PROTECTING NEW ZEALAND CONSTRUCTION SUBCONTRACTORS

by

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Abstract

Non-residential construction projects typically involve a large number of parties and a complicated “pyramid” of contractual relationships. At the top of the project an owner or developer commonly employs a head contractor, who employs specialist contractors, who employ subcontractors, who finally employ workers and material suppliers. Funds for the project are fed in at the top and are intended to trickle down to those at the bottom. However, evidence indicates that this often does not happen and that those at the bottom - most significantly subcontractors - suffer substantial losses.

Many countries attempt to reduce subcontractors’ losses through legislative intervention. The Canadian common law provinces apply both a statutory “builder’s lien”, which allows an unpaid subcontractor to register a charge against construction land, and supplementary holdback and trust requirements. By contrast, New South Wales, Australia and the United Kingdom apply a “quick and dirty” form of adjudication in an attempt to reduce the delays in payment disputes. New Zealand is currently investigating the form of legislation that it should enact and has modelled the Construction Contracts Bill on New South Wales adjudication measures.

This thesis examines the Canadian, New South Wales and United Kingdom systems for protecting subcontractors, as well as the New Zealand Construction Contracts Bill. It describes these different systems, and applies Cooter and Ulen’s perfect contract analysis in an attempt to compare them. It concludes that the New South Wales approach is the most favourable, particularly because of its attempts to reform areas of the construction industry beyond just the problems that subcontractors face. However, it also notes that this approach has very high transaction costs, to such an extent that some proposed reforms may never come to fruition. It therefore recommends that New Zealand take a cautious approach in
copying these measures. In addition, the thesis recommends that New Zealand researchers take more time to examine North American builder’s lien systems. Protecting construction subcontractors is a complicated issue and the best solution for New Zealand will result from a careful consideration of the many different systems, both before any legislation is enacted and afterwards.
# Table of Contents

Abstract ................................................................................................................................. ii

Table of Figures ..................................................................................................................... vi

Acknowledgements ................................................................................................................ vii

I The Construction Industry and Problems that It Faces ...................................................... 1
   1 Introduction ...................................................................................................................... 1
   2 Players in the Industry ..................................................................................................... 2
   3 The Payment Problem ..................................................................................................... 5
   4 Current Evidence of Payment Problems ........................................................................ 9
   5 Legal Responses to the Problem .................................................................................... 18
   6 New Zealand's Situation ................................................................................................ 28
   7 An Outline of This Thesis .............................................................................................. 29

II The Canadian System .......................................................................................................... 33
   1 Builders' Liens Across North America .......................................................................... 33
   2 The British Columbia 1997 *Builders Lien Act* ............................................................. 39
   3 Builder's Liens and Holdbacks in British Columbia ......................................................... 46
   4 Construction Trusts in British Columbia ...................................................................... 57
   5 Other Devices ................................................................................................................. 72
   6 The Law in Québec .......................................................................................................... 82
   7 Analysis of the Canadian Systems ................................................................................ 88

