HOUSING INDUSTRY ASSOCIATION

Submission to the
NSW Department of Finance, Services and Innovation

Draft Building and Construction Industry Security of Payment Amendment Bill 2018 & Securing payments in the building and construction industry – a proposal for 'deemed' statutory trusts Consultation Paper

18 September 2018

HOUSING INDUSTRY ASSOCIATION

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ABOUT THE HOUSING INDUSTRY ASSOCIATION

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry, including new home builders, renovators, trade contractors, land developers, related building professionals, and suppliers and manufacturers of building products.

As the voice of the industry, HIA represents some 40,000 member businesses throughout Australia. The residential building industry includes land development, detached home construction, home renovations, low/medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA members comprise a diversity of residential builders, including the Housing 100 volume builders, small to medium builders and renovators, residential developers, trade contractors, major building product manufacturers and suppliers and consultants to the industry. HIA members construct over 85 per cent of the nation's new building stock.

HIA exists to service the businesses it represents, lobby for the best possible business environment for the building industry and to encourage a responsible and quality driven, affordable residential building development industry. HIA's mission is to:

> *"promote policies and provide services which enhance our members' business practices, products and profitability, consistent with the highest standards of professional and commercial conduct."*

The residential building industry is one of Australia's most dynamic, innovative and efficient service industries and is a key driver of the Australian economy. The residential building industry has a wide reach into manufacturing, supply, and retail sectors.

The aggregate residential industry contribution to the Australian economy is over $150 billion per annum, with over one million employees in building and construction, tens of thousands of small businesses, and over 200,000 sub-contractors reliant on the industry for their livelihood.

HIA develops and advocates policy on behalf of members to further advance new home building and renovating, enabling members to provide affordable and appropriate housing to the growing Australian population. New policy is generated through a grassroots process that starts with local and regional committees before progressing to the National Policy Congress by which time it has passed through almost 1,000 sets of hands.

Policy development is supported by an ongoing process of collecting and analysing data, forecasting, and providing industry data and insights for members, the general public and on a contract basis.

The association operates offices in 23 centres around the nation providing a wide range of advocacy, business support including services and products to members, technical and compliance advice, training services, contracts and stationery, industry awards for excellence, and member only discounts on goods and services.

1 INTRODUCTION

The Housing Industry Association (HIA) takes this opportunity to provide submissions in response to the proposed reforms to the NSW Security of Payment legislation.

The Government has released for comment the *Building and Construction Industry Security of Payment Amendment Bill 2018* (Exposure Draft Bill) together with its explanatory statement and also a Consultation Paper, *Securing Payments in the Building and Construction Industry — A Proposal for 'Deemed' Statutory Trusts* (Consultation Paper).

HIA provides the following comments in response.

1.1 DEEMED STATUTORY TRUSTS CONSULTATION PAPER

HIA opposes the imposition of any form of trust arrangement in the construction industry and specifically in the residential building industry. HIA has expressed this view since the 2012 Collins Inquiry.

The imposition of trust arrangements will not stop insolvencies or guarantee payments to subcontractors. They will however impose additional costs for residential building work that will impact housing affordability. There is also no evidence that the imposition of deemed statutory trusts is a *'necessary regulatory framework to support sustained growth into the future'* in fact, HIA is concerned that such an approach would do the opposite.

The use of trust funds will not stop unethical conduct or unscrupulous behaviour nor stop spending of monies purportedly held in trust. It is impossible to fully legislate against this behaviour and it is unfair to impose harsh obligations on the majority of builders operating in the industry who do pay their contractors on time and operate lawful and compliant businesses.

The introduction of any form of construction trust arrangements for residential building work would place undue stress, administration and cost on the Head Contractor, for no improved protection for any stakeholder.

While not canvassed in the Consultation Paper, numerous inquiries have recommended against the introduction of trust arrangements. There is nothing in the current Consultation Paper that dismantles the views held during those inquiries.

Of note in 2013, the NSW Government did not support the recommendation of the Collins Inquiry to implement deemed statutory construction trusts. Instead the NSW Government has trialled the use of Project Bank Accounts (PBA) of Government projects. The Consultation Paper provides no information on the operation of PBAs on Government projects. The Consultation Paper also provides no evidence in support of a change in circumstances to justify a different position to that which was put forward in 2013.

It is equally relevant that amendments made to the NSW *Building and Construction Industry Security of Payments Act 1999* (the Act) in 2013 (commencing in 2014) in response to the Collins Inquiries recommendations expressly excluded the residential building Industry[1]. The Minister, in his second reading speech noted that:

> *In response to concerns about the potential impact of the reforms in this bill on small business in the residential sector, upon becoming Minister for Finance and Services in August this year I undertook to conduct additional consultation with the industry. As a result of this consultation, the bill provides a limited exemption targeting small businesses operating in the residential sector...This means that the amendments will not apply to a residential contract that is connected to the contract between the consumer and head contractor—referred to in the bill as the "main contract".*

HIA continues to strongly advance the position that the residential building industry represents a distinct and unique component of the construction industry and if the Government was inclined to adopt the proposed approach, the residential building industry should be excluded.

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[1] *Building and Construction Industry Security of Payment Amendment Act 2013*

Of note, the residential building industry has the following characteristics:

- it is principally comprised of small businesses and self-employed independent contractors;
- the terms and conditions under which the residential building industry operates differ from those in other construction sectors;
- it is a highly input costed, highly taxed and heavily regulated sector; and
- risk allocation is heavily influenced by an extensive consumer protection framework.

These factors set the sector apart for the rest of the construction industry and justify a different approach.

1.2 EXPOSURE DRAFT BILL

HIA understands that the Exposure Draft Bill seeks to respond to a number of matters raised through consultation. Despite this, HIA is concerned that a number of proposals lack sufficient interrogation to justify their adoption, for example, no justification has been provided for the proposed reduction in the threshold for the holding of retention money on trust from $20 million to $10 million. HIA opposes such moves.

