
- * indemnity insurance to a certain value;
- * use of independently audited trust funds to hold prepayments; or
- * other financial recourse as agreed to by the Commercial Tribunal, which is responsible for issuing those licences.

In the event of insolvency, the financial backing would be used to cover the debts of the licence holder.¹⁵⁸ In this State, the SCGA Report recommended that each applicant for registration should be required to produce to the Builders' Registration Board a cash redeemable guarantee from a financial institution.¹⁵⁹

3.91 In Western Australia, the Builders' Registration Board may hold an inquiry into the financial resources of a registered builder and may suspend or cancel the registration of a builder who does not have sufficient financial resources to meet its financial obligations.¹⁶⁰ Although the intention of the inquiry is to reduce the likelihood of builders getting into financial difficulties it has been criticised as being ineffective because it is likely that a builder will be in severe financial difficulty before an inquiry is instituted.¹⁶¹ In South Australia, the Ministerial Working Party recommended that there should be more stringent and more effective monitoring of builder's licences with an expanded role for the Commercial Tribunal.

¹⁵⁷ BISCOA(SA) at 6 criticised such a requirement. It stated that;

"Such a requirement would be detrimental to the on-going operation of the contractor who will have his available assets significantly limited. Furthermore, there will be problems if an insolvency does occur with cross claims by the liquidator over these funds."

¹⁵⁸ SA Working party 12.

¹⁵⁹ 41-42.

¹⁶⁰ *Builders' Registration Act 1939* s 13(1)(ba).

¹⁶¹ SCGA Report para 5.16.

The Working Party recommended that the Tribunal provide an "early warning" of impending financial problems by allowing it to deal with complaints of the late or non payment of subcontractors. The Tribunal could require licence holders to seek specific assistance, such as business expertise, to overcome problems.¹⁶²

11. ASSESSMENT OF MAJOR OPTIONS

(a) Introduction

3.92 The various approaches discussed in this chapter have different strengths and weaknesses. Some will have greater costs and provide greater security than others. In assessing the various approaches to regulation examined in this chapter, the Commission welcomes comment on each approach to regulation according to the following criteria -

1. cost;
2. effectiveness in providing security of payment;
3. administrative complexity;
4. need for government or third party involvement;
5. scope for evasion;
6. interference with freedom of parties in organising projects or managing a project;
7. commercial or economic effect on the industry.

(b) Cost

3.93 Some approaches to reform will involve direct additional costs which may make them undesirable. For example, both payment bonds and insurance will require the payment of a premium and covenanting will require the payment of a commission to the covenanting agency. Others will involve indirect costs or additional administrative costs. The trust scheme may involve more complex bookkeeping and accounting with additional associated costs. It may also be necessary to provide for the auditing of trust accounts with the cost that entails. On the other hand, this might be offset if the trustee could retain the interest paid on trust

¹⁶² SA Working party 11.

funds. Experience in the United States of America suggests that a holdback adds to the cost of a project.¹⁶³

(c) Effectiveness

3.94 A number of approaches may be favoured because they are likely to be highly effective in ensuring security of payment: payment bonds, managed contracts, covenanting and insurance. However, the effectiveness of other approaches may be difficult to assess.

(d) Administrative complexity

3.95 Some approaches, such as payment bonds and insurance, may be viewed favourably because they are unlikely to be administratively complex. Trusts and managed contracts involve a change in the relationship of those involved in a project which will not necessarily involve much greater administrative complexity than exists at present except that trusts may involve more complex accounting. Covenanting might be considered to involve too much complexity because it involves another party and proof of the completion of work before payments are made to a subcontractor. Some of the implied conditions might also be considered to involve too much administrative complexity.

(e) Government or third party involvement

3.96 A number of approaches may be considered to be desirable because they do not involve the government or a third party: managed contracts, implied conditions, the stop notice and the holdback. Unless the trustee were a government body or a trustee company, the trust scheme would not involve the government or a third party. The others would: payment bonding (a financial institution); insurance (an insurance company); covenanting (a covenanting agency); grading of builders (the Builder's Registration Board).

