A Clayton’s Trust

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This article contains an important warning to all head contractors who enter large construction contracts on or after 1 May 2015 for work in New South Wales and all subcontractors who might mistakenly think that the new New South Wales ‘retention money trust account’ will protect them. It also shows how the retention money trust account will affect adjudication under the Building and Construction Industry Security of Payment Act 1999 (NSW) (‘the SOP Act’).

I have called the retention money trust a ‘Clayton’s trust’¹ because it provides no security whatsoever for subcontractors. Following the insolvency of a number of large head contractors the New South Wales Government commissioned Mr. Bruce Collins QC to conduct an inquiry into construction industry insolvency in New South Wales.² The Government’s terms of reference for the inquiry³ included considering legislative responses that can be taken into account to minimise the incidence and impact of insolvency including the effectiveness of trust arrangements in protecting subcontractor payments. Recommendation 6 of the Report⁴ is for the enactment of legislation for a Construction Trust. In that recommendation Mr. Collins says:

The first important characteristic of this trust is that the moneys are not at any time deposited into a bank account owned and operated by the head contractor.

In enacting s 12A of the SOP Act and the Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW), the Government has ignored the recommendations of the Collins Report and has once again elected to leave subcontractors unprotected. Very sadly for many subcontractors, this will be illustrated when next there is a spate of head contractor insolvencies.

On 1 May 2015 the Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW) (‘the Regulation’) commenced.⁵ The regulation only affects ‘head contractors’ as defined in the SOP Act s 4. It only applies to subcontractors’ retention money held by a head contractor who enters a head contract on or after 1 May 2015.⁶ The Regulation amends the Building and Construction Industry Security of Payment Regulation 2008. Section numbers referred to are those in the 2008 Regulation as amended.⁷

Henceforth, any prudent head contractor proposing to enter a large construction contract for a project in New South Wales will ensure that subcontracts let by the head contractor do not include retention money as security, as distinct from holdback. For the reasons pointed out below, this will protect the head contractor against the impositions that the Regulation imposes.

$20 million threshold

The Regulation applies to head contractors who deduct retention money from money payable to subcontractors but it only applies when the head contractor’s construction contract with the principal has a value of $20 million or more. That would occur if the
contract sum is $20 million or more. If the contract does not provide for a contract sum (for example, it is a cost plus contract, a schedule of rates contract or a contract where the consideration is a lease or right to collect tolls) then the ‘market value of the work to be carried out and the value of goods and services to be supplied’ by the head contractor must be assessed. If that equals or exceeds $20 million then the Regulation applies.  

8 If, initially, the contract sum or market value of the head contractor’s contract with the principal is less than $20 million, it may be increased to $20 million or more if variations are directed or approved after the contract was entered. 9 On the date that occurs, the $20 million threshold will be reached. It is convenient to describe this as ‘the threshold date’. There may be subcontracts that have been let by the head contractor before the threshold date and subcontracts let by the head contractor after that date. If that occurs, the Regulation only applies to retention money deducted under a subcontract let by the head contractor on or after the threshold date. The consequence is that retention money under subcontracts let before the threshold date does not have to be paid into the trust account, but retention money under subcontracts let on or after the threshold date does have to be paid into the trust account.

The statutory retention money trust account

Section 6(1) of the Regulation provides that a head contractor (to whom the Regulation applies because the $20 million threshold exists) who holds retention money as security (under a subcontract let on or after the $20 million threshold exists) is to hold the money in trust for the subcontractor from whom the money is retained. The head contractor must establish a retention money trust account with an authorised deposit-taking institution, called an ‘approved ADI’. See s 4 of the Regulation for the definition of ‘approved ADI’.

The Regulation describes the requirements for setting up the trust account and the records that the head contractor must keep. Within 14 days after creating the trust account, the head contractor must provide details to the Chief Executive of the name of the approved ADI, the branch, BSB and name of the account and the opening balance. The head contractor does not have to give subcontractors any details of the account, deposits or withdrawals. Consequently, a subcontractor will not know how much of the subcontractor’s money is in the trust account at any particular time.

At the end of each financial year, a head contractor who operates the trust account must give the Chief Executive an annual account review report and a retention account statement. A fee of $1500 must accompany the report and statement. A head contractor need only create one trust account for all the head contractor’s projects. The advantage of this is that each year the head contractor has to provide only one account review report and one retention account statement and pay one fee.