Equally unjustified are the range of enforcement and compliance measures, including those relating to accessorial and executive liability proposed by the Exposure Draft Bill. These measures represent a concerning drift away from the core legislative intent of the security of payments laws. Notably, neither the Collins Inquiry or the Murray Review recommended the inclusion of this form of enforcement and compliance powers in security of payment legislation.

HIA is also concerned that a number of proposals, previously discussed, are not being progressed, for example the removal of the current exemption of owner builders from the Act. Owner builders are actively participating in the residential building industry and the remedies available under the Act should be made available to parties who contract with them.

Also not included in the Exposure Draft Bill but in need of redress is that builders under the Act are prevented from using the rapid adjudication processes against homeowners despite subcontractors on the same job being able to avail themselves of these remedies against the builder. This is unfair and financially disproportionate to the detriment of the builder.

HIA continue to advocate for the application of the Act to claims against homeowners. Of note the Murray Review recommended that the legislation apply to the residential housing sector so as to enable a residential contractor/builder to make a progress payment claim against an owner-occupier[2].

In the Explanatory Statement accompanying the Exposure Draft Bill it is stated that the rationale for reform includes that, *'A key finding of the Review was that an opportunity exists to make enhancements to the Act to ensure that it more effectively deliver its objectives*' and that the proposed reforms are designed to *'provide greater protection for subcontractors and promote cash flow and transparency in the contracting chain.'*

As such it is disappointing that builders in the residential building industry are excluded from the remedies that are available for their peers in the wider construction industry simply on the basis that the 'principal' in the residential building industry happens to be a homeowner, or 'consumer.'

This approach is not novel and operates elsewhere, for example, under the Tasmanian model, claims can be made against home owners who have an additional 10 days to respond to a builder's payment claim. Additionally, there is a second opportunity to respond before the matter is adjudicated.

Introducing this change will also remove confusion as to whether or not the Act applies in relation to a homeowner in circumstances where the owner does not reside in the property or intend on residing in the property, that is, the property in question is an investment property.

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[2] See Recommendation 12

2 THE BUSINESS OF RESIDENTIAL CONSTRUCTION

2.1 THE RESIDENTIAL BUILDING INDUSTRY

The residential building industry, including the home improvements and alterations market, is a key component of the Australian economy. The residential building industry is also the dominant sector in the building and construction industry.

Whilst often overlooked, in reality the practice and paradigm in the residential building industry differs significantly from those businesses operating in commercial and civil construction. This is critical to discussions relating to security of payment laws.

Firstly, unlike the commercial and civil construction sectors, the residential building industry is principally comprised of small businesses and self-employed independent contractors.

HIA estimates that more than 90 per cent of the residential building industry is comprised of small businesses and sole traders.

With such a high number of small businesses, this sector is particularly vulnerable to the negative impact of additional red tape and government regulation.

Secondly, the terms and conditions for commercial builders and those engaging in government contracts are significantly different from the terms and conditions a builder faces when working on a residential building project.

Commercial projects and government works are generally characterised by:

- a tendering process that often forces negative margins with the hope that future variations will cover the shortfall;
- the use of retentions;
- longer payments terms (up to between 45 and 60 days compared to 21 days in residential);
- limitations on a builders ability to select subcontractors;
- contract administration by a superintendent/ architect;
- significant amounts for liquidated damages; and
- long defects liability periods.

Such elements are not present in the residential building environment, which faces equally as challenging yet different factors such as:

- the homeowner, whose significant emotional and financial investment places additional pressures on the builder and trade contractors;
- prescriptive statutory contractual arrangements;
- quasi regulation of payment terms through the involvement of financial institutions;
- ineffective, time consuming and often litigious methods of recouping late payments;
- demanding terms of trade from suppliers; and
- significant exposure to uncontrollable events such as inclement weather and fluctuations in the supply of building materials.

In fact the terminology, used in the Act, being a Principal, Head Contractor and Subcontractor(s) reflect the focus on the commercial construction sector of the Act. This model does not often reflect the contractual arrangements on a residential building project. The majority of residential building projects involve a homeowner as 'Principal'. In HIA's view this significantly alters the approach that should be taken to manage security of payments in the residential building industry.

Thirdly, the residential building industry is heavily regulated when compared to other building sectors.

Home builders must manage a complex web of national, state and local laws, regulations and codes. These range from planning, design, environment, health and safety, to local authority inspection and certification and a multitude of building, electrical, mechanical and plumbing processes.

The businesses must also comply with a legislative framework that spans licencing, ATO contractor reporting requirements, dispute resolution, builders warranty obligations and contractual requirements.

There are significant cost implications associated with these regulations.

Fourthly, the cyclical nature of the residential building industry is relevant to the operation of security of payments laws and the relationships between contracting parties.

The high cost and highly regulated nature of the industry together with the small business profile of firms also means that they are especially susceptible to economic cycles and changes in government policies and regulation. Financial failure for some firms will be an unavoidable consequence of the competitive forces of Australia's market economy.

There are also inherent uncertainties in contract prices which arise from the fact that works are required to be priced before construction commences and are based on technical, financial and workforce assumptions, together with material costs/availability, access to site, timeframes, weather, statutory approvals and delays.

Finally, a consistent challenge for builders is maintaining cash flow under a negative cash flow model. Whilst a trade contractor is typically paid for work in arrears and must finance this cost, the same holds true for builders who must 'finance' an owner's costs.

Subcontractors and suppliers will naturally not wait for the substantial client to builder payment late in the duration of the job and often builders must source other financing arrangements to keep cash 'flowing'.

Builders in the residential building industry ordinarily fund their works by way of debt financing. Revenue on the other hand is derived from client payments which are highly regulated and paid after completion of work and after the building costs are incurred. Yet, the activities undertaken are subject to a high level of risk.

The reliance of builders on cash flow to manage operations and cyclical conditions exposes them to an even greater extent in the event of non-payment by a client.

These factors are amongst those that may contribute to the high levels of insolvencies in the construction industry. However, ASIC data does not disaggregate between large public infrastructure projects nor the civil, commercial and residential sectors and as such fails to paint an accurate picture of the level of insolvency in the residential building industry.