(f) Evasion

3.97 Some of the approaches to reform are likely to provide limited scope for evasion by contractors: bonds, covenanting, insurance, stop notice and holdback. It might, however, be

¹⁶³ Para 3.81 above.

considered that there is more scope for dishonest people to evade the other approaches to reform. Although a person could breach a trust, the remedies for breach of trust provide means of tracing and recovering money. Evasion of a grading scheme for builders would depend on the ability of the licensing authority to check information given to it by a builder and the resources it had to monitor builders.

(g) Interference with freedom of parties

3.98 Most approaches to reform involve some interference with the parties' freedom to organise projects and manage resources and might be considered to be undesirable for this reason. Trusts change the relationship between the parties and prevent the use of funds for one project on another project. Managed contracts and covenanting also change the relationship of the parties to a project. Implied conditions impose special conditions on the parties to a project. Bonds and insurance schemes require parties to a project to enter into an additional contract and pay a premium to a financial institution or insurance company. The stop notice and holdback schemes may result in one party being required to hold money due on account of the contract and to pay the money to some party with which it does not have a direct relationship. The scheme of licensing of builders is the only one which does not involve any direct interference with the freedom of parties to a project.

(h) Commercial or economic effect

3.99 The final criterion that might be considered is the commercial or economic effect of the approaches to reform. This might involve consideration and balancing of a number of effects. It might, for example, be necessary to consider whether or not each approach to reform would -

1. exclude some builders from the whole or a part of the industry with a consequent reduction in competition;
2. change the way in which projects are funded;
3. impose additional requirements on builders or subcontractors to borrow money to meet obligations to those entitled to receive payments from them because of a reduction in working capital;
4. discourage spurious disputes;

5. provide an incentive to avoid, reduce or settle genuine disputes;
6. give one party unfair bargaining power;
7. speed up payments to subcontractors;
8. make the industry more stable by, for example, reducing bankruptcies;
9. encourage skilled tradesmen to remain in the industry.

3.100 At present, some subcontractors might be able to absorb the costs associated with losses through defaults or delays in payment as part of their pricing structure. Adoption of any of the approaches to reform might not be accompanied by the removal of this pricing effect, at least in the short term. If not, and the approach to reform involved additional costs, it might lead to lower profit margins for others in the pyramid or increased costs for owners.

Chapter 4

QUESTIONS AT ISSUE

4.1 The Commission seeks comment on the issues raised in this Discussion Paper and, in particular, on all or any of the following questions –

THE NEED FOR REFORM

1. Should the law be amended to regulate the payment of head contractors and subcontractors in the building and construction industry when the payment of unsecured creditors in other industries is unregulated?

Paragraphs 2.1-2.2

STATUTORY TRUST

Should provision be made for a statutory trust?

2. Should it be provided that money paid to a head contractor or subcontractor in relation to a project constitutes a trust fund for the benefit of its subcontractors?

Paragraphs 3.2-3.8

3. Should moneys in the hands of the owner for the purpose of a project or payable to the head contractor on account of the project be a trust fund for the benefit of the head contractor and subcontractors?

Paragraphs 3.3 and 3.10-3.13

Who should act as the trustee?

4. If provision is made for a statutory trust, should the trustee be –
 - (a) one of the participants in the construction project; or
 - (b) a government body?

Paragraph 3.14

Should there be a single trustee?

5. If the trustee were one of the participants in the construction project, should there be a single trustee or should each participant who is under an obligation to pay a subcontractor be a trustee?

Paragraph 3.16

For whom should the trustees hold the funds in trust?

6. Should each trustee hold funds in trust only for those with which it had contracted directly (known as the "privity of trust" approach) or for all those down the chain from it?

Paragraph 3.17

Should the trustee be required to keep a separate trust account?

7. Should the trustee be required to keep a separate trust account?

Paragraphs 3.20-3.21

Should there be a consolidated trust account?

8. Should there be a consolidated trust account?

Paragraph 3.22

When would the trustee be entitled to receive or use funds held in trust?

9. Should the trustee be entitled to receive or use funds held in trust -
- (a) when the project is completed, so long as all obligations to subcontractors had been met;
 - (b) where the trust account balance exceeds the moneys owing to subcontractors;
 - (c) where the trustee meets its obligations out of its own money or borrowed money;

- (d) where the subcontractor owes a trustee money for outstanding debts, claims or damages either -
 - (i) unrelated to the project; or
 - (ii) only when related to the project?

