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# 'DEEMED' STATUTORY TRUSTS FOR THE CONSTRUCTION INDUSTRY



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## OVERVIEW

The NSW Business Chamber ('the Chamber') welcomes the opportunity to make a submission to that part of the consultation *Statutory Trusts in Security of Payments in NSW* which is analysing the financial impact of statutory trusts in the building and construction industry.

The Chamber is one of Australia's largest business support groups, with a direct membership of more than 20,000 businesses, providing services to over 30,000 businesses each year. Tracing its heritage back to the Sydney Chamber of Commerce, established in 1825, the Chamber works with thousands of businesses ranging in size from owner operators to large corporations, and spanning all industry sectors from product-based manufacturers to service provider enterprises.

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## INTRODUCTION

In its previous submission (dated 19 September 2018) to this consultation, the Chamber raised two issues. The first related to the *“need for additional evidence and consideration to assess how a system of ‘deemed’ statutory trusts will precisely impact construction businesses”* and the second was *“whether policy interventions such as ‘deemed’ statutory trusts can reduce the instances of insolvency”*.

Instead of responding to the specific questions contained in the questionnaire attached to the Houston Kemp report (‘the report’), the Chamber’s submission will provide some context to its concerns which challenge some of the assumptions underpinning the report.

## HOW THE SYSTEM WILL IMPACT THE CONSTRUCTION INDUSTRY

The report refers to the possibility of removing the exemption for residential construction work from the *Building and Construction Security of Payment Act 1999*.

The proposed design of the statutory trust model (as described in the report) would appear to require a builder (being the head contractor) to deposit every payment received under its residential building contract into a trust account, rendering it unable to draw down funds to pay its other creditors (including its employees) until all of its subcontractors have been paid in full.

This approach assumes all building work (whether residential or commercial) is performed and invoiced on a ‘do-and-charge’ basis and, given the recent amendments made to the *Building and Construction Industry Security of Payment Act 1999*, also assumes that the practice of withholding retention monies is adopted in both the commercial and the residential sector. Neither is true.

## IT FAILS TO ACCOMMODATE DIFFERENT INVOICING PRACTICES

Not only are there significant differences with invoicing practices between the commercial building sector and the residential building sector, but they also exist within the residential building sector.

Typically, commercial building projects are paid on a ‘do-and-charge’ basis with progress claims supported by evidence prepared by a quantity surveyor. There is a direct correlation between the amount of the claim on the one hand and the work both performed and completed on the other.

In comparison, due to the regulatory framework governing the residential sector, the ability to perform residential construction work on a ‘do-and-charge’ basis is rarely permitted.

The residential construction sector is heavily regulated, mainly for consumer-protection reasons. Residential builders are required to invoice for their work according to a statutory formula which prescribes limits for the deposit and each progress payment.

The prescribed building stages (and percentages) do not necessarily align with the work being performed by, and amounts owing to, subcontractors.

The proposed 'deemed' statutory trust system does not take these timing differences into account as it assumes that payments to subcontractors (within the residential sector) are time-based, not results-based.

The proposal to remove the current exemption for residential construction work from the *Building and Construction Security of Payment Act 1999* will have the effect of allowing a subcontractor to lodge monthly payment claims. Replacing a results-based payment system with a time-based payment system will have significant and unintended consequences for the sector. This is due to the fact that a high proportion of subcontractors are sole traders and the question whether a builder pays a contractor for a result or for a period of time worked is one of the common law tests used to determine whether the individual is an employee or an independent contractor. It also cuts across other areas of the law, such as negligence and taxation law (both at a State and federal level).

Imposing such a system on the residential building sector has the potential to create not only an unnecessary and unacceptable delay in funds being released to the builder so it can pay itself and its other creditors (including its employees), it will also have unintended, yet significant, consequences for the sector.

