19TH ANNUAL ASIAN REAL ESTATE SOCIETY CONFERENCE
WASHINGTON, D.C., USA 6TH – 9TH JULY 2015

ADJUDICATION IN AUSTRALIA: A STUDY OF THE BUILDING AND CONSTRUCTION INDUSTRY SECURITY OF PAYMENT AMENDMENT ACT 2013 (NSW)

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Abstract

This paper is an extended version of a paper presented at the 21st Pacific Rim Real Estate Society (PRRES) Annual Conference, 18-21 January 2015, Kuala Lumpur, Malaysia. The purpose of this paper is to give a background to the security of payment problem in the New South Wales construction and property industry and the problem of insolvency giving rise to the Building and Construction Industry Security of Payment Amendment Act 2013 (NSW) ('2013 Amendment Act'). The paper explains and analyses the operation of the 2013 Amendment Act and the Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW) ('the Regulation'). A review of the relevant literature was undertaken on the security of payment problem and insolvency in the NSW construction industry and the problem giving rise 2013 Amendment Act. Focus was given on the 2012 NSW Government independent inquiry into construction industry insolvency in NSW ('the Collins Inquiry'), which considered what legislative response (if any) could be taken to minimise the incidence and impact of insolvency in the construction industry. The Collins Inquiry reported that to protect subcontractors in the event of insolvency of the party whose obligation it is to pay them, the Government should amend the Act to provide for statutory construction trusts. The analysis of the 2013 Amendment Act and the Regulation presented in this paper may be of interest in international jurisdictions where statutory adjudication for the construction and property industry has been introduced or is being contemplated.

Keywords: Adjudication, Australia, insolvency, New South Wales, security of payment.

INTRODUCTION

This paper reports on an on-going research project being undertaken by the authors into the performance of the *Building and Construction Industry Security of Payment Act 1999* (NSW) (hereafter referred to as 'the NSW Act').[4] The purpose of this paper is to give a background to the security of payment problem in the New South Wales construction industry and the problem of insolvency giving rise to the *Building and Construction Industry Security of Payment Amendment Act 2013* (NSW) (hereafter referred to as 'the 2013 Amendment Act'). The paper explains and analyses the operation of the 2013 Amendment Act and the *Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015* NSW considers the implications for construction industry stakeholders.

LITERATURE REVIEW

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[4] New South Wales (abbreviated as 'NSW') is one of six states of the Commonwealth of Australia.

Sub-contracting and the security of payment problem

The Australian building and construction industry is a project-based industry and consists of a large number of small private firms (ABS, 2013). In project-based industries like the building and construction industry the delivery of projects to clients typically requires a head contractor to purchase 'sub-projects' and expertise from a large number of external trade suppliers. Consequently, head contractors in the construction industry often act as 'systems integrators' and take responsibility for actively coordinating a network of subcontractors (Martinsuo & Ahola, 2010). Thus, construction projects are characterised by a hierarchical chain of contracts involving cascading payment obligations (Commonwealth Government, 2002). Under this hierarchical chain the Principal (sometimes called 'the Employer' or 'the Owner') pays the head-contractor, the head contractor then pays the subcontractor and the subcontractor then pays sub-subcontractors and suppliers.

Harris & McCaffer (2001) and Uher and Davenport (2009) agree that subcontracting has become widespread in the construction industry and is an essential component of the project procurement structure and delivery process. The reasons for the widespread use of subcontracting in the construction industry are many. However, according to Goldfayl (1999), one notable advantage to head-contractors of sub-contracting is the ability of head-contractors to divest much of the financial risk of delivery of the works under the head contract to subcontractors – the advantage for head contractors being improved cash flow through the effective up-front financing of the bulk of a project by subcontractors (Maqsood *et. al.*, 2003). This reduces head contractors' need for interim borrowings and so reduces head-contractors' project costs.

While money flows smoothly down the contractual chain, all is well. However, all too often one party in the chain does not pay the other party for work done contrary to the contract between them. If the head contractor wants to reduce its overdraft or is short of money, there is a temptation to delay or withhold passing on payments down the chain. Sometimes the head-contractor will simply not want to part with money to project participants down the chain. Sometimes the head-contractor is dishonest and, in effect, takes the subcontractor's money with no intention of ever paying the subcontractor. Sometimes, instead of passing money down the chain, the head contractor uses the money to pay other creditors. In any event, a delay or failure to make payments by one participant higher up in the contractual chain can create significant financial strain on many more project participants lower down in the chain. Ongoing delays or failures by a head contractor to pass money down the chain can reduce subcontractors' cash flow to zero. If this happens, a subcontractor may be forced to carry bad debts, and in extreme cases, may be forced into some form of insolvency (Commonwealth Government, 2002).

