Comments on 'deemed' trusts

Philip Davenport

These comments are on the August 2018 Consultation Paper on a proposal for 'deemed' statutory trusts.

As a lawyer I have had 50 years experience in drafting, interpreting, litigating and adjudicating building and construction contracts. For 20 years I have been urging the Government to legislate for the 'deemed' trust. I consider that I am well qualified to comment on the Consultation Paper.

These comments comprise (1) *Background* and (2) *Response to questions for comment* [Appendix A of the Consultation Paper].

1. Background

1. From time to time different methods of procurement for building or construction works have been favoured. Also from time to time different methods have been adopted to protect subcontractors. And different jurisdictions have adopted different methods.

2. Until the 1980s the NSW Department of Public Works [and most other Australian and UK Government construction authorities] favoured nominating subcontracting as the method of procurement for larger building works. This provided the greatest protection for the Government and nominated subcontractors in the event of insolvency of a head contractor.

3. It worked as follows. The Department would call tenders for the head contract and separately call tenders for major components of the work, eg electrical works, lifts, communications, etc which would be carried out by subcontractors. The Department would select the best subcontractors and nominate them to the head contractor. The head contractor would let subcontracts to the nominated subcontractors. The head contractor would certify the amount owed to each nominated subcontractor and the Department would pay the nominated subcontractor directly. The head contractor would never receive payment of moneys to which nominated subcontractors were entitled.

4. If the nominated subcontractor's work was defective or the subcontractor was liable for liquidated damages the head contractor would certify the amount to be deducted from the subcontract price. However, the Department would get the benefit of the deduction. The head contractor would not get it. Hence, there was no incentive for the head contractor to certify deductions in order to make a profit, as so often happens in other methods of procurement.

5. When the McKell Building was being built the head contractor was placed in liquidation. Within a matter of days [my recollection is two days] the Department engaged another head contractor and all the nominated subcontractors signed up with the new head contractor immediately. They were owed nothing by the first head contractor and lost nothing as a consequence of the insolvency of the head contractor.

6. With nominated subcontracting, subcontractors had even greater protection than the proposed statutory trust would provide. The Government was, in effect, trustee for nominated subcontractors of the moneys to which they were entitled. The method of payment involved no additional administrative burden for head contractors. Head contractors had no difficulty obtaining finance for the projects. However, they could not show as credit in their accounts moneys that were payable to nominated subcontractors.

7. Contrast that with the situation that arose when the Department adopted the traditional method of procurement and the head contractor became insolvent. The traditional method of procurement is when the head contractor receives all moneys due for work carried out by subcontractors. When the head contractor became insolvent, the subcontractors were owed money by the head contractor. They refused to sign up with another head contractor until they were paid by the Department the amounts owed to them by the head contractor. To complete the project the Department had to pay the debts of the insolvent head contractor to the subcontractors on the project.

8. The Department took assignments from the subcontractors of the debts owed by the insolvent head contractor but, because the liquidator of the head contractor had no money to distribute to unsecured subcontractors, the assignments were worthless. Insolvency of the head contractor proved very costly for the Department and resulted in lengthy delays in completing the project.

9. Under the traditional method of procurement there have been many instances of the Government having to pay subcontractors when the head contractor became insolvent. There will be more. The proposed statutory trust will go a long way towards solving that problem.

10. I recall one instance where the Department was concerned that the lowest tenderer for a project to be procured by the traditional method might not have the financial capacity to complete the project. The tenderer had large loans from a bank. To protect subcontractors the Department asked the lowest tenderer [subsequently the head contractor] to agree to a clause in the head contract to the effect that all moneys received by the head contractor would be received upon trust. The terms of the trust were, in effect, the statutory trust recommended by Mr Collins.

11. The head contractor agreed to the trust provision which was one additional clause in the contract conditions. This did not impose any additional administrative burden on the head contractor. The head contractor did not have to establish a separate trust account. The head contractor did not become insolvent. However, had the head contractor become insolvent the bank would not have had priority over subcontractors, as is usually the case on an insolvency. Moreover, had the head contractor not complied with the terms of the trust the subcontractors could have brought a class action against the directors and officers of the company who unlawfully took the subcontractors' trust moneys.