In broad terms HIA acknowledges that high rates of insolvency are a poor outcome for productivity in any industry.

While an effective and efficient statutory framework is required to help business and creditors deal with the impact of insolvency, at the same time it must not seek to impose unnecessary regulation that makes it even more difficult for businesses to enter the market and grow.

2.2 Home Warranty Insurance

One defining feature of the residential building industry is the mandatory regime of Home Warranty Insurance (HWI), which provides a guarantee for home owners/consumers albeit currently limited to $340,000. In practice it means that a consumer can only access the benefit of the policy of insurance when the builder dies, disappears, does not comply with NCAT orders or becomes insolvent.

Under the *Home Building Act 1989* (HB Act) any residential building project over $20,000 must obtain HWI prior to the receipt of money or the commencement of work.

In order to obtain HWI a builder must be deemed 'eligible'. In determining eligibility a range of financial and non-financial information is provided by the business and is examined in order to assess the risk of potential threats to solvency.

Warranty insurance does not operate like other forms of insurance, for example, it is not like workers compensation (which allocates risk based on payroll size and claims history) or third-party insurance (which

aggregates actuarially quantifiable risks to persons who have no control over the occurrence of that event). The scheme currently operates on a flat (one size fits all) premium structure, so regardless of the risk the premium level is simply based on contract value.

Home Warranty Insurance operates as a ‘check and balance’ on the solvency and financial management of residential builders. Such measures do not exist in the commercial building industry. The scheme operates as a quasi-regulator and a significant barrier to entry, preventing those without the requisite financial circumstances from trading.

2.3 The Subcontract System

It is well known that residential building, in particular the detached housing and renovation work, rely on the use of subcontractors.

In commercial construction, whilst there may be a large number of subcontracting firms, the overwhelming majority of those working are actually employed by these subcontracting firms. Further subcontracting occurs only in specialist areas. Many, if not most, employees are union members and casual labour is seldom used.

By contrast, in the residential building industry, subcontracting predominates down to the lowest levels, so that there are relatively few employees on a low or medium density housing site.

The flexibility of the subcontract system and the highly competitive nature of the residential building industry have interacted to secure a high degree of efficiency and productivity.

There are around 25 – 30 different trades involved on-site in the building of a house. The familiar ones are of course concreters, bricklayers, framing carpenters, plumbers, electricians, roof tilers and painters. Others include the contractor who pegs out the site, backhoe operators, drainers, termite system installers, plasterers, floor tilers, glaziers, kitchen installers, the fitting out carpenter, the floor sander, the brick cleaner and finally the garage door fixer.

As with any commercial relationship, there are risks for both builders and trade contractors in managing the subcontractor relationship. For builders and principal contractors there are ongoing challenges ensuring the trade work is done to an adequate standard and will perform for its designed life, particularly during defects liabilities periods. Builders frequently cite difficulties locating offending trade contractors who often move away following the work.

Many trade contractors, in turn, often do not want to give 6 or 12 months defect warranty. The perception is that it is not the quality of the work that is the issue, rather it relates to design limitations of the building products, damage caused by following trades, or the end client’s service providers adding services to the building at a later date.

In spite of such issues, it is HIA’s view that the relationship between the head contractor and subcontractor must be able to operate largely unencumbered in order to maintain the advantages of the subcontract system for housing supply and affordability.

HIA would strongly advise a conservative approach be taken when considering measures that affect the contractor/subcontractor relationship.

2.4 Risk Allocation

HIA supports the Abrahamson Principle, namely that ‘a party to a contract should bear the risk where that risk is within that party’s control’. However, the statutory consumer protection framework established under the HB Act distorts the usual allocation of risk in favour of the consumer, or home owner.

The HB Act requires residential builders to incorporate a number of mandatory terms and conditions into their contracts for the benefit of home owners.

Under the HB Act a contract for residential building work must include:

- mandatory terms and conditions such as the name of the parties, a description of the building works, the contract price and any plans and specifications;
- consumer checklists;
- variations in writing;
- implied warranties of materials and workmanship;
- limits on deposits and bans on up front progress payment;
- restriction on the use of caveats without a court order;
- requirements that builders take out home warranty insurance;
- outlawing and/or voiding unconscionable contractual provisions; and
- a five day cooling-off period during which a consumer can withdraw from a contract without penalty.

In the residential building industry builders claim upon defined progress stages being completed. Draw downs on project finance is normally only available upon lenders being satisfied with completion of certain recognised building stages.

In addition, a residential builder is required to obtain all variations in writing and have them signed by the parties. If these requirements are not complied with a builder risks not being paid for the variation.

The 'unfair contract' provisions of the *Competition and Consumer Act 2010* and the Australian Consumer Law provide additional protections around the use of standard form industry contracts.

3 RESPONSE TO CONSULATION PAPER

3.1 DO YOU SUPPORT THE ESTABLISHMENT OF DEEMED STATUTORY TRUSTS?

HIA opposes the introduction of any form of trust scheme in the residential building industry.

Trust arrangements are held out as ways of securing the payments of subcontractors by:

- Protecting monies owed to subcontractors in the event of the insolvency of the principal; and
- Preventing the misappropriation of funds during the payment cycle.

HIA submits that these arrangements cannot address these issues or assist in protecting subcontractors from the effects of insolvency. Mandatory trust arrangements are not practical, cost effective or workable for this scale of construction work and the nature of the contracting arrangements prevalent in the residential building industry.

The Consultation Paper references previous reviews that recommended the adoption of statutory trusts, namely the recent Murray Review, the Collins Inquiry of 2012 and the 1998 Law Reform Commission of the WA Review.

Over the past two decades there have been a number of other inquiries and reports in Australia which considered mandating statutory construction trust arrangements and for good reason previous governments have rejected the implementation of trust schemes.

