

NSW Security of payment reform

Submission September 2018



Master Electricians Australia (MEA) is the trade association representing electrical contractors recognised by industry, government and the community as the electrical industry’s leading business partner, knowledge source and advocate. Our website is www.masterelectricians.com.au .

Master Electricians appreciates the opportunity to comment on the discussion paper for proposed changes to the Security of Payment Reforms. Master Electricians, in reviewing the document, has done so based on the experience of what an electrical contractor and/or consumer may experience.

Master Electricians has contributed to a number of reviews and reports concerning security of payment and we agree with the discussion paper’s premise for change and agree with the historical difficulties and problems still facing the industry.

The vexed issue of security of payment in the construction industry has a long history in all states of Australia. It is interesting that from MEA’s own history one of the first issues identified in our Association’s Minutes of meetings was to address the issue of “receiving payment from builders”. This was 1937. Many options have been tried including retention trusts, project bank accounts, civil proceedings and fast-tracked adjudication statutory models. All have advantages and disadvantages.

The case for change

MEA supports the discussion papers view of the cost and impact of insolvencies in the Building and Construction industry on Subcontractors and their Employees. In examining the 2016 – 17 Construction Industry reports from ASIC we see the following table

Table 3.2.2.4 - Initial external administrators' reports for Construction industry—Assets, liabilities and deficiency by region (1 July 2016–30 June 2017)									
	Australian Capital Territory	New South Wales	Northern Territory	Queensland	South Australia	Tasmania	Victoria	Western Australia	No. of reports
DEFICIENCY CATEGORIES									
\$0–\$50,000	1	108	0	24	1	1	35	10	180
\$50,001–\$250,000	14	212	3	77	12	3	154	54	529
\$250,001–less than \$500,000	3	82	1	42	11	4	58	40	241
\$500,000–less than \$1 million	4	71	3	36	6	0	73	30	223
\$1 million–less than \$5 million	10	85	2	86	11	0	76	50	320
\$5 million–\$10 million	2	16	1	6	1	1	17	16	60
Over \$10 million	0	15	0	8	8	0	9	18	58
Total	34	589	10	279	50	9	422	218	1,611

If we assume that the results of each deficiency of asset over liabilities is equally distributed and results in the mean deficiency equalling the midpoint of the above range, we find the costs associated with Building and Construction insolvencies in Australia for 2016 – 17 is a conservative \$2.6 billion.

\$0–\$50,000	\$4,500,000
\$50,001–\$250,000	\$79,350,000
\$250,001–less than \$500,000	\$90,375,000
\$500,000–less than \$1 million	\$167,250,000
\$1 million–less than \$5 million	\$960,000,000
\$5 million–\$10 million	\$450,000,000
Over \$10 million	\$870,000,000
Total	\$2,621,475,000

Source ASIC Released: December 2017 Series 3: External administrators' reports 3.2 - External administrators' reports for selected industries, 1 July 2016–30 June 2017.

Other Reviews

Currently the Western Australia State Government is undertaking an extensive review of Security of Payment legislation and has produced an extensive consultation paper regarding a number of possible outcomes, including examining Project Bank Accounts, Retention Trust Accounts and Deemed Statutory Trusts. Whilst no outcomes have been announced as yet discussion paper 4, attached, at pages 53 to 61 gives a concise history and reasoning about Deemed Statutory Trust (DST) and the countenance of arguments relating to the actual cost etc.

In our submission to the WA review we stated:

“MEA strongly supports action that will address current problems with security of payment. It is our view that the most appropriate options presented here in paper 4 is that of Deemed Construction Trusts. Whilst MEA has strongly supported PBA’s in Queensland recently Construction Trusts were not an option considered by the State Government in its recent amendments.

We agree with the advantages of construction trusts stated in the discussion paper being

- *Secures payments due to subcontractors and suppliers in circumstances where an entity against whom a payment claim has been made becomes bankrupt or insolvent.*
- *Subcontractors and suppliers may reduce their prices in contemplation of receiving guaranteed payments out of the trust.*
- *May facilitate the growth of small businesses by reducing the risk of non-payment in the event that an entity from which payment is owed becomes insolvent.*
- *Should prevent contracting parties from using money received for works or materials provided by subcontractors and suppliers as part of their operating cash flow – this would constitute a breach of trust.*
- *Would provide an incentive for head contracting parties to maintain more working capital.*