#### IT FAILS TO ACCOMMODATE DIFFERENT PAYMENT PRACTICES

The practice of withholding retention monies from a subcontractor's progress payment is a common feature of the commercial sector. It is a practice where, although a subcontractor has performed and completed the work described in its progress claim, a small percentage of the progress claim amount is withheld by the contractor before the balance is paid to the subcontractor.

The amounts withheld are held on trust for a period of time known as the 'defects period'. The trust exists because, at the point in time when the money is withheld, the amount being withheld is the property of the subcontractor. It is held on trust for the benefit of the builder, should there be any building defects requiring rectification works.

The defects have to be identified during the 'defects period' before the retention monies can be used to pay for the rectification work. Upon expiry of the defects period, the balance remaining in the retention fund is released to the subcontractors.

This is the business practice described in and regulated by section 12A of the *Building and Construction Industry Security of Payment Act 1999*.

Retention monies do not feature in the residential sector because subcontractors are paid for a result (which includes a required standard of workmanship). The subcontractor is not entitled to payment until it has achieved the required result. Once achieved, the subcontractor is paid the entire amount owing. There is no need to retain any funds.

In effect, by failing to accommodate the business practices peculiar to the residential construction sector, the proposed 'deemed' statutory trust system will place the interests of subcontractors above the interests of the builder's other creditors, add considerable pressure on the builder's cash flow, and have much wider ramifications for the residential construction sector as a whole.

## WHETHER THE SYSTEM WILL REDUCE THE RATE OF INSOLVENCY

### IT FAILS TO ADDRESS INDUSTRY-SPECIFIC RISKS OF INSOLVENCY

Relying on statistics, the report cites the building and construction industry as having the highest rate of insolvency in NSW with the largest reported cause for construction businesses being 'inadequate cash flow or high cash use'<sup>1</sup>.

Although the report acknowledges the need for further information, it is unlikely that the information required to understand the underlying industry-specific drivers behind these figures will be adequately sourced by a questionnaire.

The Chamber understands that each Trustee in Bankruptcy and Liquidator (of an involuntary liquidation) is required to examine the books and records of the insolvent business and provide a report to the relevant regulator explaining the reasons why the business became insolvent. For a business in the residential construction industry 'inadequate cash flow' could be due to any number of reasons, including under-quoting on a job (either deliberately, in order to win the job, or due to a lack of business acumen); failing to claim an extension of time in the event of wet weather resulting in having to pay delay damages to the owner; or failing to lodge a variation when the scope of works have changed.

These examples represent a handful of typical industry-specific risks of insolvency, none of which would be fixed by the imposition of a 'deemed' statutory trust system.

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<sup>1</sup> at page 5

Requiring the builder to wait until all the subcontractors are paid before being able to access the residual funds in order to pay its other creditors (including its employees) not only interferes with the builder's other legal obligations but, of itself, is likely to present an industry-specific insolvency risk.

## IT CONFLICTS WITH OTHER INSOLVENCY LAWS

As well as being in direct conflict with a number of other legal obligations imposed on a builder, by creating a trust fund for a sub-set of ordinary creditors, the proposed 'deemed' statutory fund system flies in the face of the priority list of creditors set out in the *Corporations Act 2001*, which is based on well-established and long-standing legal and equitable principles.

## CONCLUSION

The Chamber understands the frequency of insolvency within the construction industry is a significant problem that needs to be resolved, especially given the domino effect the chain of contracts typically used in the residential building industry has, with many of those at the bottom of the ladder experiencing a similar fate.

However, the Chamber has not been provided with evidence to support a conclusion that a system of 'deemed' statutory trusts is the best or only solution. More work needs to be done to not only understand the differences between residential and commercial construction practices but also the differences within the residential construction industry.

The Chamber believes a thorough understanding of these and other industry-specific issues will be necessary before it can be determined how a system of 'deemed' statutory trusts will impact construction businesses (to ensure any proposed measure will minimise unnecessary costs and achieve desired outcomes) and mitigate insolvency risks.

The Chamber calls for detailed consultation with industry participants and business to ensure the best outcomes are achieved for all stakeholders within the system.