12. Banks, other lenders and head contractors will be most opposed to the proposed statutory trust: the banks because they will lose their priority over subcontractors in any liquidation: the head contractors because their directors and officers could be civilly and criminally liable if they knowingly facilitated or permitted the head contractor to misappropriate trust moneys.

13. At present, if a head contractor becomes insolvent the directors and managers of the company simply walk away leaving subcontractors unpaid. If the 'deemed' trust is legislated, they could have personal liability if subcontractors can prove that on a project the head contractor was paid by the principal money for work carried out by subcontractors and the head contractor failed to pass those moneys onto subcontractors.

14. In the 1980's the Department changed its preferred method of procurement from nominated subcontracting to construction management. Construction management involved a construction manager managing trade contracts that were made directly with the Department. Trade contracts were what would be subcontracts under the traditional method of procurement. The construction manager would certify the amount of the progress payments due to each trade contractor and the Department would pay the trade contractor directly. This protected trade contractors against the insolvency of a head contractor.

15. In any comparison between the situation in the UK and Australia it is most important to bear in mind that in the UK [but not in Australia] there is the *Unfair Contract Terms Act 1977*. That Act renders void unfair contract terms in a contract of adhesion. For 40 years I have been urging the Government to enact similar protection for Australian contractors and subcontractors.

16. The *Building and Construction Industry Security of Payment Act 1999* has a major flaw that does not exist under UK law. A principal in a head contract or a head contractor in a subcontract can include most unreasonable terms and adjudicators and courts give effect to them. These unreasonable terms are regularly used by head contractors to deprive subcontractors of fair payment for their work.

17. One example is time bar clauses, ie clauses that provide that unless the subcontractor gives notice within a very limited time [sometimes as short as three days] of a claim for a variation, extension of time or damages for breach of contract by the head contractor, the subcontractor's entitlement will be extinguished.

18. Another example is indemnity clauses. Sometimes the subcontractor has to indemnify the head contractor from losses the head contractor suffers by reason of acts of third parties such as other subcontractors.

19. Yet another example is set off provisions. These are provisions that enable the head contractor to set off against payment to the subcontractor any amounts that the head contractor claims for backcharges.

20. It was in the 1990's that principals and head contractors started to depart from generally recognized standard forms of contract and subcontract and to draft their own contract conditions. Word processing made this easy. I have observed that contract conditions are becoming ever more unfair.

21. The proposed statutory trust alone will not stamp out the iniquitous practice of using unfair contract terms to deprive subcontractors of fair payment for their work. But the statutory trust will have an important deterrent effect and will support the object of the SOP Act. Some examples will best explain this.

22. Assume that the principal pays the head contractor $1 million for cladding provided by a subcontractor. At the moment this $1 million is the head contractor's money. The head contractor can use it for any purpose without being guilty of misappropriating the subcontractor's money. It is not the subcontractor's money. In an adjudication under the SOP Act the head contractor can use iniquitous contract conditions to claim a set off and avoid making a progress payment.

23. If the 'deemed' trust is enacted as part of the SOP Act, the head contractor holds that $1 million as trustee for the subcontractor. It is the subcontractor's money. A trustee cannot lawfully take and use the money for the trustee's own purposes. That is misappropriation for which there are civil and criminal consequences. In an adjudication, the set off clauses now used by head contractors to avoid paying subcontractors will longer be effective. The head contractor will not be able to withhold payments under the SOP Act on the ground that the contract permits the head contractor to do so. The head contractor will only be able to lawfully withhold payment if in doing so the trustee was not in breach of the Trustee Act 1925.

24. If sued by the subcontractor for the money that should be in trust, to defend the claim the head contractor would have to prove that the subcontractor is indebted to the head contractor. A mere claim of a right of set off would not be a defence. The Trustee Act 1925 will govern the rights of the head contractor and subcontractors with respect to the money in trust. If at the end of the litigation the head contractor is found to be indebted to the subcontractor and the head contractor is insolvent, the subcontractor will likely have a claim against any director or officer of the head contractor who knowingly facilitated or permitted the head contractor to misappropriate trust moneys.

25. At present the situation is that at the end of ligation by a subcontractor the head contractor may be placed in liquidation and the subcontractor receives nothing. If the 'deemed' trust is enacted, liquidation of the head contractor need not be the end of the story.