- *May provide an incentive for head contracting parties to not under-bid when tendering to secure projects. This could have positive flow on effects, such as ensuring the full payment of award rates and entitlements to workers.*
- *Provides assurance to principals and head contractors that supply chain participants at lower tiers have been paid, potentially reducing the risk of defects, timeframe blow-outs and disputes.*
- *When compared to PBAs, construction trusts on private projects are likely to be much less administratively complex. Firstly, construction trusts would not require the use of Trust Deeds, Payment Instructions and Payment Reports. Secondly, construction trusts would not unduly extend payment times if applied to parties down the contracting chain (e.g. sub-subcontractors and suppliers).*
- *Will overcome some of the legal uncertainty of PBAs in terms of how they operate with the Corporations Act and the PPSA.*

We recognise PBA have had a significant effect in WA and we see while they work well there has been presented the opportunity to evaluate Construction Trusts. We say that based on the PBA experience in WA that a better outcome can be achieved in conjunction with the Murray review outcomes that will Australia resolve the issue at hand being late /non-payment of subcontractors.

This single action alone of Construction Trusts cannot be undertaken in isolation and must accompany other recommendations from the Murray review to be fully effective and we encourage the reviewers and the Government to not be shy at an important juncture of this industry to finally resolve systemic problems that have existed since before 1937. How does MEA know this? In our minutes of our association when it was first formed in 1937 one of the reasons behind its formation was “the late/non-payment of members by Builders”.

The aim of this is review must be the focus. That focus is to reduce the current loss of \$337 Million to the subcontractors their employees and the WA economy as soon as possible to restore confidence and certainty to the sector and the broader economy in WA.”

In response to the NSW discussion paper MEA supports the establishment of deemed trust in the Act. Without repeating our submission to the Western Australia review we do support them for a number of reasons including that trust will:

- secure payments due to subcontractors and suppliers in circumstances where an entity against whom a payment claim has been made becomes bankrupt or insolvent.
- facilitate the growth of small businesses by reducing the risk of non-payment in the event that an entity from which payment is owed becomes insolvent.
- prevent contracting parties from using money received for works or materials provided by subcontractors and suppliers as part of their operating cash flow.

- provide an incentive for head contracting parties to maintain more working capital.
- provide an incentive for head contracting parties to not under-bid when tendering to secure projects. This will have positive flow on effects, such as ensuring the full payment of award rates and entitlements to workers.
- lead to principals and head contractors ensuring the supply chain participants at lower tiers have been paid, potentially reducing the risk of defects, timeframe blow-outs and disputes.
- when compared to PBAs, construction trusts on private projects are likely to be much less administratively complex and more likely reflect current accounting practices and not introduce unnecessary complications.

Deemed Statutory Trust and the Contractual Chain

MEA does support cascading trusts and after consultation with members believe that the whole chain of head contractor, subcontractor, second and third tier subcontractors should include suppliers. However, we do not believe that suppliers should be required to have deemed statutory trust toward manufacturers or importers.

Deemed Statutory Trusts and the Value of Projects

MEA has previously supported a \$1 million value for projects in various sectors and jurisdictions. However, after further considering the views of members and the ASIC Asset Liabilities and Deficiencies data plus other ASIC data we have formed a view that the value of the contract may not describe where the problems arise. In fact, in examining the ASIC data a \$1 million contract value may well lead to some 76% of claims not being covered. MEA's position is that a suitable level would be for all contracted construction work to be covered by the DST. MEA does recognise that each state jurisdiction has nuances and in this case the \$20,000 limit for building work as deemed by NSW Home Warranty Insurance Scheme may well address that concern.

It is important however that any legislation has in it robust features such as

- Anti-avoidance requirements (such as dividing projects to avoid obligation)
- Clear procedures for determining the contract value in the event variation and additional work increase the cost
- Clear enforcement
- Accountability and transparency by subcontractors on relevant DST transactions and ledger accounts and overall status of the account.

Deemed Statutory Trust Creation

In the event that the vast majority of the industry is required to operate under a DST, then the creation of a DST only has to occur once. This then means that the Business owner will operate all projects out of the one trust. In the event the legislation is passed then all companies will have a specific period in which to establish a trust fund. We say that this is after

a consultation, education and notification period to the industry to explain their process and give time for owners and their accounting and banking advisors to establish the account and relevant ledger accounts.

For new entrants we envisage that NSW Fair Trading will, in the Construction licensing and relevant associated trade areas, require them to be formed prior to issuing a license for trade. This then ensures that all are aware of their obligation to meet the requirement that a DST is identified within the business operations. This may well be their primary bank account or other bank account depending on the operation of the proposed legislation.

In the alternative if the limit for DST within the Construction industry is set at \$1 million project value and the entity has not previously entered into a Construction contract for work that would require the existence of the DST then once the funds are received into an account that account is deemed to be the creation of the DST.