Security of payment legislation in New South Wales

The NSW Act commenced on 26 March 2000 and was introduced as part of the New South Wales Government's policy to eradicate the practice of developers and contractors arbitrarily delaying payment to subcontractors and suppliers in the NSW building and construction industry. The NSW Act was the first comprehensive legislative scheme to be introduced in Australia to provide, *inter alia*, contractors, subcontractors and building professionals with a statutory right to, and a procedure to recover, progress payments. The NSW Act has undergone three amendments since its

introduction – the first in 2002[5], the second in 2010[6] and the third in 2013.[7] A review of the 2012 Amendment Act was undertaken by Brand M C & Davenport P (2012). The 2013 Amendment Act is the focus of this paper.

Similar legislative schemes to that operating in NSW and the UK have since been introduced in all Australian states and territories,[8] New Zealand,[9] Singapore[10] and the Isle of Man.[11] On March 8 2011, the Irish Construction Contracts Bill 2010 was passed by the upper house of the Irish Parliament. The Malaysian *Construction Industry Payment and Adjudication Act 2012* was gazetted on 22 June 2012.

RESEARCH METHOD

A review of the relevant literature was undertaken on the security of payment problem in the NSW construction industry and the problem of insolvency giving rise to the 2013 Amendment Act. The research focused on the NSW Government's independent inquiry into construction industry insolvency in NSW ('the Collins Inquiry'), which considered what legislative response (if any) could be taken to minimise the incidence and impact of insolvency in the construction industry.

BACKGROUND TO THE 2013 AMENDMENT ACT

In 1996 the New South Wales Parliament established the Joint Standing Committee on Small Business ('the Committee). Following continued reports of subcontractor difficulties in securing payment when head contractors became insolvent the Committee decided to investigate the issue.[12] The Committee considered a proposal for legislation, such as exists in many Canadian Provinces,[13] to require a person who receives payment for construction work carried out by subcontractors to hold that money in trust for the subcontractors until they have been paid for the work done. The Committee called this the 'deemed trust' proposal. It is also known as a statutory construction trust. The Committee reported that the trust proposal was divisive and support for the trust proposal was far from universal. The Committee was confronted with contrasting legal opinions as to the possible implications of the proposed legislation. The Committee decided that in the absence of industry consensus concerning a trust-based solution, it would not consider the matter further.

Following recommendations in the final report of the Committee, the Government enacted the NSW Act. Despite amendments introduced by the 2002 and 2010 Amendment Acts,[14] the NSW Act failed to protect the subcontractors against the insolvency of head contractors. In the two financial

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[5] *Building and Construction Industry Security of Payment Amendment Act 2002* (NSW).

[6] *Building and Construction Industry Security of Payment Amendment Act 2010* (NSW).

[7] *Building and Construction Industry Security of Payment Amendment Act 2013* (NSW).

[8] *Building and Construction Industry Security of Payment Act 2002* (Vic); *Building and Construction Industry Payments Act 2004* (QLD); *Construction Contracts Act 2004* (WA); *Construction Contracts (Security of Payments) Act 2004* (NT); *Building and Construction Industry Security of Payment Act 2009* (Tas); *Building and Construction Industry (Security of Payment) Act 2009* (ACT); *Building and Construction Industry Security of Payment Act 2009* (SA).

[9] *Construction Contracts Act 2002* (NZ).

[10] *Building and Construction Security of Payments Act 2004* (Singapore).

[11] *Construction Contracts Act 2004* (Isle of Man).

[12] The Hon E. Obeid tabled the report entitled 'Security of Payment for the New South Wales Building Industry', dated September 1998, in the NSW Legislative Council together with a discussion paper and a background paper.

[13] For example, in British Columbia, sections 10(1) and 10(2) of the *Builders Lien Act 1997* (SBC).

[14] *Building and Construction Industry Security of Payment Amendment Act 2002* (NSW); and *Building and Construction Industry Security of Payment Amendment Act 2010* (NSW).

years ending 30 June 2013 more than 1,000 construction companies went into external administration in NSW due to insolvency.[15]

In August 2012, the NSW Minister for Finance and Services announced an inquiry into the construction industry to help shelter the interests of subcontractors in the building and construction sector. The announcement was prompted by the financial collapses of some prominent head contractors companies in NSW. The effects of these insolvencies were most felt by subcontractors and their employees. Mr. Collins QC was appointed to conduct the Inquiry (hereafter referred to as 'the Collins Inquiry'). The purpose of the Collins Inquiry was to consider legislative response that could be taken to minimise the incidence and impact of insolvency in the construction industry, including the effectiveness of trusts in protecting subcontractors.

The Mr. Collins' Final Report (hereafter referred to as 'the Final Report') was released on 28 January 2013. The Final Report is a detailed body of work and makes numerous findings. These findings are the basis upon which the 44 recommendations were made. The most detailed of the recommendations was for the introduction of a statutory construction trust.