In 1991 there were:

- NSW Business and Consumer Affairs Agency, Issues Paper on Financial Protection for Building Subcontractors, 31 January 1991,
- SA Report of the Ministerial Working Party on Insolvency in the Building Industry,
- Qld Security of Payment for Subcontractors in the Building & Construction Industry, Discussion Paper, November 1991.

In 1996 there were two reports at the Commonwealth level, one in NSW and one in Qld:

- Cth Australian Procurement and Construction Council, National Action on Security of Payment in the Construction Industry, 1996,
- Cth The Price Waterhouse report, National Public Works Council Inc, Improving Security of Payment in the Building and Construction Industry, 19 July 1996,
- NSW Coopers & Lybrand Consultants, Independent assessment of the viability of the NSW Security of Payment Committee Proposal, August 1996,

- Qld Inquiry into Security of Payment in the Building and Construction Industry, Queensland Government, September 1996.

Notably in the 1996 Price Waterhouse Report it was concluded that the complex commercial and administrative burdens and obligations of trusts would be likely to prevent their implementation on a widespread basis throughout the building and construction industry. Further, the detailed legal issues and considerations involved with trust law, onerous trustee obligations and potential additional tax burdens (arising from funds which are trust funds invested) were found to potentially negate the workability of trusts within the industry.

The criticism articulated by Price Waterhouse (and other the many other inquires outlined above) about trusts remains cogent and relevant, namely that forcing cash flows through trust arrangements does not recognise the commercial reality of the building industry where projects often run concurrently and cash flows are pooled, not separated on a project-by-project basis. In general, the issue is more about management practices and the application of appropriate financial management skills.

Such arrangements represent a significant regulatory interference in a principal contractor/builder's capacity to manage their own cash flow and run and operate a viable construction business.

It should be made clear that money paid to a builder, under a contract with a home owner is the builders' legitimate property and is not in any legal or moral sense the property of the subcontractor. The builder is fully entitled to use it as he or she pleases, provided that payment (out of this money or out of other money) is made in full to subcontractors when due and payable under the relevant subcontracts.

To upset this arrangement by introducing even further regulation to 'manage' business to business arrangements, to "protect" one business at the expense of another or mandate levels of business risk or control are counterproductive and will aggravate the difficulties faced by business.

Cash flow and the distortion of risk

Trust mechanisms distort risk allocation in commercial arrangements and only superficially 'protect' the money owed to a subcontractor. In reality, the imposition of any of the proposed trust options would place additional risks on the overall viability of the builders' business and exposes them to financial challenges.

As outlined at the outset of these submissions, normal practice in the residential building industry is that both builder and trade contractor are paid periodically, and in arrears, during the execution of the works. Both parties essentially finance the work and operate under a negative cash flow model.

There is certainly no easy access to money nor any ability on the part of builders to hold on to payments of clients. Setting aside funds, will not only exacerbate that, but will add cost as head contractors look to supplement capital in order to have the required funds to ensure the job remains on foot.

If these progress claim funds are to be held in a trust account for the benefit of particular subcontractors (even if not yet due and payable) builders will incur additional financing costs for working capital to fund the works and manage their ongoing risk. These costs will be passed on to the homeowner.

The imposition of trust arrangements discriminates against the party that wears the bulk of the risk on the construction project – the builder.

Further, any moves to introduce construction trust arrangements in the residential building industry would jeopardise a builder's HWI eligibility. Requiring additional working capital and the holding of funds on trust will have significant consequences for a builder's ability to gain eligibility, jeopardising their ability to trade.

At the same time, in certain circumstances builders are required to provide bank guarantees and injections of working capital to satisfy eligibility criteria in order to obtain the insurance. Perversely, this can impact on the financial and operational viability of these builders.

Objectives of Security of Payments laws

Holding money on trust is at odds with the objectives of security of payments laws.

The Murray Report notes, *'First and foremost, one should not lose sight of the prime purpose of the legislation which is to promote prompt payment and maintain the cash flow of contractor/subcontractor.'*

Holding money in trust satisfies neither of these criteria. Only on insolvency can a deemed trust be justified as having any role to play in securing the release of payments to contractors and even then, only where there are sufficient funds available in that trust account having been received from the client.

In fact, 'ring fencing' funds and paying the principal/head contractor/builder last is at odds with prompting effective cash flow.

Legal concepts and trustee obligations

As a legal concept, there are practical difficulties and shortcomings in determining which parties in the supply chain are worthy of legislative protection. To that end whilst the use of trust funds may commonly be found within the legal, accounting, stockbroking professions and the real estate industry, this is because there is a fiduciary relationship based between principals and agents where funds are held on trust over time.

Such a fiduciary relationship does not exist in the residential building industry where the relationship between the parties is one based on contract. A builder does not accept payment from the client as agent for the subcontractor or supplier. Accordingly, unless the contract between the parties includes a term that monies are held in trust, there is nothing intrinsic in the relationship as to suggest any equitable or agency relationship between the builder and subcontractor.

The obligations imposed on a trustee are complex and onerous. Administering payment to and from a trust account is a complicated process requiring accounting and legal expertise. As many small business builders simply do not have the internal expertise to manage these responsibilities they would need to outsource to experts. This would undoubtedly add cost to the project in terms of bank charges and time spent in accounting and legal costs.

A trustee of a trust account must exercise significant due diligence and care to ensure that all trust requirements are met. The trustee would have specific and discretionary powers. Actions would be governed by trust legislation, common law and the law of equity.

At the very least individuals in the industry would need to become aware of and comply with the powers, duties, responsibilities and obligations of trustees, a significant task given the majority of individuals enter the industry due to its physical nature as opposed to any desire to 'do paperwork'.

The potential for unintended breaches of trustee obligations is tangible.

Effect on third parties

There are practical difficulties and shortcomings in governments "picking winners" and determining which parties in the supply chain are worthy of legislative protection.

HIA would highlight that a potential consequence of a trust system is that the position of employees and other secured creditors is in reality disturbed.

In the event of a contractor insolvency where project funds are held in trust, those funds will no long be available for distribution in the liquidation to employees, ultimately limiting the funds available to higher order creditors.