The account review report is a report given by a registered company auditor. The auditor must certify that ‘it is the auditor’s opinion that, based upon a review of the operation of the account, the account operator has complied with all the requirements of Part 2 of the Regulation in relation to the account’. That is all the auditor can say. It is a very short report. The auditor cannot give a qualified report. That would not be an
account review report. Presumably, the ‘account operator’ is the head contractor. It does not seem that the account auditor has to check that the head contractor has paid subcontractors all they are entitled to or that the head contractor has paid into the account all the retention money that the head contractor should have paid into the account. A review of the operation of the account would not show that.

It seems that the auditor should be looking at withdrawals from the account. If a withdrawal is made otherwise than in accordance with an order of a court or tribunal or with the agreement in writing of the head contractor and the subcontractor, the auditor should query why it was withdrawn. If the auditor is satisfied that head contractor admits that under the construction contract the subcontractor is entitled to the amount withdrawn, that the amount was that subcontractor’s retention money (in the trust account) and that the money was paid directly to the subcontractor, the auditor would presumably be satisfied that with respect to that withdrawal the head contractor has complied with the requirements of Pt 2 of the Regulation.

A more difficult task for the auditor is where the head contractor has withdrawn an amount from the trust account and not paid it to the subcontractor whose money it is. Section 8 of the Regulation allows the head contractor to withdraw retention money from the statutory trust ‘for the purpose of the payment of money in accordance with the terms of the construction contract under which the money was retained by the head contractor’. There is no limit upon the terms of the construction contract. Some construction contracts provide that the superintendent can certify an amount due from the subcontractor to the head contractor and that the head contractor may deduct the amount from the subcontractor’s retention money.

Some construction contracts allow the head contractor to deduct from the retention money an amount that the head contractor asserts will become due from the subcontractor, irrespective of whether the amount is actually due. In Watpac Constructions v Austin Corp [2010] NSWSC 168, McDougall J considered the following clause:

Without limiting the Builder’s rights under the Subcontract the Builder may deduct from any money due to the Subcontractor:

(a) any money due, or a reasonable estimate of amounts which the Builder asserts will become due, from the Subcontractor to the Builder whether under or in connection with the Subcontract or otherwise; …

At [37] McDougall J said:

In terms, that clause permits an offset to be made for the estimated amount of a backcharge, whether or not the amount of the backcharge has been settled authoritatively as between Watpac and Austin.

Retention money and holdback

In s 4 of the Regulation, ‘retention money’ is defined to mean ‘money retained by a head contractor out of money payable by the head contractor to a subcontractor under a construction contract, as security for performance of obligations of the subcontractor’.
The important point is that only money payable to a subcontractor is retention money as defined. If a subcontract provides that the amount of a progress payment by the head contractor to the subcontractor will be 100% of the value of the subcontractor’s construction work to the date of the progress claim and the head contractor will retain as security 10% of the amount of the progress payment, the 10% would be retention money as defined.

However, if the subcontract provides that the amount of a progress payment will be 90% of the value of the subcontractor’s construction work at the date of the progress claim, there is no retention money as defined. The 10% is ‘holdback’, not retention money. The amount of holdback is not money payable to the subcontractor. It is the head contractor’s money. A holdback provision provides much greater security to the head contractor than retention money would provide.

There will probably be arguments that a holdback provision is void because it is an attempt to contract out of the provisions of the SOP Act contrary to s 34 of that Act. However, s 9(a) of the Act provides that the amount of a progress payment is to be ‘the amount calculated in accordance with the terms of the contract’. There is nothing in the Act that would prohibit a contract from providing that the amount of a progress payment will be a certain percentage of the value of work. Of course, the percentage could not be so small that is effectively prevents the subcontractor from obtaining a progress payment.

Since time immemorial contracts have provided for holdback. The very reason for s 9(a) of the SOP Act is to enable the parties to agree upon how the amount of a progress payment is to be calculated and upon holdback. Contracts can provide for staged payments that are independent of the value of work. Contracts can provide that unfixed materials will not be included in the valuation of a progress payment. There is nothing in the common law that entitles a subcontractor to payment of the whole subcontract price before the subcontractor has completed the subcontractor’s obligations under the contract. Consequently, holdback is not money payable to the subcontractor and it is not retention money as defined.