Mr. Collins investigated the use of a statutory construction trust such as that considered and rejected by the Joint Standing Committee on Small Business. Mr. Collins considered the contrasting legal opinions that confused the Committee and reports on the anticipated effect of such a trust. In the Final Report, Mr. Collins said (NSW Government 2012:133): "There is no question that the statutory construction trust is fully effective in protecting subcontractors against the loss of progress claims paid by the owner to the head contractor and lost in the event of the head contractor's insolvency". Mr. Collins recommended that a statutory construction trust should apply to all building projects valued at AU$1,000,000 or more and that the vehicle for doing so should be an amendment of the NSW Act (NSW Government 2012).

The NSW Government's response was to enact the 2013 Amendment Act. However, the recommendation in the Final Report to legislate for a statutory construction trust was not supported. Instead, the Government's response to the recommendation is a proposal to trial the use of trust accounts (through Project Bank Accounts) on selected government construction projects before consideration is given to a wider application of the recommendation (NSW Government 2013).

On 1 May 2015 the *Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015* NSW commenced.

ANALYSIS OF THE 2013 AMENDMENT ACT

Overview of the 2013 Amendment Act

The 2013 Amendment Act commenced on 21 April 2014. It only applies to a construction contract made on or after that date.[16] Hereafter, in this paper a reference to the NSW Act is a reference to the NSW Act as amended by the 2013 Amendment Act.

At the end of the second reading speech introducing the bill for the 2013 Amendment Act, the Minister for Finance and Services said: "In summary, this bill provides for fairer payment terms for

[15] Minister for Finance and Services, Hansard NSW Legislative Assembly, Second reading speech, Building and Construction Industry Security of Payment Amendment Bill 2013, 24 October 2013.

[16] *Building and Construction Industry Security of Payment Amendment Act 2013* (NSW), Schedule 2, Part 5.

subcontractors, it will hold head contractors to account for the statements they make about payments to subcontractors and will make it simpler and easier for subcontractors to utilise the Act". However, for reasons explained below, the authors contend that the objectives will not be achieved.

Section 4 of the NSW Act is amended by the inclusion of definitions of exempt residential building contract, head contractor, principal and subcontractor. Section 11 of the NSW Act is amended by inserting maximum periods for payment after receipt of some (but not all) payment claims.

Section 12A has been inserted to permit the making of regulations with respect to retention moneys. Such regulations have not been made and might never be made. For reasons explained below, section 12A is misconceived.

Section 13 has been amended to remove for some contracts (but not all) the need for an endorsement on the payment claim that the claim is made under the NSW Act. Section 13 has been amended so that for contracts let on or after 21 April 2014 a head contractor must provide to the principal a supporting statement in the prescribed form that includes a declaration to the effect that all subcontractors have been paid all amounts due and payable in relation to the construction work concerned. The form of the supporting statement is prescribed by regulation.

Sections 36, 36A and 36B enable the Director-General of the Department of Finance and Services to appoint an authorised officer to investigate compliance by head contractors with the requirement for a supporting statement. The amendments include some penalties.

The NSW Act does not apply to a construction contract for the carrying out of residential building work (within the meaning of the *Home Building Act 1989* (NSW)) on such part of any premises as the party for whom the work is carried out resides in or proposes to reside in. Such a construction contract is an exempt residential construction contract.[17] The remainder of this paper points out the problems that the 2013 Amendment Act has created for the construction industry in NSW and for adjudicators.

Confusing definitions

The 2013 Amendment Act inserts into section 4 of the NSW Act definitions of *head contractor*, *principal* and *subcontractor* and creates three categories of claimant in place of one. In this paper the defined terms are in italics to distinguish them from the terms when they are used in their ordinary meaning. To minimise confusion, the term 'owner' will used to describe a principal who may or may not be a *principal* and the term 'main contractor' will be used to describe a head contractor who may or may not be a *head contractor*.

It is a mistake for an Act to define a term to mean something different to the ordinary meaning of the term. For example, it is a mistake to give *subcontractor* a meaning that includes contractors who are not subcontractors, to give *head contractor* a meaning that excludes some main contractors but can include contractors or consultants who are not main contractors. There will be many construction contracts where there is more than one *head contractor*. It is possible to have a project where there is no *principal* and the owner, the main contractor, other contractors, the project manager and consultants are all *subcontractors*. The status of *principal* or *head contractor* depends upon the particular construction contract between two parties. Consequently, on the one project, the owner may be a *principal* with respect to a number of contractors and consultants but not a *principal* with respect to other contractors and consultants.

[17] 'Exempt residential building contract' is defined in section 4 of the NSW Act. Section 7(2)(b) continues to exclude such a construction contract from the operation of the NSW Act.

A *principal* is a *principal contractor* as defined in section 26A(4) of the NSW Act but a *head contractor*, an owner who is not a *principal* and a *subcontractor* can also be a *principal contractor*. A main contractor who contracts with an owner who is not a *principal* is not a *head contractor* but is a *subcontractor*. In the course of a contract, a *principal* can cease to be a *principal* and a *subcontractor* can become a *head contractor*. On any day, a party or an adjudicator may not know whether the party or another party to a construction contract is a *principal*, a *head contractor*, a *subcontractor* or something else.