In HIA's submission, it would be peculiar for governments to go further and consider that subcontractors and suppliers are worthy of protection and priority over and above employees of the building company, the Australian Tax Office and other creditors.

3.2 What Alternative Reforms Could Be Implemented?

HIA draws attention to a range of measures currently being undertaken by the Commonwealth Government focusing on targeting illegal phoenixing activity, a complicating factor when considering the reasons for and risks of insolvency.

Within this context HIA submit that the proposed trust arrangements are pre-emptive and unnecessary.

Current Regulatory Framework

There are a number of Commonwealth laws in place to address and regulate corporate insolvencies.

Under the *Corporations Act 2001*, directors have a direct and positive duty to prevent their company from insolvent trading. A company is insolvent if it is unable to pay all its debts when they are due. Directors must prevent their company from incurring debts where the company is insolvent, or becomes insolvent by incurring the debt(s) and at that time, there are reasonable grounds for suspecting the company is insolvent, or would become insolvent.

There are various penalties and consequences of insolvent trading, including civil penalties, compensation proceedings, criminal charges and/or disqualification from managing a corporation.

A company must also keep financial records to correctly record and explain transactions and the company's financial position and performance. A failure of a director to take all reasonable steps to ensure a company fulfils this requirement contravenes the legislation.

Directors also have fiduciary duties which include the duties to act in good faith in the best interests of the company, to act for proper corporate purposes and to avoid conflicts of interest. It has been held that the duty of directors to act in good faith and in the best interests of the company includes consideration of the interests of creditors upon insolvency.

Under taxation laws, directors' personal liability may arise where the Commissioner of Taxation issues a Director Liability Notice ("DLN") under Section 222AOE of the *Income Tax Assessment Act 1936* to the directors at a time when the company has failed to remit tax. The objectives of these provisions are to ensure that a company satisfies particular income tax obligations or is promptly placed into voluntary administration or liquidation.

Liquidators and external administrators have obligations to investigate causes of failure and identify and report breaches of law to ASIC. This is aimed at ensuring inappropriate director/corporate behaviour is identified and addressed by the party capable of taking disciplinary action, generally the corporate regulator.

Liquidators also have powers to investigate and void certain transactions such as unfair preference payments.

ASIC, in turn, has a number of powers to take action against such reported breaches. To enforce the deterrent intent of the current laws are being met it is important that ASIC take effective action against reported breaches.

The above laws provide a solid and sound regulatory framework for regulating insolvencies.

Further, the unique nature of the residential building industry, including its mandatory licensing of builders and HWI (discussed earlier) reduces the ability of directors to utilise phoenix arrangements. Directors who have controlled an insolvent company under the HB Act fail the "fit and proper" person licensing requirements.

The utility of trust arrangements as a part of security of payments laws only materialises on insolvency.

HIA submit that the current regulatory arrangements preventing and responding to insolvencies provides sufficient confidence that businesses operating in the residential building industry are effectively vetted and disincentivised from acting in ways that may lead to insolvency.

Requiring that funds be held on trust is simply a 'band aid' solution that fails to assist in preventing insolvencies and may in fact contribute to them.

Reforms on foot

The Commonwealth Government is currently directing significant resources at the issue of corporate phoenixing.

HIA understands the following to be a summary of the Commonwealth activity:

- The Phoenixing Taskforce

In 2017, the Minister for Revenue and Superannuation, Kelly O'Dwyer established a taskforce to address illegal phoenixing. The taskforce comprised over 20 Federal, State and Territory government agencies, including the ATO, ASIC, the Department of Employment and the Fair Work Ombudsman.

The aim of the taskforce is to provide a whole-of-government approach to combatting illegal phoenix activity, using sophisticated data matching tools to identify, manage and monitor suspected illegal phoenix operators.

- Director Identification Numbers

In August 2017, the Commonwealth government announced the introduction of director identification numbers (DIN) to track company directors. The implementation of this requirement is ongoing and has been referred to in other inquiries, such as the Black Economy Taskforce.

- Combatting Illegal Phoenixing

The *Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2018*, currently out for public consultation seeks to implement a number of reforms proposed by a 2017 discussion paper *Combatting Illegal Phoenixing*, including creating new offence provisions for certain transactions entered into within 12 months of liquidation and ensruing directors are held accountable for misconduct by preventing directors from improperly backdating resignations or ceasing to be a director when this would leave the company with no directors.

- Changes to the Fair Entitlements Guarantee Scheme to respond to certain 'sharp' corporate practises that are said to be leading to more reliance on FEG to account for unpaid employee entitlements. It has also been observed that many of these practices are associated with phoenix behaviour.

- Changes to GST Withholding on Residential Properties

- Changes to the Superannuation Guarantee

It is important that the NSW Government consider other regulatory reforms currently under consideration, which are targeted at the same or similar concerns as being dealt with through this review, when reflecting on potential changes to security of payments laws.

3.3 MONETARY THRESHOLDS

Do you support the proposal to apply the requirement for 'deemed' trusts to construction projects valued at $1 million or more?

What would be an appropriate alternative monetary threshold?

As stated above, HIA does not support the introduction of any form of trust scheme in the residential building industry.

However, if the Government is minded to adopt this approach HIA has concerns with the use of a monetary threshold, particularly in the absence of any cost/benefit analysis in relation to any such threshold. HIA is open to further discussions on this.

Notwithstanding this, in HIA's view the threshold for the imposition of mandatory statutory trust arrangements should be greater than $1million.

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

What would be an appropriate contract value?

HIA understands that the proposal would seek to limit the application of the requirement to parties based on the value of their individual contracts, as opposed to the value of the head contract alone.

HIA would not oppose this approach. HIA would also be open to considering the threshold of $1 million being the minimum amount of a construction contract to which the requirement would apply. However, as indicated above, any monetary threshold requires a cost/benefit analysis.