Methods, other than by holdback, by which a head contractor can avoid the impositions created by the Regulation include requiring security by a bank guarantee or requiring deposits by the subcontractor into a trust account for the benefit of the head contractor. A subcontract could provide that progress payments will not exceed ten times the amount of the security provided by the subcontractor to the head contractor.

**The risk to the head contractor**

The main advantage for the head contractor of holdback is that the head contractor can, without the approval of the subcontractor or suing the subcontractor, use the money for the head contractor’s own purposes or to meet any alleged liability of the subcontractor.

A risk that the head contractor incurs when depositing retention money into a statutory trust account arises if the subcontractor becomes insolvent. Any money in
the trust account that can be identified as the subcontractor’s retention money will be claimed by the subcontractor’s liquidator. The money in the account is still, in law, the head contractor’s money but it is held in trust. The question is whether the head contractor must hand it over to the liquidator.

Section 8(1)(a) of the Regulation says that a head contractor can withdraw retention money from the trust account for the purpose of the payment of money in accordance with the terms of the subcontract. The problem is that, upon the winding up of the subcontractor, Commonwealth insolvency law applies and supersedes the Regulation. The moneys in the statutory trust account are then held in trust for the subcontractor’s liquidator. They not held in trust for the head contractor. If the head contractor wants to use the money in the trust account to meet a claim by the head contractor that the subcontractor breached the subcontract, the head contractor is likely to have a dispute with the liquidator.

**The risk to the subcontractor**

Usually, a head contractor treats retention money as holdback and does not deposit it in a separate trust account. The problem is that if the head contractor becomes insolvent there will be no separate retention money that the subcontractor can identify and claim. The subcontractor has effectively lost the retention money. The Regulation is designed to ensure that upon the insolvency of the head contractor, the subcontractor can recover its retention money. The problem is that, as the Regulation stands, a head contractor does not have to keep subcontractors informed of how much of their money is in the trust account and the head contractor can withdraw money from the trust account at any time ‘for the purpose of payment of the money in accordance with the terms of the construction contract under which the money was retained by the head contractor’.

It appears from *Watpac* that a head contractor can include in a subcontract a provision that the head contractor may deduct from a subcontractor’s retention moneys a reasonable estimate of amounts which the head contractor asserts will become due from the subcontractor to the head contractor whether under or in connection with the subcontract or otherwise. There is no requirement that, before withdrawing from the trust account the subcontractor’s retention money, the head contractor must satisfy a court or adjudicator under the SOP Act that the money is due to the head contractor under the terms of the subcontract.

When a head contractor is short of money, there will be a temptation to withdraw money from the trust account. The head contractor will claim that the withdrawal is for the purpose of meeting a liability, or estimated future liability of the subcontractor to the head contractor. The alleged liability may be for liquidated damages for delay, the cost of rectification of defective work or some other claim. Once the money is withdrawn and the head contractor is placed in liquidation, the retention money will be lost to the subcontractor.

Assume that the head contractor is insolvent and a subcontractor can prove that the head contractor paid an amount (retention money due to the subcontractor) into the retention money trust account but the amount is no longer in the trust account. Even if the subcontractor can prove that the head contractor withdrew the money without
authority under s (8)(1) of the Regulation, the subcontractor will almost certainly not be able to trace the money and recover that money. The subcontractor will be left with a claim for damages and that claim will rank with the claim of all unsecured creditors. It will almost certainly be worth nothing. When next a head contractor goes into liquidation, it is most unlikely that the Regulation will provide any protection for subcontractors.

If the head contractor is not in liquidation but won’t pay the subcontractor amounts held in the trust account as retention money, the subcontractor would have to sue the head contractor. Section 13(3)(b) of the SOP Act provides that a payment claim under the Act may include any amount that is held under the construction contract by the respondent that the claimant claims is due for release. An amount in the trust account is not held under the Act. It is held under s 12A of the SOP Act and the Regulation. An adjudicator cannot determine that the head contractor must withdraw and pay a subcontractor retention money from the retention money trust account. Only a court or tribunal can do that\textsuperscript{15}.

Section 10(1) of the Regulation provides that retention money held by a head contractor is not available for the payment of the debts of the head contractor. Once a head contractor is placed in liquidation, this provision would no longer apply. In the event of insolvency, the \textit{Bankruptcy Act 1966} (Cth) and the \textit{Corporations Act 2001} (Cth) would override any inconsistent provision in a State Act. If a head contractor is insolvent (even though not yet in liquidation), the head contractor cannot effectively give a subcontractor a preference by depositing the subcontractor’s retention money in a trust account. The tracing back provisions of the Commonwealth Acts would apply. Consequently, even if at the time of the winding up of the head contractor there is money in the retention trust account, there is no guarantee that it will be available to subcontractors. If the Government had legislated for the \textit{Construction Trust} recommended in the Collins Report, subcontractors would be immensely better off.