The definitions are relevant from the point of view of the time for payment (sections 11(1A) to 11(1C) of the NSW Act), trust accounts for retention (section 12A of the NSW Act) and the *supporting statement* (section 13(9) of the NSW Act). The result is that sometimes it will be very difficult to determine the due date for payment, whether a party must put retention into a trust account and whether a claimant must include a *supporting statement* with a payment claim.

A person can only be a *principal* if the person is:

(a) a person for whom construction work is to be carried out or related goods and services supplied under a construction contract (either by a *head contractor* or a *subcontractor*);

and not

(b) a person engaged under a construction contract to carry out construction work or supply related goods and services as part of or incidental to the work or goods and services carried out or supplied under the main contract.

A *head contractor* is defined to mean:

> the person who is to carry out construction work or supply related goods and services for the principal under a construction contract (the main contract);

and for whom construction work is to be carried out or related goods and services supplied under a construction contract as part of or incidental to the work or goods and services carried out and supplied under the main contract.

A person can only be a *head contractor* if the person is party to at least two construction contracts, one with a *principal* and one with a *subcontractor*. Anyone, other than a *head contractor*, who under a construction contract is to carry out any construction work or supply any related goods and services is defined in section 4 as a *subcontractor.* An owner could be a *subcontractor* or both a *principal* and a *subcontractor* at the same time.

Sometimes under a construction contract, or a separate arrangement (which is a construction contract as defined in section 4 of the NSW Act), an owner agrees with the contractor or another contractor or consultant to supply some materials or services to the contractor or consultant, for example, to supply tiles to be laid, provide the use of a crane or a site office or to review and approve shop drawings. The owner could be said to have engaged under a construction contract to provide goods or services incidental to the work of the main contractor. In that instance the owner would not be a *principal* and the main contractor would not be a *head contractor*. The main contractor would be a *subcontractor*. The owner might also be a *subcontractor*. The status of an owner or contractor could change in the course of the contract.

Three categories of claimant

For construction contracts let on or after 21 April 2014 there are three distinct categories of claimant, namely:

1. a *head contractor*;
2. an ordinary *subcontractor* (one whose construction contract is not an *exempt residential construction contract* and not connected with an *exempt residential construction contract*); and
3. a *subcontractor* under a construction contract that is connected with an *exempt residential building contract*.

The NSW Act applies differently to each category of claimant. The main problem for adjudicators will be that many parties will not address the question of the status of the parties, that is, whether the claimant is a *head contractor* or a *subcontractor* and, if so, which type of *subcontractor*, and whether the respondent is a *principal*, a *head contractor,* a *subcontractor* or something else. Or if they do address the status, they may get it wrong.

Due date for payment

Section 11(1)(b) of the NSW Act originally provided that if a construction contract makes no express provision for the due date for payment, the due date is 10 business days after a payment claim is made under the Act. The section has been repealed. Now, under section 11 of the NSW Act, after receipt of a progress payment the maximum periods for payment are:

1. by a *principal* to a *head contractor* – 15 business days (section 11(1A));
2. by anyone to an ordinary *subcontractor* – 30 business days (section 11(1B)); and
3. by anyone to a *subcontractor* under a construction contract that is connected with an *exempt residential building contract* – 10 business days or such longer period as is provided in the construction contract (section 11(1C)).

The Figure 1 (below) shows the due date for payment for the three categories of claimants. Under section 4 of the NSW Act, a construction contract is defined to mean a contract or other arrangement under which one party undertakes to carry out construction work, or to supply related goods and services, for another party. Many construction contracts are oral and many do not provide for a due date for payment. Previously, in those instances, the due date for payment was 10 business days after the payment claim was made. Now the period has been extended to 30 business days. For these subcontractors the 2013 Amendment Act does not provide fairer payment terms as predicted by the Minister in his second reading speech.

In some instances an owner contracts directly with a contractor or other person to carry out construction work or to supply related goods and services (for example, a plumber, electrician or a consultant such as an architect or project manager) and that person does not subcontract any part of the work or services. A contractor or consultant engaged directly by the owner is then a *subcontractor* even though there is no main contractor. The time for payment is then a maximum of 30 business days after a payment claim under the Act is made (section 11(1B)). There is an exception if the construction contract is connected with an *exempt residential construction contract* (section 11(1C)).

However, if the contractor or consultant (who has contracted directly with the owner) enters a construction contract with anyone (a third party) to carry out any part of the contractor's work or to supply any goods or services for the carrying out of the contractor's work, the contractor or consultant immediately becomes a *head contractor* and the owner immediately becomes a *principal*.

The advantage for the contractor or consultant of this mutation is that the maximum time for payment is halved to 15 business days (section 11(1A)).

For example, a plumber (who has contracted directly with an owner) may purchase fittings for installation under the construction contract with an owner. The contract to purchase the fittings would be a construction contract within the meaning of section 4 the Act. Upon entering an agreement with a store to purchase the fittings the plumber would become a *head contractor*, the owner would become a *principal* and the maximum time for payment by the owner to the plumber would be reduced from 30 to 15 business days. With the payment claim, the plumber would have to provide a *supporting statement* (section 13(7) of the Act).