3.4 Operation of the Deemed Statutory Trust

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

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

If the Government does legislate for 'deemed' trusts in construction contracts, HIA submits that a deemed trust should not arise before any contract monies have been received by the head contractor or subcontractor. If it were to arise before any money has been received there is a danger that a third party unknowingly becomes beholden to trust obligations.

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

Whilst not supporting the notion of a party to a construction contract becoming a trustee once money has been received, this outcome is preferable to that of a third party such as a government agency or financial institution fulfilling the role of trustee. The third party option would create more red tape and increase the potential for delays.

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

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

Again, whilst not supporting the deeming of trusts in construction contracts, if this regime is to be imposed a consolidated trust account is preferable to having a requirement to maintain separate trust accounts for each project or deemed beneficiary.

As has been outlined above, on a residential construction project they may be up to 25-30 different contractors engaged, on multi-residential projects, this number may conservatively be double or even triple.

The cost and administrative burden in managing and maintaining the number of trust accounts is obvious; it is simply unworkable for the residential building industry.

3.5 Compliance and Enforcement

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

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

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

HIA supports the proposal not to require external auditing of the operation of accounts in which trust funds are maintained. To require otherwise would be unnecessarily burdensome and would entail additional unwarranted expense. There would be additional cost and regulatory burden associated with any record keeping requirements for each trust, whether that be on a per project or per contractor basis.

If the compliance and enforcement powers that are being proposed in the Exposure Draft Bill are enacted there would be more than adequate protection for deemed beneficiaries. Comment on these powers contained in the draft bill can be found below.

However, HIA posits that the costs associated with the requirement of the regulator to enforce proposed anti-avoidance provisions will inevitably be passed on to the industry, whether that is through a fee or levy, or some other mechanism.

3.6 Payments From the Trust Account

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

When should a trustee be permitted to withdraw funds?

There should be no limitations or constraints on a trustee being able to withdraw funds from the account before a subcontractor beneficiary has been paid if there are sufficient funds remaining to meet the obligations of remaining beneficiaries. To require otherwise would have a negative effect on the trustee running their business, limit their cash flow and jeopardise their ability to meet other commercial and financial obligations.

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

What other model of distribution would be preferred?

If there are insufficient funds in a deemed trust account, it is HIA's view that the common law duty to act impartially between the beneficiaries should not be disturbed. It is noted that the entitlements to beneficiaries would still remain despite any distribution and the trustee would still remain liable.

3.7 Dispute Resolution

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

Are any new or amended mechanisms required?

If there is a dispute about monies held in a deemed trust, HIA supports the proposal that the existing dispute resolution mechanisms should be relied on. Parties should also be free in contract to have disputes determined through alternative arbitral or court processes.

3.8 Investment of Trust Money

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

Are any further provisions necessary to support the operation of this proposal?

There should be no barrier to the investing of deemed trust monies consistent with the *Trustee Act 1925* provided the trustee exercises the care, diligence and skill as required under the *Trustee Act 1925*. The trustee would have to ensure that any monies that are invested would be available when payments are required.

3.9 Inspection of Records

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

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

HIA opposes the proposal to make it a statutory right to allow beneficiaries to inspect trust records. Presumably, failure to comply would be made a statutory offence. Not only is this proposal administratively burdensome, without any disincentive it could lead to, or encourage, vexatious behaviour by subcontractors. Further, such a right does not consider the impact on other subcontractors who may not wish to have their payment terms and arrangements on display for other contractors to examine. The approach forces a trustee to release potentially sensitive commercial information. If any right is given it should be limited to a subcontractor's own trust account records.

It is also unclear how this information would actually be of use to a subcontractor. A subcontractor will know if they have not been paid, they do not need access to trust account records for that purpose. If the right is provided to ensure that the money is actually being held on trust, there is enough incentive under the general law of trusts to incentivise trustees to comply. Using subcontractors in the shoes of a regulator is inappropriate and could potentially harm commercial relationships.

3.10 Director Liability

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

HIA strongly opposes this proposal. As the Consultation Paper notes, and as outlined above a director already has a duty under the *Corporations Act 2001* (Cth) not to trade while insolvent (see Division 3 of Pt 5.7B).

Section 588G(1) states the conditions for the application of the section as being that a person is within s 588G if:

- he or she was a director when the company incurred a debt;
- the company was then insolvent, or became insolvent, by then incurring that debt, or by then incurring debts including that debt;
- when the company incurred the debt, there were reasonable grounds for suspecting that the company was insolvent, or would become insolvent, as the case may be; …

Persons who are within s 588G(1) can, by failing to prevent the company from incurring the debt:

- become liable under s 588G(2) without proof of fault to a civil penalty order under Pt 9.4B for contravention of s 588G unless they can prove one of the defences in s 588H;
- in proceedings for a civil penalty order, be ordered under s 588J to pay to the company compensation for the loss or damage sustained by the creditor to whom the debt was incurred;
- be convicted of a criminal offence under s 588G(3) if they suspected insolvency and their failure to prevent the company incurring the debt was dishonest; the liability being absolute (see Criminal Code Act 1995 (Cth) and Criminal Code s 6.2(2));
- in proceedings for a criminal offence under s 588G(3), be ordered under s 588K to pay to the company compensation for the loss or damage sustained by the creditor to whom the debt was owed;
- be liable to be proceeded against under s 598 for breach of duty;
- be made liable under s 588M without proof of fault at the suit of the liquidator or the creditor (with the liquidator's consent (s 588R) or after notice to the liquidator (s 588S)), to pay compensation for the loss or damage suffered by the creditor unless they can prove one of the defences in s 588H.

The fact that the debt is not enforceable against the company does not prevent directors being liable[3]:

HIA submits the provisions of the *Corporations Act 2001* are adequate enough and do not need supplementing through amendments to the Act.

3.11 Expected Benefits & Costs from establishing 'deemed' statutory trusts

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

Are there any other significant benefits that are relevant?

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

Are there any other significant costs that are relevant?

HIA disagrees with the assessment of the costs and benefits of the proposal to establish 'deemed' statutory trusts.

Not only does the assessment lack rigour, it significantly underestimates the cost impact of such arrangements.