In practicality, and to further protect industry participants, the legislation should contemplate making it a requirement of principals / project owners to ensure that all contracts entered into clearly state the requirement that by entering into the agreement and its execution that a DST has been created. MEA believes that this would again be particularly pertinent in the event that the \$1 million limit is enforced by the legislation.

DST and who is responsible

MEA agrees that the legislation should clearly identify that the responsibility for the DST is with the trustee. The legislation should contemplate that the trustee has a suitable relationship with the business and in MEA's position they should be a director and that person should be a "fit and proper person". MEA believes that a trustee must fulfil the following requirements:

- is competent to operate a credit business (as demonstrated by the person's knowledge, skills and experience);
- has the attributes of good character, diligence, honesty, integrity and judgement;
- is not disqualified by law from performing their role in business; and
- either has no conflict of interest in performing their role in business, or any conflict that exists will not create a material risk that the person will fail to properly perform their role in business.

The NSW Government may well have other "fit and proper person" tests that have other various requirements however we believe that the above are a starting point for such a test.

DST and Co-mingling of funds

MEA submits that it should be a requirement for a DST to be a separate bank account. Our view is formed on the notion that in the event of an insolvency, receivers who are appointed need to quickly ascertain the state of the business. This would be better served by having a separate bank account so that monies are not co-mingled, and that employee entitlements and subcontractor cash is kept separate.

In addition, MEA believes that to increase transparency and accountability subcontractors should be able to review the DST and to review all related ledger accounts that are associated with their interest in the trust account. By having a separate account this allows for the private affairs of the construction company or subcontractor lower down the chain to remain confidential.

MEA agrees with the discussion paper concerning the other advantages of separate accounts:

- to prohibit a bank's ability to otherwise use funds held with it to repay debts owed to that bank, providing greater protection that those monies reach the intended recipient;
- to prevent trust funds becoming mixed with other money of the trustee and consequently becoming unidentifiable;
- to discourage the misapplication of trust funds and educate head contractors and others that these monies cannot be used to supplement cash flow; and
- to facilitate the tracing remedy in an insolvency, making plain that the trust monies do not form part of the general pool of funds to be distributed to creditors as part of insolvency.

In support of this stance it is important to highlight that trustees, such as those in the Real Estate and Legal communities have obligations in operating Statutory Trusts, these include having to comply with the 'general law' principles of:

- duty of loyalty
- duty not to mix trust funds with its own funds
- duty to keep and render accounts
- duties to inform beneficiaries of their rights under the trust

It is MEA's view that a DST must follow the same principles within the legislation and common law to ensure there is reduced risk of subsequent disbursement of monies that are owed for work completed on a project.

DST and External Audits

MEA is cautious about removing the requirement to have DST externally audited. We are cautious for a number of reasons:

1. Without seeing the proposed legislation subcontractors do not have rights to investigate or challenge the veracity of statement of those with the DST. Nor can they instigate an investigation or call into question the activities of the Trustees.
2. Not all DST holders will be subject to ASIC regulation and auditing and financial records requirements, thus reducing the enforceability of requirement on trustees / company directors.
3. NSW Fair Trading inspectors currently do not have the appropriate powers to investigate, enter premises or seize relevant documents or computers to investigate breaches of the act.

4. NSW Fair Trading currently does not have an identified workforce / inspectorate that can undertake the enforcement of this regime.

MEA believes that until such time that the above issues are addressed then a DST holder should be required to have accounts audited and that those audit reports should be made available within 5 business days to subcontractors or relevant parties upon request. We also believe that the Department of NSW Fair Trading should establish a working relationship with ASIC to allow for data matching and information sharing on ASIC entities and their performance in compliance with relevant ASIC functions such as submitting relevant audited financial reports and bankruptcy status.

In the event that the above concerns are addressed with relevant resources powers and legislative change then previously audited DSTs may well be done on a risk / complaint generated basis.

DST and entitlement to payment

MEA agrees that a trustee may remove funds once all monies are accounted for or assigned appropriately. However, this does not mean an unfettered right to take money at any stage. MEA submits that within the DST the ledger accounts should include a disputed funds account. If a dispute arises concerning the quality / quantity of work the disputed funds should be accrued into the disputed funds ledger account. If this is done the Trustee can then pay themselves for work that they have been approved for by the client.

In addition to disputed funds a serious concern for under/delayed /disputed payment is variations of work and non-payment of variations. The NSW Government has an opportunity, through this process to require, that variation of works are conducted through the DST and that this work is recorded in the event of disputation.