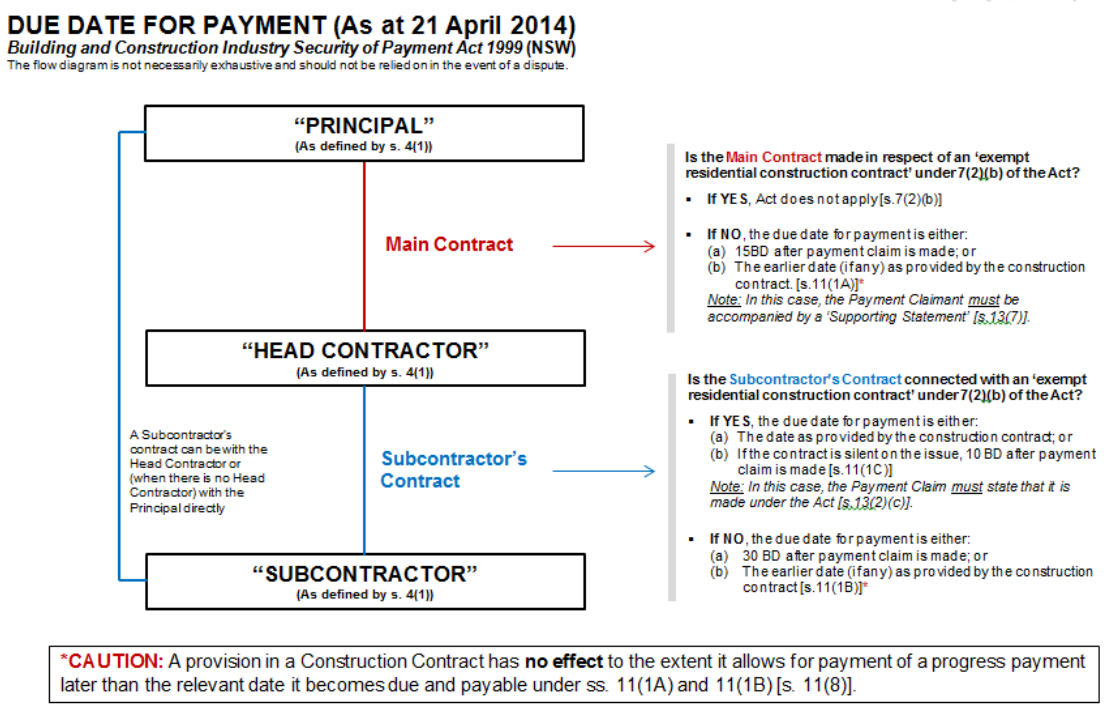

Figure 1: Due Date for Payment

No limit on the reference date

There has been no amendment of section 8 of the NSW Act. It defines *reference date* and provides that a payment claim can only be made on or from a *reference date*. The paying party (the respondent in an adjudication) remains in control of the *reference dates* in their contracts. Controlling maximum times for payment (after a payment claim is made) without controlling reference dates leaves subcontractors exposed to long delays between the time that they carry out construction work or provide related goods and services and the time that they are entitled to payment.

For example, take a main contract that provides that the *head contractor* can make a payment claim on the last day of each month.[18] This is the *reference date*. Assume that the *head contractor* makes a claim on the last day of each month. Ignoring non business days, the *principal* must pay the *head contractor* by the end of the third week after the payment claim is made. Consequently, for work

[18] For the example, it will be assumed that a 'month' is a 'named month' as defined in section 181 of the *Conveyancing Act 1919* (NSW) and section 21 of the *Interpretation Act 1987* (NSW).

carried out by subcontractors in, say, July the *head contractor* can make a payment claim on 31 July and must be paid by 21 August.

The *head contractor* can provide in subcontracts that the time for subcontractors to make payment claims (the *reference date*) is the last day of the month after the month in which the subcontractor carries out work. Such a provision is quite common. The consequence would be that for work carried out by the subcontractors in July, they cannot make a payment claim under the NSW Act before 31 August. Then, ignoring non business days and assuming that subcontractors make their payment claims on the reference date, the last day for payment by the *head contractor* of the subcontractors would be 6 weeks (30 business days) after 31 August, i.e., on 12 October.

In this example, for more than 7 weeks for each progress payment the *head contractor* would be holding money for work done by subcontractors. Assume that progress payments to subcontractors total $1 million per month for 12 months. The *head contractor* would have hold 12 instalments of $1 million each for 7 weeks (plus business days). The amount of interest on $1 million for the equivalent of 86 weeks or more (7 weeks x 12 plus non business days) would be considerable.