There is nothing in the Consultation Paper pointing to any work that has been done to assess the cost-benefits associated with introducing deemed trusts and, as raised in the NSW Auditor-General's 2016 report, there is a lack of 'a considered assessment of the impacts, benefits and costs of introducing regulation.'

HIA submits that while the inclusion of this attempted cost/benefit analysis in the Consultation Paper is supported, the approach does not go far enough.

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[3] *FAI Traders Insurance Co Ltd v Ferrara* (1996) 41 NSWLR 91.

Firstly, the discussion does not satisfy the requirements of a *Better Regulation Statement*. According to the 2016 *Guide to Better Regulation* the Statement should be a stand-alone document, address the Better Regulation Principles and provide:

- *decision makers with sufficient information to allow them to make an informed decision about whether to approve the proposal. An important element is demonstrating that the impacts of the proposal, including compliance costs, are well understood. Wherever possible, the assessment must be supported by quantitative analysis, and*
- *business and the community with information about decision making, ensuring transparency and accountability in the regulatory development process.*[4]

Given the significant impact the imposition of mandatory trust arrangements would have on the construction industry a thorough and quantitative regulatory impact analysis must be carried out.

Secondly, the attempt to categorise costs and benefits as 'medium' and 'low' is essentially meaningless without some transparency as to the factors used to reach that conclusion. What factors have been used to conclude that, for example, the net benefit of the additional protections that can be offered by trust arrangements is 'medium'? Equally what factors have been used to determine that the net cost accompanying the impact of trusts on the ability to obtain finance is 'low'? Without more these labels signal very little in terms of the costs and benefits of this proposals.

To that end, in HIA's view, the costs of the proposal significantly outweigh any of the perceived benefits of trust arrangements.

As set out earlier in these submissions, builders in the residential building industry face unique cash flow challenges. Trust funds would further restrict the ability of a builder to use money received from progress payments in a flexible manner, further depriving them of working capital and forcing them to incur additional financing costs. Inevitably, the practical effect of the proposals is increased costs to builders.

Deemed trust arrangements would distort commercial contracting arrangements, hinder industry cash flow and significantly and detrimentally impact on housing costs. Builders will pass on not only the increased overheads as result of the new red tape and administration costs but also increase their contract prices to reflect their additional business risks under this new environment. The ultimate impact of introducing such measures would be the increase in housing prices and decrease in housing affordability

As noted in the Price Waterhouse Report, *'There are accounting and taxation reporting provisions required for trusts which are complicated. Whether or not those accounting and taxation requirements can be made less onerous is a policy issue as to what the level of reporting requirements are to be.'*

The obligations imposed on a trustee are complex and onerous. Administering payment to and from a trust account is a complicated process requiring accounting and legal expertise. As many small business builders simply do not have the internal expertise to manage these responsibilities they would need to outsource to experts. This would undoubtedly add cost to the project in terms of bank charges and time spent in accounting and legal costs.

Further, the quarantining of monies into trust will also erode a builder's margin and likely make it impossible to generate significant cash surpluses on projects. Often these cash surpluses enable expansion of the business and investment in other developments.

Feedback from many builders to HIA is that they would simply exit the market. Other builders will incorporate these extra costs and risks into their contract and tendering prices, such that the costs are passed onto home owners.

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4 EXPOSURE DRAFT BILL 2018

Establishing a minimum monthly entitlement to a progress payment

HIA understands the intent of this reform is to seek to overhaul the definition of 'reference date' to provide a statutory minimum entitlement to a progress payment at least once per month, for work done within that month, while maintaining the freedom of the parties to agree in their contracts that progress payment claims be made more frequently.

As the clause is drafted however, it will prevent a party from making more than one payment claim after the construction work, associated with a claim, has been completed. This is also contrary to the operation of existing s 13(4) of the Act, which allows for the serving of claims within 'the period of 12 months after the construction work to which the claim relates was last carried out.'

HIA submits that Recommendation 14 of the Murray Review is apposite and should be adopted:

> *'To avoid confusion within industry the use of the expression 'reference date' should be abandoned. The legislation should provide that a person who has undertaken to carry out construction work (or who has undertaken to supply related goods and services) under a construction contract is able to make a payment claim for every named month, or more frequently if so provided under the contract.'*

HIA further submits that the ability to serve a payment claim within 12 months is too long and consideration should be given to reducing this period. In Queensland proceedings must commence within six months after the completion of all construction work or the supply of related goods and services. In Victoria the period is three months from when the work was performed. HIA observes that this has aided in restricting the unreasonable banking of claims by contractors and the practice of using claims as an ambush.

Establishing an entitlement to a final progress payment after termination

HIA understands this reform will establish a statutory entitlement, where a contract has been terminated, to make a final progress payment for work carried out (or related goods and services supplied), up to the date of termination.

The High Court determined[5] that where a contract expressly provides for reference dates, these reference dates do not survive the termination of the contract.

HIA supports this amendment, but notes that some rewording may be necessary if the Murray Review Recommendation 14 is adopted.

Shortening payment due dates

While HIA opposes the use of statutory prompt payment terms HIA sees value in reconsidering their operation in light of the existing operation of the Act.

Allowing inspection of trust account records

HIA opposes the proposal to require that a head contractor keep records and that those records be available to subcontractors to inspect for the same reasons given above in respect of allowing beneficiaries to inspect the records of 'deemed' trust accounts.

Endorsement of payment claim

HIA supports the reinstatement of the requirement that a payment claim must include a statement that it is a claim being made under the Act.

Expressly provide for the withdrawal of adjudication applications

HIA does not oppose this proposal.

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[5] *Southern Han Breakfast Point Pty Ltd (in liq) v Lewence Construction Pty Ltd [2016] HCA 52*

Adjudicator to determine an application within 10 business days

HIA does not oppose this proposal.

Code of practice for authorised nominating authorities (ANAs)

HIA does not oppose this proposal. A Code of Practice for adjudicators should assist in improving the consistency and accuracy of adjudication outcomes and could deliver efficiency gains within the adjudication process that will produce a benefit to all parties.