If the Trustee cannot identify a disputed trust ledger account within the DST or refuses to account for monies in this manner, then the Trustee is required to only remove money at such time as the subcontractors are paid the appropriate amount.

DST and insufficient funds

If there are insufficient funds within the account this creates a number of jurisdictional concerns for both the Trustee and the Directors of the Company. The Trustee as described in the discussion paper, has responsibilities to operate the DST effectively and with impartiality, but Directors have responsibilities to ASIC in ensuring that companies do not trade insolvently. This occurrence and its cause may well be an area for concern and care must be taken in drafting any legislation and/or regulation.

The concern is that a Company to avoid insolvency must have the financial means to pay its debts in the business. Should a DST become low in funds does this create a situation where the business is “unable to pay its debts” thus enlivening the ASIC requirements? MEA believes Directors must ensure the DST is able to pay its debts and as such must ensure the fund has sufficient funds. If the Company is not in a position to fund the short coming, then the Directors

must assume that they cannot fulfil their requirement to stay solvent and in this case, must declare themselves unable to meet their requirements.

In some jurisdictions, such as Queensland Project Bank Accounts it will be a requirement for the Builder to ensure, by using their own funds, that funds are available. This means that Builders and the Construction chain will be required to have sufficient reserves capital or capacity to draw upon.

In a cascading event whereby, the high level becomes insolvent resulting in a “knock on” effect there are circumstances whereby prorate of funds may well alleviate a short-term cash flow issue for industry participants, however this should not be seen as a manipulative way to retain current practices of delayed payment. MEA’s view is that to remove this risk that in the first instance the originating DST that falls into arrears should be made to fund the short coming from their own reserves.

DST and disputes

MEA agrees that the current adjudication model should be retained. MEA submits our previously stated position concerning the recording of disputed ledger accounts in a DST will assist. The disputed DST account should be presented to the adjudicator upon acceptance of the claim for adjudication, as proof that the contractor has been fulfilling the statutory obligation to the subcontractor and proof that they have been discharging their duties as a Trustee. This also addresses MEA’s previous submission concerning reducing external auditing fees when third parties are in dispute. If there are reduced external auditing, then a dispute procedure is an effective way to reward those who operate correctly and to check those in dispute that old poor habits of slow or non-payment are not reoccurring and that this is a genuine dispute about quality/quantity of work.

DST and Investment

MEA submits that monies should be readily available for payment and funding of invoices on projects. MEA suggests that if the Murray review timings and procedures are adopted then it is doubtful that investment will be a significant earner for any contractors except possibly those at the highest of levels. There is now also reduced ability to have unfair payment terms stretching out to 120 days past invoice date that allow significant funds to be invested in markets to provide a significant return.

DST and inspection / auditing

MEA’s previous submissions have stated that beneficiaries should and must be allowed to review accounts. Our submissions concerning ensuring comingling means that companies may still hold some confidential information about their own arrangements. However, given MEA’s concern about a lack of enforcement and officers with appropriate powers it is vital to have beneficiaries not only able to review but also to report anomalies and suspected contraventions.

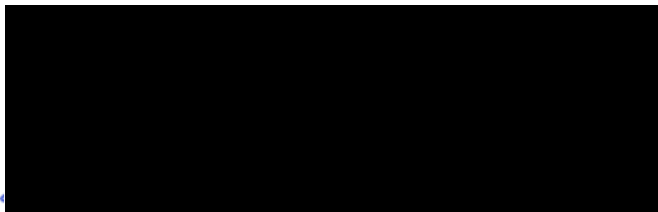
DST and Directors Liability

MEA supports the proposal to apply executive liability to directors and other relevant persons. The discussion paper highlights the LRCWA Review and it particularly point out the following;

Trusts law principles relating to personal liability of persons who deal with trust property in breach of trust: The case of Barnes v. Addy¹⁹¹ establishes that third parties who knowingly deal with trust property in a manner inconsistent with the performance of the trust will be subject to constructive trusteeship of the trust property. Directors of contractors where there are breaches of trust may be held personally liable under this statute.

DST and expected costs

The discussion paper highlights many concerns regarding the introduction of DST. It is MEA's view that these costs as described were well considered in the Murry and Collins reviews. It is our view that the changing of culture and entrenched behaviours identified by these two reports and others need to change. It is our view that these changes will not outweigh the estimated \$2.6 billion a year that this industry losses in productivity wages and progress payments. The additional benefits that MEA expects to be derived from these changes will stretch to include reduced reliance of social welfare such as Centrelink and Fair Entitlement Guarantee scheme and reduced social impact whereby mental health and related social costs will improve as an indirect benefit as the industry improves its performance and reduces insolvencies and their related costs.



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