2. Response to *questions for comment*

1. *Do you support the proposal to establish statutory trusts in the Act?*

What is "the proposal to establish statutory trusts in the Act"? The Consultation Paper sets out "key features" of the recommendations of the Murray Review, the Collins Report and the Law Reform Commission of WA (LRCWA) but it does not specifically state what is "the proposal" or whose proposal it is. Does the Government have a proposal?

The majority of the questions for comment [Appendix A] in the Consultation Paper ask, "Do you support the proposal that…". There are numerous proposals.

The Minister says, "Mr Murray determined that the concept of a statutory trust is the only proposal that will provide a cost-effective and fair means of dealing with a party's entitlement to be paid". Later the Minister refers to "a proposal to give effect to this recommendation". Appendix C is titled "Key Collins inquiry recommendations endorsed in Murray Review".

At p 153 of his report Mr Collins says, "[t]he Inquiry is of the view that the Maryland construction trust legislation is to be preferred …". The Maryland construction trust legislation is set out on p 150 of the Collins Report. It is:

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

Section 8(2) of the Ontario Act is equally simple. It is:

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

If "the proposal" is to incorporate such provisions in the *Building and Construction Industry Security of Payment Act 1999* NSW, then I support the proposal.

However, in the Consultation Paper there are many other proposals referred to. Many of these other proposals are not consistent with simple legislation such as that in Maryland, British Columbia and Ontario legislation cited by Mr Collins at pp 150 to 152 of his report. If "the proposal" is to complicate the legislation by incorporation of these other proposals then, to that extent, I don't support "the proposal".

2. *What alternative reform(s) could be implemented?*

An alternative would be to have the principal hold the moneys in trust. This, in effect, was the nominated subcontracting procurement method.
The enacting of an Unfair Contract Terms Act rendering void unfair contract terms in construction contracts of adhesion would enhance the effectiveness of the *Building and Construction Industry Security of Payment Act 1999* [the SOP Act] but would not provide protection in the event of insolvency of the paying party. A statutory trust is also required.

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

   Yes. Most emphatically. The Canadian legislation does just that. However, I don't support the scenarios on pp 12 and 13 of the Consultation Paper to the extent that they envisage that the head contractor will be required to separate moneys into a trust account and the head contractor's personal account. That introduces unnecessary complications. In the event of the insolvency of the head contractor, all the head contractor's moneys should be available to meet the entitlements of subcontractors.

   The head contractor should not be able to isolate some moneys in a trust account and other moneys in the head contractor's personal account. The liquidator should not be able to say that some moneys held by the head contractor in the head contractor's personal account are not trust moneys and are not available to subcontractors. If a liquidator could do that then a preferential creditor such as a bank could seize moneys that would otherwise be available to subcontractors.

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

   There is no appropriate point. There should be no limit. There can be no valid reason for protecting big business and not small business.

5. *Do you support the proposal to apply a requirement for 'deemed' trusts to construction contracts valued at $1 million or more.*

   Most definitely not. Mr Collins made the recommendation based on the Inquiry's discussions with the HIA and the MBA. They represent big business not the multitude of small subcontractors who are the ones who suffer most in an insolvency.

   The so called "commonly held view among most stakeholders" is the view of that category of contractor or subcontractor who would benefit most from a limit. The views of small business has not been taken into account.

   If a head contractor becomes insolvent all subcontractors should rank equally in the winding up, as is presently the case. If there is limit, larger subcontractors will have first call on any assets and will be able to bring a

class action but smaller subcontractors will miss out. What possible justification could there be for having two categories of subcontractors?

All subcontractors should have the right to participate equally in a winding up and in a class action against those who have breached the trust. That will be achieved by having no monetary limit.

Imagine a liquidation. The Government would have to tell small subcontractors that the Government decided only to protect subcontractors where the construction contract [or subcontract] was valued at $1 million or more. What justification could there be? What an opportunity for the opposition to criticize the Government. The opposition could promise to protect equally all subcontractors. It would cost the Government nothing to do so.

At p 14 the Consultation Paper refers to "likely administrative burdens". There should be no administrative burdens. If there are then they will have been imposed by the Government. The statutory trust can be legislated in simple and clear words that impose no administrative burdens. See the Canadian legislation. Mr Collins has a chapter in his report titled "The old chestnut: "Administrative difficulties, burdens and costs". The "old chestnut" is being used to justify a limit on the protection of subcontractors.