Section 6(1) of the Regulation provides that the head contractor must pay into the trust account and retain in the trust account retention money held in trust for a subcontractor. This must be read with s 8 that permits the head contractor to make certain withdrawals. Assume that upon the insolvency of the head contractor a subcontractor finds that, in breach of s 6(1), the head contractor has not paid the subcontractor’s retention money into the trust account or, having paid it in, the head contractor has withdrawn it in breach of s 8(1). A claim against the liquidator in the winding up of the head contractor would rank with any ordinary creditor’s claim. It would most likely be worthless.

The head contractor would have committed an offence under s 6(1) and be liable to a fine of up to 200 penalty points. This is currently $22,000. Will the police commence a prosecution of an insolvent company? The approval of the Supreme Court might be required before action could be taken against the liquidator. Would there even be any funds to meet the fine? Note that there is no fine on the directors and management of the company. The Regulation ignores the recommendation in the Collins Report\textsuperscript{16} that such criminal offences would equally have to cover directors and officers in the event that the head contractor is a corporation.
Some construction contracts expressly provide for the deposit of retention money into a more secure trust account than that provided by the Regulation. For example, cl 5.9 of AS2124-1992 provides that a party holding retention money or cash security must deposit the money in a joint trust account in the joint names of the principal and the contractor. Money cannot be withdrawn by one party from that trust account except with the approval of the other party. That protection was omitted in the Regulation. It seems that where the Regulation applies, then so far as concerns the subcontractors’ retention money, cl 5.9 will be superseded by the Regulation. The head contractor will have to deposit the subcontractors’ retention money into the less secure trust account prescribed by the Regulation. Cash security would still have to be deposited into the more secure trust account prescribed by cl 5.9 of AS2124-1992.

The diminished rights of subcontractors under the SOP Act

When the Regulation requires the head contractor to pay retention money into the retention money trust account, the entitlement of the subcontractor under the SOP Act is reduced. Section 13(3)(b) of the SOP Act provides that a payment claim can include any amount that is held under the construction contract that the claimant claims is due for release. If the head contractor holds retention money as holdback, a subcontractor can make a payment claim under the SOP Act for the amount held by the head contractor as retention. But a subcontractor cannot use the SOP Act to recover money in the statutory trust account. An adjudicator cannot order the release of money in the statutory trust account.

Assume that a subcontractor submits a claim under the SOP Act to adjudication and the subcontract is one under which the head contractor is obliged to pay retention money into a statutory trust account. Assume that the subcontract provides for 10% retention money. If the adjudicator finds that the head contractor is liable to make a progress payment of $100,000 to the subcontractor, the head contractor would have to pay $10,000 into the statutory trust account and only $90,000 to the subcontractor. However, having paid that amount into the statutory trust account the head contractor can then withdraw it from the account ‘for the purpose of the payment [to the head contractor] in accordance with the terms of the construction contract’. The subcontractor could not make another adjudication application to recover the amount withdrawn. To recover an amount in the statutory trust account or an amount that the head contractor has withdrawn from the account without lawful authority, the subcontractor must sue in a court.

Conclusion

The New South Wales Government has elected to ignore the recommendation in the Collins Report for the enactment of legislation for a *Construction Trust*. Instead, the Government has enacted legislation for a *Retention Money Trust Account*. When next there is a spate of insolvencies in the construction industry, it will be found that subcontractors are left exposed. The *Retention Money Trust Accounts* will prove to be worthless. Only the enactment of the *Construction Trust* as recommended in the Collins Report will provide subcontractors with protection.
‘Clayton’s’ is an Australian term of the 1980s for something illusionary or nonexistent. It comes from the proprietary name of a soft drink, which was advertised with the slogan ‘It’s the drink I have when I’m not having a drink’ (Brewer’s Dictionary of Phrase & Fable).


Section 5(2) of the Regulation.

Section 5(1) of the Regulation.

The 2008 Regulation will be automatically repealed on 1 September 2015 but will presumably be replaced by a new regulation.

Section 5(2) of the Regulation.