Paragraphs 3.23-3.27

How should trust funds be distributed to beneficiaries?

- 10. Should a trustee pay the beneficiaries of the trust on a pro rata basis or as claims fall due?

Paragraph 3.28

How should trust funds be distributed to beneficiaries if the trust fund is insolvent?

- 11. If the trustee becomes insolvent, should the trust fund be distributed amongst its beneficiaries on a pro rata basis?

Paragraph 3.29

Priority as between trust beneficiaries and a judgment creditor who has obtained an attachment order

- 12. Should money owing or accruing from the owner to the head contractor be subject to the trust so that it could not be attached by a third party?

Paragraph 3.30

Priority as between trust beneficiaries and an assignee of an account

- 13. Should an assignee take money subject to any trust which would attach to those moneys in the hands of the assignor?

Paragraph 3.31

Information and training as to trust obligations

- 14. Should a training course be developed dealing with trust obligations and the requirements for maintaining and operating a trust account?

15. Should those seeking registration as a builder be required to pass a test demonstrating an elementary understanding of trust obligations and requirements?

16. Should others in the industry who handle trust funds be required to obtain a licence, by passing the test, before being able to operate in the industry?

Paragraph 3.32

Should a breach of trust be sufficient reason to suspend or revoke the registration of a builder?

17. Should failure to comply with a trust scheme be a ground for disciplinary action, including deregistration, against a builder?

Paragraph 3.33

Should a special limitation period be provided for the enforcement of the trust scheme?

18. Should those who benefit from the scheme be required to make a claim promptly, say within 12 months of the completion, abandonment or other discharge of the contract?

Paragraph 3.34

Who should be liable for a breach of trust?

19. Should every director, officer, employee, agent or other person having effective control of a corporation who might be responsible for a breach of trust to be liable for the breach?

Paragraph 3.35

Disputes relating to trust money

20. Should disputes relating to trust money be dealt with by the Supreme Court as with other trusts?

Paragraph 3.36

Criminal offence

21. Should it be an offence for every person upon whom a trust is imposed knowingly to appropriate or convert any part of any trust moneys to his own use or any use not authorised by the trust?

Paragraph 3.38

PAYMENT BONDING OR GUARANTEES

Should provision be made for payment bonding or guarantees?

22. Should builders or head contractors be required to obtain a bond from an insurance company or bank guaranteeing the payment of all subcontractors?

Paragraphs 3.39-3.43

Who should be required to obtain a bond?

23. If payment bonding were introduced, should there be one bond covering all subcontractors regardless of the participant's position in the project's contractual chain or should every intermediate person in the contracting chain with obligations to others be required to obtain a separate bond?

Paragraph 3.45

Would it be necessary to nominate a single insurer as the construction industry project insurer?

24. Should there be a single insurer?

Paragraph 3.46

Limiting the amount of the payout on a claim

25. Should the insured proportion of the subcontractors' claims be restricted to sums less than 100%, say 80%?

Paragraph 3.47

Should an excess be provided?

26. Should there be an excess of say \$500-\$1,000?

Paragraph 3.48

Notification of default in an insurance policy

27. Should the insurance company be required to notify the Builders' Registration Board, the owner, head contractor and subcontractors if the insured defaulted on its policy?

Paragraph 3.49

Time limitations on claims

28. Should a subcontractor be required to take action on a bond within say six months of the final settlement or abandonment of the head contract?

Paragraph 3.50

Distribution of proceeds

29. Should the proceeds of a bond be paid to claimants on a pro rata basis if it is insufficient to meet all claims?

Paragraph 3.51

Inspection of a bond

30. Should all interested parties have a right to inspect the bond at the owner's or head contractor's business address or the head contractor's site office (if it has one)?

Paragraph 3.52

MANAGED CONTRACTS WITH DIRECT PAYMENT

31. Should the owner and the head contractor be required to enter into a managed contract with direct payment?

Paragraphs 3.53-3.56

COVENANTING

32. Should a covenanting system be introduced?

Paragraphs 3.57-3.58

IMPLIED CONDITIONS

"Proof of payment" clause

33. Should all head contracts contain a "proof of payment" clause along the lines of clause 43 of AS 2124-1992 unless there was provision for direct payment along the lines of clause 10.5 of AS 2124-1992?