At pp 149-150 of his report Mr Collins sets out the trust legislation of Maryland, British Columbia and Ontario and says [at p 149] the Inquiry's own recommended legislative trust provisions draws upon a comparison of these trust acts. None of these acts has a limit. The Maryland Act is one paragraph [page 150]. None of these acts require the creation of a separate trust fund. None of these acts impose any administrative burden on anyone. None of these acts impose any additional cost upon head contractors or anyone else down the construction chain.

There would also be the problem of defining how a construction contract is to be valued. Not all construction contracts have a contract price. Some have a "contract sum" instead of a contract price. Some are schedule of rates contracts. Some are cost plus contracts. Some have a mixture of rates and prices. Even where the construction contract has a contract price, it can change during the course of the contract. Any attempt at defining "a contract value of $1 million" will only lead to disputes. Why create problems when it is not necessary?

6. *What would be an appropriate alternative monetary threshold?*

There is no appropriate threshold. It would not be appropriate or fair to exclude any subcontractor from the scheme.

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

No. All subcontractors should be treated equally. Also, it will not be possible to unambiguously define the "value" of individual contracts. The proposal will only create more problems for the construction industry.

8. *What would be an appropriate contract value?*

There is none.

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

The question does not make sense. The very essence of the "deemed" trust is that the trust arises when the contract moneys are received by the trustee. If it were otherwise, the whole purpose of the legislation would be defeated. The basic flaw in s 12A of the SOP Act is that the retention moneys are paid by the head contractor into a trust account.

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

The question does not make sense. The "deemed" statutory trust comes into effect as soon as the act creating it commences. It isn't established at a point in the contract lifecycle. It is not part of the contract. It is an entitlement provided by law.

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

The question does not make sense. The person receiving trust moneys [the trustee] has responsibility for managing them. Who else could have responsibility?

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

13. Yes. The accounting should be left to the trustee. The legislation should not impose unnecessary administrative burdens on trustees. As a solicitor I can have one trust account. I don't have to have a separate account for each client. The reasons given at p 16 of the Consultation Paper for separate trust accounts are not valid. If a head contract receives any moneys in trust and instead of paying those moneys to the beneficiaries the trustee applies them to the trustee's own purposes [including using them to repay the trustee's debts to the bank] all the trustee's assets can be used to make up the shortfall. If the payments can be traced, the beneficiaries may be able to recover them from third parties. And those responsible for creating the shortfall can be personally liable.

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

No.

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

Yes.

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

The compliance and enforcement provisions of the exposure draft bill are unnecessary. They should not be enacted. I have addressed this in separate response to the exposure draft bill.

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

Those in s 13(1) of the Ontario Act recommended in the Collins Report at p 152.

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

Yes. The trustee would be withdrawing the trustee's own money. The trustee would not be breaching the trust while the amount received by the trustee on account of the work of subcontractors was still held in trust. For example, a progress payment by the principal to the head contractor may be $100,000 but only $80,000 may be in respect of work carried out by subcontractors. The head contractor would be entitled immediately to $20,000. The head contractor would hold the remaining $80,000 in trust.

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

When the amount received by the trustee exceeds the amount that the trustee must hold in trust. See the last example.

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

This situation would only arise on insolvency of the trustee. The legislation should not interfere with what is presently the law – the Trustee Act 1925 and

Federal insolvency law. There is no need for the 'deemed' statutory trust legislation to deal with this question. To attempt to do so may even be unconstitutional: ie contrary to Federal insolvency law.

21. *What other model of distribution would be preferred?*

See the preceding answer.

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

Yes.

23. *Are any new or amended mechanisms required?*

If the Canadian model is adopted [as recommended by Mr Collins] there are no other new or amended mechanisms required.

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

The situation is adequately covered by the Trustee Act 1925. No change should be made.

25. *Are any further provisions necessary to support the operation of the proposal?*

No.

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

No. Such a provision would serve no purpose. It would impose an unnecessary additional regulatory burden on the building and construction industry.

In the event of litigation, the court will decide what records must be made available by the defendant and how and when they must be produced or made available for inspection. The process is known as "discovery". Courts have adequate powers to support their orders.