HIA understands the Code will be drafted and released for public consultation at a later date.

Supreme Court power to sever and remit adjudication determinations

HIA supports this reform that expressly enables the Court, where appropriate, to sever part of an adjudicator's determination that is affected by jurisdictional error and, in the process, confirm that the balance of the adjudication decision remains enforceable.

Prohibiting a corporation in liquidation from making payment claims

HIA is of the view that this proposed reform is too broad. This reform expressly provides that the Act does not apply to a claimant corporation that is in liquidation. A corporation in liquidation cannot serve a payment claim on a person or take any action to enforce a payment claim (including by making an application for adjudication of the claim) or an adjudication determination.

Further, the reform provides that if a corporation in liquidation has made an adjudication application that is not finally determined immediately before the day on which it commenced to be in liquidation, the application is taken to have been withdrawn on that day.

HIA submits that consideration should be given to exempting companies from the proposed reform who are trading under a Deed of Company Arrangement.

Standard information sharing provisions

This reform adopts and is consistent with standard information sharing provisions contained in other legislation administered by Fair Trading and will only be permissible in accordance with s 23 of the *Privacy and Personal Information Protection Act 1998* (NSW).

HIA does not oppose this proposed reform.

Appointment of authorised officers

Compliance and enforcement powers and associated offences

HIA understands that the proposed reforms will confer additional compliance and enforcement powers under the Act, in line with other legislation administered by Fair Trading.

The reforms introduce powers to:

- request, inspect and take possession of documents (s 32F)
- ask and require answers to questions (s 32G)
- enter premises (ss 32H – with or without a search warrant, 32I – with a warrant if used for predominantly residential purposes)
- obtain a search warrant. (s 32J)

HIA is not convinced that these proposed reforms to expand the powers of inspectors appointed under the Act is warranted.

The amendments to the Act which were introduced four years ago contained a number of measures that were designed to enforce compliance with the legislation. Authorised officers have the power to compel head contractors to produce relevant evidence of their compliance with the Act. Failure to comply, or provision of false documents in relation to a notice comes with a liability for a maximum penalty of $22,000, three months imprisonment, or both.

HIA submits that this represents more than sufficient government encroachment into a commercial relationship between two commercially contracting parties.

The ACCC is already equipped through the relevant provisions of the Competition and Consumer Act 2010 to deal with matters relating to conduct that is unfair, unconscionable or anticompetitive.

The Consultation Paper asserts that the intended outcomes of the proposed provisions 'are proportionate to achieving the objects of the Act and ensuring its efficacy.' Such an assertion is in HIA's view misleading. The object of the Act is quite simply:

> *[T]o ensure that any person who undertakes to carry out construction work (or who undertakes to supply related goods and services) under a construction contract is entitled to receive, and is able to recover, progress payments in relation to the carrying out of that work and the supplying of those goods and services.*

The investigative and enforcement powers, including those relating to accessorial and executive liability, that are being proposed are not proportionate to achieving this object. Rather, they are further examples of 'mission drift' away from the core legislative intent of the Act. Together with previous amendments, they will see the Act drifting further away from the Act's objective and impose further regulatory burdens on payees in the industry.

Prescribing penalty infringement notice offences

HIA understands that the intent of this reform is to provide an authorised officer with the ability to issue a penalty infringement notice to a person or corporation where it has contravened the Act. The offences subject to penalty infringement notices are to be set in the regulations.

HIA contends that offences subject to penalty infringement notices should not be set in the regulations. HIA questions the need for such notices under the Act in the first place.

The Fines Act 1996 (NSW) should not be extended in its application to penalty infringement notices issued to offending recipients within the building and construction industry. It is not appropriate for the Act, or its regulations to contain such penalties.

Introducing accessorial and executive liability

HIA understand the purpose of this reform is to ensure that directors and other individuals involved in the management of a corporation are held liable for their involvement in contraventions of the Act.

The reforms will apply accessorial liability to all offences under the Act which are capable of being committed by a corporation. Specifically, liability will extend to a person who is involved in contravention where the person:

- aids, abets, counsels or procures the commission of the corporate offence
- induces, whether by threats or promises or otherwise, the commission of the corporate offence
- conspires with others to effect the commission of the corporate offence
- is in any other way, whether by act or omission, knowingly concerned in, or party to, the commission of the corporate offence.

HIA strenuously opposes these proposed reforms. As stated above the HIA submits the provisions of the *Corporations Act 2001* are adequate enough and do not need supplementing through amendments to the Act. There is no justification for further liability to be imposed under the Act, particularly if it is proposed that a breach of a provision by the company would automatically extend to directors or individuals in management positions.

The introduction of an offence of aiding, abetting, counselling or procuring a corporate offence is not appropriate under this Act. If a person is found guilty of such an act in light of the serious nature of the offence and the specialised area of law, it is HIA's view that this is best dealt with in the criminal justice system and not through the Act.

Commencement of proceedings

HIA notes that this reform will increase the statutory limitation period for the commencement of proceedings to two years for offences under the Act rather than the current six months from when the offence was allegedly committed under s 179 *Criminal Procedure Act 1986*.

HIA does not oppose this proposal.

Reducing the threshold for retention money trust requirements

The Regulation currently requires head contractors to pay retention monies into a trust account for construction projects valued over $20 million. This proposed provision will reduce the threshold from projects with a value of at least $20 million to projects with a value of at least $10 million.

HIA opposes the proposed amendment to clause 5. There is no evidence to support such a move, nor is there any evidence as to the current successful operation of the model to justify this change.

It is HIA's position that retention funds should not apply to any residential construction projects.

Streamlining retention money trust reporting requirements

HIA supports amending the Regulation to remove the annual reporting requirements in clause 16. This will remove the trustee's costs associated with conducting reviews of accounts, although it is noted that under the proposals subcontractors will effectively be responsible for policing compliance through their power to inspect, which as noted above HIA objects to for the reasons provided.