During the time that the *head contractor* is holding the money it is the head contractor's money. If the *head contractor* becomes insolvent the subcontractors have no claim on the money even though it represents the value of their work. Even if the *head contractor* has not spent the money or granted a bank or someone else a charge over it, subcontractors have no more entitlement to the money (paid by the *principal* for their work) than any other ordinary creditor of the *head contractor*. If the statutory construction trust (as recommended by Mr. Collins) had been enacted, subcontractors would have first call on the money and would be protected against claims by the liquidator or other creditors.

Conditions precedent to payment

The new section 11(1) of the NSW Act provides:

> Subject to this section and any other law, a progress payment made under a construction contract is **payable in accordance with the terms of the contract** [emphasis added].

The reason for this new provision is not apparent. It cannot be assumed that it is meaningless. It may raise problems for claimants and adjudicators. Section 11(1) does not say that, subject to this section and any other law, a progress payment is payable at the time provided in the contract. That is covered in sections 11(1A) to 11(1C). It says, 'in accordance with the terms of the contract'. A contract could impose terms of payment that go beyond the due date for payment. The reference date is one such term. Another is that prior to any payment or payment for unfixed materials, the claimant must provide a bank guarantee or other security. Retention money is another such provision.

Sections 9 and 10 of the NSW Act provide how a progress payment is to be calculated. Perhaps section 11(1) has been inserted to ensure that certain conditions precedent to a right to a progress payment, such as provision of statutory declarations, warranties, certificates, releases and expert determinations are effective. Section 11(1) may even be the answer to the problem of ambush claims.[19]

[19] A payment claim that is not only for an instalment of the contract price (or the adjusted contract price) but includes amounts claimed for disputed variations and other disputed extras such as latent conditions and delay and prolongation costs is often called an ambush claim. When calculating the progress payment the adjudicator is not only valuing work but is also determining disputes over the cause of delays, extensions of time, and liability for extras and damages. The expedited adjudication procedures prescribed

For example, a NSW Department of Public Works' contract provided in clause 42.1 that the contractor's only entitlement to payment for carrying out work is the Contract Price and prior to becoming entitled to the Contract Price the contractor's entitlement to progress payments will not, in aggregate, exceed the Contract Price. There was provision for adjustment of the Contract Price by agreement or by an expert in expert determination. In *Minister for Commerce v Contrax Plumbing* [2004] NSWSC 823 McDougall J found that section 34 of the NSW Act (no contracting out) invalidated these provisions. This judgment legitimised ambush claims.

On appeal (*Minister for Commerce v Contrax Plumbing* [2005] NSWCA 142) the Court of Appeal did not have to decide whether on this issue McDougall J was correct. Hodgson JA deals with the matter at [50] to [54]. At [51] he expressed the view, without deciding the issue, that section 34 did have that effect. However, Bryson JA at [58] said:

> I respectfully say that I do not join in Hodgson JA's observations at paras [51] to [54] to the effect that s 34 invalidates some parts of clause 42 of the construction contract. The avoidance provisions should be applied according to their terms and no more widely. Rulings by McDougall J on the interaction of the construction contract with the Act and s 34 are open to question because his Honour's demonstration of the manner in which provisions of the contract excluded or modified or restricted the operation of the Act, or otherwise fell within s 34(2), was not appropriately specific. As decision does not turn on this I do not pursue it further. If the application of the references in s 8(2) and s 9 to the terms of the contract and to whether or not the contract make express provision with respect to specific matters with which ss 8 and 9 deal were fully considered, it may be that the parts of clause 42 which McDougall J considered would fall outside them and the relation between s. 34 and cl. 42 would not be important.

Section 11(1) may support an argument that, without offending against section 34 (no contracting out), it is open to a construction contract to provide that progress payments in aggregate will not exceed the adjusted contract price and that the contract price can only be adjusted by agreement or a determination of an expert. If this argument were to succeed, a construction contract could effectively bar ambush claims.

Section 13 Notice that claim made under the Act

For construction contracts entered before the commencement of the 2013 Amendment Act (i.e., 21 April 2014) a payment claim must state that it is made under the NSW Act. However, under construction contracts made after the commencement of the NSW Act, the claimant only has to state that the claim is made under the NSW Act if the construction contract is connected with an *exempt residential construction contract.*

A subcontractor to a builder who is party to an *exempt construction contract* with the person who resides in or proposes to reside in such part of the premises where the work is carried out, must state in a payment claim under the NSW Act (served on the builder) that the payment claim is made under the Act. If the subcontractor fails to do so, the payment claim is invalid (section 13(2)(c) of the NSW Act).

For *head contractors* the removal of the requirement for an endorsement that the payment claim is made under the Act is replaced by an even more stringent notice requirement, namely, a *supporting*

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by Act are not suitable for determining the wider issues raised by an ambush claim. The respondent has only 10 business days to provide reasons for withholding payment and 5 business days to respond to an adjudication application. These times cannot be extended. The respondent is said to be ambushed.

statement that indicates that it relates to the payment claim (section 13(7) of the NSW Act). A *principal* will know when a *head contractor* is making a payment claim under the NSW Act. It will be accompanied by a *supporting statement*.