In the event of adjudication under the SOP Act power of inspection of the respondent's records would serve no purpose. For example, if a subcontractor claimant claims $50,000 from the head contractor respondent it is quite unnecessary for the claimant to inspect the "deemed trust accounts". Assuming that the adjudicator decides that the respondent must pay the subcontractor $50,000, the respondent must pay it. The amount in the trust account is irrelevant. The subcontractor is not limited to the amount in the trust account. There is no reason why the subcontractor should be entitled to inspect the respondent's accounts or the respondent should be burdened with an obligation to disclose accounts. There are also privacy issues.

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

I don't understand "similar degree of awareness". In adjudication under the SOP Act "awareness" of the amount held in trust is not an issue. In litigation the courts have adequate powers to require disclosure by trustees.

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

There is no need to apply executive liability. It exists anyway. To make it clearer, the 'deemed' trust legislation could include the following from the Ontario Act:

> 13(1) Liability for breach of trust by corporation
>
> In addition to the persons who are otherwise liable in an action for breach of trust under this Part,
>
> 1. every director or officer of a corporation; and
> 2. any person, including an employee or agent of the corporation who has effective control of a corporation or its relevant activities,
>
> who assents to, or acquiesces in, conduct that he or she knows to or ought reasonably to know amounts to breach of trust by the corporation is liable for breach of trust.

At p 152 of the Collins Report Mr Collins recommends that such a provision be enacted in NSW.

It is important to note that the recommended provision would give claimants a civil right. A major problem with the proposed amendments to the *Building and Construction Industry Security of Payment Act 1999* NSW is all the criminal offences that would be unnecessarily created.

29. Do you consider these are the likely benefits associated with the proposal?

The question is not clear. I don't consider that the mooted additional regulatory burdens provide any likely benefits. A simple scheme such as that in the three Canadian Acts cited by Mr Collins would provide very significant benefits for the construction industry, subcontractors and commerce generally. The significant benefits will not be enhanced by "other possible remedies available" set out on p 23 of the Consultation Paper.

30. Are there any other significant benefits that are relevant?

No.

31. Do you consider these are the likely costs associated with the proposal?

Again, what is "the proposal"? There will be likely costs if the Government imposes additional unnecessary burdens on the construction industry; such as the burdens contained in many of the proposals. The Canadian legislation recommended by Mr Collins would not impose any costs on anyone acting honestly.

Banks and other financiers are big enough to look after themselves. After the recent Banking Commission's exposure of the conduct of banks, the Government would not want to be seen to be rejecting recommend protection for small business in order to protect banks.

32. Are there any other significant costs that are relevant?

If the legislation is kept to the simple scheme in the Canadian Acts cited by Mr Collins, there will be no costs whatsoever to honest head contractors and subcontractors down the construction claim. Simple legislation would not require head contractors or those down the construction claim to do anything to change what should be there current contracting practices. Simple legislation would not require them to create separate trust accounts or to change their accounting procedures.

It is only if a head contractor or someone down the construction chain is unable to pay their subcontractors that the trust legislation would change things for that person. Then subcontractors may call upon the trust legislation to recoup what is owed to them. It is then that other creditors may be affected.

For example, if the principal had paid a head contractor $10 million on a project and subcontractors on the project are entitled to be paid $8 million for their work but they have only been paid $3 million they will be looking for the extra $5 million which the head contractor received in trust. If the head contractor has $1 million in assets, the subcontractors would have a claim against that money in preference to unsecured creditors. A trustee is taken to have paid the trustee's own moneys first and any money left over is trust money.

Sometimes when a head contractor becomes insolvent there is still money owed to the head contractor by the principal. Under the trust, subcontractors would have first claim on that money.

After the trust legislation banks may be more cautious in lending to head contractors but they are likely to have less subcontractors become insolvent owing money to them.

It is true that financing costs may increase for some head contractors, namely, those who have to rely upon subcontractors' money to keep afloat. The existing method used by some head contractors to finance projects with subcontractors' money puts the construction industry at risk.

Another effect of the proposed legislation will be the ability of subcontractors to pursue claims [sometimes as a class action] against directors and those in corporations who have unlawfully expended trust moneys. This may make it more difficult to set up phoenix companies.

If when a head contractor becomes insolvent and the Government decides to pay out subcontractors in order to continue the project and takes an assignment of the amounts owed to subcontractors the Government may be able to recoup the misappropriated trust moneys.

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