Paragraphs 3.61-3.63

34. What mechanism should be provided for dealing with disputes over the subcontractor's right to payment?

Paragraph 3.65

Proof of funding clause

35. Should the owner be required, prior to commencement of work, to provide evidence of adequate project funding and a warranty as to its capacity to pay the contract sum?

Paragraph 3.66

Romalpa clause

36. Should a Romalpa clause, which ensures that property in goods and materials supplied but not yet incorporated into a building does not pass to the owner until the contractor is paid, be implied in contracts?

Paragraph 3.67

Assignment of progress payments

37. Should an implied condition provide for direct payment from a financier for a project to the head contractor on receipt of a progress certificate by the financier?

Paragraph 3.68

Payment of liquidated damages

38. Should it be provided that no party in the contractual process should be liable for more than the cost of the consequences of its actions?

Paragraph 3.69

Suspension of works

39. Should a subcontractor have a right to suspend works because of an act or omission, such as failure to make a progress payment, of the head contractor?

Paragraph 3.70

Retention funds

40. Should retention funds be held in a trust fund?

Paragraph 3.71

41. Should a subcontractor be entitled to provide a bank guarantee in lieu of a cash retention?

Paragraph 3.71

INSURANCE APPROACH

42. Should a compulsory insurance scheme be introduced?

Paragraphs 3.72-3.75

STOP NOTICE

43. Should a stop notice procedure by which a subcontractor can force undisbursed funds which the owner may owe to the builder under the head contract to be held for its own payment be introduced?

Paragraphs 3.76-3.79

HOLDBACK FUND

Should a holdback fund scheme be introduced?

44. Should a holdback scheme under which the owner is required to retain a percentage of the contract price (say 10%) for a period of time after construction has been completed be introduced?

Paragraphs 3.80-3.82

At what rate should the holdback be set?

45. If a holdback scheme is introduced, at what rate should the holdback be set?

Paragraph 3.84

When should holdback money be released?

46. Should the holdback money be released -
- (a) On completion of the contract, that is, on the actual and final completion of all work on the project.
 - (b) On substantial, not necessarily total, performance of the contract?

Paragraph 3.85

Time limit on claims

47. What time limit should be imposed on claims being made on the holdback following completion or substantial completion or abandonment of the project?

Paragraph 3.86

Setting aside the holdback money

48. Should the owner be required to set aside the holdback money in a separate secure fund such as a trust fund?

Paragraph 3.87

Failure to retain holdback money

49. Should the owner be liable to the subcontractor for any loss suffered by the subcontractor as a result of the owner's failure to retain holdback money?

Paragraph 3.88

GRADING OR LICENSING OF BUILDERS

50. Should the grading of builders by way of a licensing scheme be introduced?

Paragraph 3.89

51. Should applicants for builder's licences meet certain prudential requirements, demonstrated by financial recourse to one or more of the following -

- * personal guarantees to a certain value covered by registered securities over specific assets;
- * bank guarantees to a certain value;
- * indemnity insurance to a certain value;
- * use of independently audited trust funds to hold prepayments; or
- * other financial recourse as agreed to by the Builders' Registration Board?

Paragraph 3.90

52. Should the Builders' Registration Board take a more active role in monitoring the financial performance of builders?

Paragraph 3.91

Appendix I

LIST OF THOSE WHO MADE PRELIMINARY SUBMISSIONS

Active Plumbing

Air Conditioning & Mechanical Contractors' Association of Western Australia (Inc)

Architectural Aluminium Fabricators Association of Western Australia

Association of Consulting Surveyors Inc

The Australian Institute of Building -Western Australian Chapter

Australian Institute of Steel Construction

Builders' Registration Board of Western Australia

Building Owners & Managers Association of Australia Limited

Cabinet Makers Association of WA (Inc)

M J Carbone

Construction, Forestry, Mining and Energy Workers' Union of Australia (WA Branch)

Contract Carpenters Association of WA

L D' Alessio

M Galipo

F Hill, Director, Kestral Holdings Pty Ltd

Housing Subcontractors Union

Hon A MacTiernan MLC JP

The Master Painters, Decorators & Signwriters' Association of Western Australia

The Master Plumbers & Mechanical Services Association of Western Australia

Painters' Registration Board

R Righton

D Schapper

Water Authority of Western Australia

Western Power