Section 13(7) to (9) *Head contractor's supporting statement*

Sections 13(7) to (9), inclusive, are new sections in the NSW Act. They only apply to a *head contractor*. Section 13(7) provides that a *head contractor* must not serve a payment claim on the *principal* unless the claim is accompanied by a *supporting statement* that indicates that it relates to that payment claim. Section 13(7) provides that it is an offence to do so. A payment claim not supported by a *supporting statement* would not be a valid payment claim. Therefore, there could be no offence under section 13(7).

Section 13(8) provides a penalty for providing a *supporting statement* that the *head contractor* knows to be false or misleading. Section 36 provides that the Director-General of the Department of Finance and Services may appoint an authorised officer to require a *head contractor* or a person employed by the *head contractor* to provide certain information relating to compliance with section 13(7).

Any prosecution for an alleged offence under the NSW Act must be dealt with in the Local Court (sections 6 and 7 of the *Criminal Procedure Act 1986* NSW). Proceedings to prosecute must be commenced not later than six months after the offence is alleged to have been committed (section 179 of the *Criminal Procedure Act 1986* NSW). It seems unlikely that any prosecutions will be launched until the *head contractor* is insolvent and by then it will probably be too late to commence a prosecution.

Section 13(9) of the Act states:

> a *supporting statement* means a statement that is in the form prescribed by the regulations and (without limitation) that includes a declaration to the effect that all subcontractors, if any, have been paid all amounts that have become due and payable in relation to the construction work concerned

There are two requirements for a *supporting statement*. The first is that it is in the prescribed form. The second is that, without limitation, it includes the prescribed declaration. The *Building and Construction Industry Security of Payment Regulation 2008* NSW was amended on 21 April 2014 to include clause 4A and Schedule 1 which contains the prescribed form.

Clause 4A and Schedule 1 of the regulation have been ineptly drafted. They are not consistent with sections 13(7) and 13(9) of the Act. Clause 4A provides that a reference in the *supporting statement* to an amount due and payable does not include an amount that is in dispute between the *head contractor* and a *subcontractor*. An amount is either due and payable in relation to certain construction work or it is not. Section 13(9) of the Act does not empower the Governor to regulate the meaning of 'due and payable' to exclude amounts that are due and payable but 'in dispute'. The Act and Regulation provide no guidance as to the meaning of 'in dispute'.

To satisfy the requirements of sections 13(7) and 13(9) the head contractor's declaration must state that all subcontractors have been paid all amounts that have become due and payable in relation to the construction work concerned. A declaration that excludes some amounts that have become due and payable (namely, amounts in dispute), would not satisfy the requirements of sections 13(7) and 13(9).

A *head contractor* who wants to ensure that the *supporting statement* accompanying the *head contractor's* payment claim is a valid *supporting statement* would be well advised to omit from the declaration (in the *supporting statement*) the words 'not including any amount identified in the attachment as an amount in dispute'.[20]

Clause 4A(4) of the regulation provides that the supporting statement under section 13(7) of the Act relates only to *subcontractors* or suppliers directly engaged by the *head contractor*. The regulating power in section 13(9) of the NSW Act does not authorise a regulation changing the meaning of s 13(7). Clause 4A(4) is inconsistent with section 13(9) of the Act. *Subcontractor* is defined in section 4 of the NSW Act to mean a person who is to carry out construction work or supply related goods and services under a construction contract otherwise than as *head contractor*. Sub-subcontractors are *subcontractors* within the meaning of the Act. The prescribed form states that for the purposes of the statement in the form, the terms "principal" and "subcontractor" have the meaning given in section 4 of the NSW Act. But that is inconsistent with clause 4A(4) of the regulation.

Sections 13(7) and 13(9) require the *head contractor* to be satisfied not only that the *head contractor's* subcontractors have been paid all amounts that have become due and payable in relation to the construction work concerned but also that all the subcontractors' sub-subcontractors and suppliers have been paid all amounts that have become due and payable in relation to the construction work concerned. The construction work concerned must mean the construction work for which the *head contractor* is claiming a progress payment. This is onerous, but, with respect, it is not open to the Governor (on the advice of the Minister) to (by regulation) ameliorate the requirements of the NSW Act. If the Minister considers that section 13 of the NSW Act is too onerous then it is up to the Minister to go back to Parliament and seek an amendment.

BUILDING AND CONSTRUCTION INDUSTRY SECURITY OF PAYMENT AMENDMENT (RETENTION MONEY TRUST ACCOUNT) REGULATION 2015 NSW

Recommendation 6 of the Report[21] 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 NSW Act and the *Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015* NSW ('the Regulation') the Government has departed from the recommendation of the Final Report. This is likely to be unhelpful to subcontractors 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 commences[22]. The regulation only affects 'head contractors' as defined in s 4 of the NSW Act. It only applies to subcontractors' retention money held by a head contractor who enters a head contract on or after 1 May 2015.[23] The Regulation

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[20] Section 80(1) of the *Interpretation Act 1987* (NSW) provides: 'If a form is prescribed by, or approved under, an Act or statutory rule, strict compliance with the form is not necessary but substantial compliance is sufficient'.

[21] At p 351 (p 356 of pdf copy) of the Final Report.

[22] Section 5(2) of the Regulation.

[23] Section 5(1) of 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.[24]

Henceforth, any prudent head contractor proposing to enter a large construction contract for a project in NSW 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[25].

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 increase to $20 million or more if variations are directed or approved after the contract was entered[26]. Upon the date that 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 new threshold date do 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[27] 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

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

[25] Section 5(2) of the Regulation.

[26] Section 5(3) of the Regulation.

[27] The Regulation refers to the Chief Executive of the Office of Finance and Services. On 17 December 2014 the NSW Government reallocated responsibility for the NSW Act to the then Minister for Fair Trading. Since the election on 28 March 2015 the responsible Minister is the Minister for Innovation and Better Regulation. This means that from 1 May 2015 the administration of the Act is transferred from NSW Procurement to the Home Building Service in NSW Fair Trading.

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*[28]. A fee of $1,500 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 it is withdrawals from the account that auditor should be looking at. If a withdrawal is made otherwise than in accordance with an order of a court or tribunal[29] or with the agreement in writing of the head contractor and the subcontractor[30], 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 Part 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 money 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 the McDougall J considered the following contractual 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

[28] Section 16 of the Regulation. A form for the *retention account statement* is in Schedule 2 to the Regulation.

[29] Section 8(1)(c) of the Regulation.

[30] Section 8(1)(b) of the Regulation.

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 NSW Act contrary to s 34 of that Act. However, s 9(a) of the NSW 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 NSW 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 large that is effectively prevents the subcontractor from obtaining a progress payment.

Construction contracts often provide for holdback. The very reason for s 9(a) of the 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 contractor 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*[31], 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 NSW 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

[31] *Watpac Constructions v Austin Corp* [2010] NSWSC 168.

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 NSW 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 s12A of the NSW 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[32].

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 *Bankruptcy Act 1966* (Cth) and the *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 *Construction Trust* recommended in the Collins Report, subcontractors would be at an advantage.

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 is most likely to be of little worth.

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[33] 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, clause 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

[32] Section 8(1) of the Regulation.

[33] Page 243 (p 248 of the pdf copy) of the Final Report.

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, clause 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 clause 5.9 of AS2124-1992.

The diminished rights of subcontractors under the NSW 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 NSW Act is reduced. Section 13(3)(b) of the NSW 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 NSW Act for the amount held by the head contractor as retention. But a subcontractor cannot use the NSW 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 NSW 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 and amount that the head contractor has withdrawn from the account without lawful authority, the subcontractor must sue in a court.

CONCLUSION

The purpose of the Collins Inquiry was to consider legislative response that could be taken to minimise the incidence and impact of insolvency in the construction industry.

The NSW Act now requires that a payment claim be accompanied by a supporting statement to the effect that all subcontractors have already been paid amounts due to them. This only applied in the case of the *head contractor*. Section 13(8) provides a penalty for providing a supporting statement that the head contractor knows to be false or misleading. However, it seems unlikely that any prosecutions will be launched until the head contractor is insolvent and by then it will probably be too late to commence a prosecution.

The NSW Act now applies differently to each category of claimant – *head contractor*; ordinary *subcontractor*; and *subcontractor*. The main problem for adjudicators will be that many parties will not address the question of the status of the parties, or if they do, they may quite easily get it wrong. Thus, the confusion inherent in the definition of each category of claimant created by the 2013 Amendment Act is likely to be seized upon by respondents as a way of having an adjudicator's determination should be set aside by the Supreme Court. The 2013 Amendment Act has, in effect, opened a new avenue for jurisdictional challenges of adjudicator's determination. This only goes to increase a claimant's exposure to the incidence and impact of insolvency.

The 2013 Amendment Act has introduced new mandatory deadlines for making progress payments. The new mandatory deadlines apply differently to each category of claimant do not necessarily provide fairer payment terms for claimants. Moreover, there has been no amendment of section 8 of the NSW Act dealing with reference dates. Controlling maximum times for payment (after a payment claim is made) without controlling reference dates leaves subcontractors exposed to long delays between the time that they carry out construction work or provide related goods and services and the time that they are entitled to payment. This only goes to increase a claimant's exposure to the incidence and impact of insolvency.

In summary, 2013 Amendment Act is likely to make it more difficult than ever for subcontractors to obtain prompt payment for their work. The introduction of the *Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015* (NSW) is likely to have no positive impression on minimising the financial impact of insolvency on subcontractors in the NSW construction industry.

ACKNOWLDGEMENT

The authors wish to acknowledge the support provided by the NSW Office of Finance & Services for the Adjudication Research + Reporting Unit (ARRU).

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