III The New South Wales and United Kingdom Systems ..................................................... 92
   1 Introduction ..................................................................................................................... 92
   2 The Australian States' Rejection of the Builder's Lien .................................................... 93
   3 The New South Wales Reform Process ........................................................................ 96
   4 The *NSW Security of Payment Act* ........................................................................... 99
   5 Responses to the *NSW Security of Payment Act* ...................................................... 104
   6 Other Aspects of the CPSC Actions ............................................................................ 109
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>So, What Happens in New South Wales Now?</td>
<td>118</td>
</tr>
<tr>
<td>Aspects of the United Kingdom System</td>
<td>119</td>
</tr>
<tr>
<td>IV The New Zealand System</td>
<td>127</td>
</tr>
<tr>
<td>1 The Law Before 1987</td>
<td>127</td>
</tr>
<tr>
<td>2 The 1987 Repeal</td>
<td>133</td>
</tr>
<tr>
<td>3 1987 to 2001</td>
<td>137</td>
</tr>
<tr>
<td>4 Phoenix Companies</td>
<td>144</td>
</tr>
<tr>
<td>5 The Introduction of the <em>Construction Contracts Bill</em></td>
<td>147</td>
</tr>
<tr>
<td>6 Potential Problems with the <em>Construction Contracts Bill</em></td>
<td>153</td>
</tr>
<tr>
<td>V An Analysis of the Systems</td>
<td>168</td>
</tr>
<tr>
<td>1 Introduction</td>
<td>168</td>
</tr>
<tr>
<td>2 Seven Assumptions About the Perfect Contract</td>
<td>171</td>
</tr>
<tr>
<td>3 Analysing the Lien and ADR Systems</td>
<td>177</td>
</tr>
<tr>
<td>4 Using Trade Associations as a Solution</td>
<td>186</td>
</tr>
<tr>
<td>VI Summary and Conclusions</td>
<td>190</td>
</tr>
<tr>
<td>1 Introduction</td>
<td>190</td>
</tr>
<tr>
<td>2 The Canadian Solution</td>
<td>192</td>
</tr>
<tr>
<td>3 The New South Wales and the United Kingdom Systems</td>
<td>195</td>
</tr>
<tr>
<td>4 New Zealand Reforms</td>
<td>198</td>
</tr>
<tr>
<td>5 The Perfect Contract Analysis</td>
<td>201</td>
</tr>
<tr>
<td>6 Final Words</td>
<td>205</td>
</tr>
<tr>
<td>VII Bibliography</td>
<td>208</td>
</tr>
<tr>
<td>VIII Appendix: Excepts from the <em>Builders Lien Act</em>, S.B.C. 1997, c.45</td>
<td>224</td>
</tr>
</tbody>
</table>
# Table of Figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>Typical Pyramid-Style Construction Project</td>
<td>3</td>
</tr>
<tr>
<td>1.2</td>
<td>Simple Representation of Construction Contracts</td>
<td>6</td>
</tr>
<tr>
<td>3.1</td>
<td>Timeframes Under the <em>NSW Security of Payment Act</em></td>
<td>108</td>
</tr>
<tr>
<td>5.1</td>
<td>Applying the Seven Assumptions to the Canadian Lien Method</td>
<td>180</td>
</tr>
<tr>
<td>5.2</td>
<td>Applying the Seven Assumptions to the NSW ADR Method</td>
<td>182</td>
</tr>
<tr>
<td>5.3</td>
<td>Applying the Seven Assumptions to the NZ ADR Method</td>
<td>184</td>
</tr>
</tbody>
</table>
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I THE CONSTRUCTION INDUSTRY AND PROBLEMS THAT IT FACES

1 Introduction

In the last few years the New Zealand construction industry has witnessed numerous insolvencies, some of which have become high profile events. In January 2001 two construction companies, GFF Ltd.\(^1\) and Tauran Construction Company Ltd., went into liquidation. At that time GFF was reported to owe 250 creditors NZ$3.1 million and Tauran 1000 creditors NZ$2.1 million. GFF had no employees and only three director shareholders, while Tauran had six employees and two director shareholders.\(^2\) Therefore, while up to 1,250 creditors stood to lose $5.2 million, only 11 people directly associated with the companies risked suffering any financial loss.

In February 2001 the New Zealand construction industry suffered another blow when the country’s fourth largest building firm - Hartner Construction - went into voluntary liquidation with NZ$17 million owed to creditors and NZ$13 million of disputed debts.\(^3\) Geoff Bayley, a building disputes arbitrator from Auckland commented that “[t]his is a disaster for the construction business... It will take a lot of other firms down with it.”\(^4\) Darrel McLeod, managing director of a plumbing company contracted to a Hartner site, said that the collapse


\(^{2}\) Ibid.

\(^{3}\) “Firms in Jeopardy After Hartner Collapse” Stuff Business (3 February 2001), online: Stuff Homepage <http://www.stuff.co.nz/inl/index/0,1008,627579a13,FF,html> (date accessed: 3 February 2001) [hereinafter “Firms in Jeopardy Article”].

\(^{4}\) Mr Bayley’s comments were published in the following article: A. Gibson, “Wayne’s World is Crumbling” The New Zealand Herald (3 February 2001), online: The New Zealand Herald Homepage <http://www.nzherald.co.nz/storyprint.cfm?storyID=170927> (date accessed: 3 February 2001).
would send a “cascade” of subcontractors out of business: “[e]specially those who put all their eggs in one basket. They end up getting locked in and I think they’re kidding themselves that it’s going to work out all right”.  

Mr McLeod’s references to the effects that construction insolvencies have on subcontractors are not unusual. Such subcontractors are typically parties at the “bottom” of a construction project, namely carpenters, plumbers, plasterers, electricians and others. According to both New Zealand politicians and the media, these are the parties to suffer the greatest financial harm when a construction company becomes insolvent. This harm then frequently causes a more general cost on society, because of the consequential suffering imposed on subcontractors’ families, employees and creditors.

New Zealand subcontractors are not alone in facing a precarious financial situation. Around the world the costs that defaulting construction firms impose both on subcontractors and then on society cause concern to governments, banks, shareholders, lawyers, accountants and others. Such uncertainties lead governments to intervene, implementing laws that aim to remedy what are seen as inherent defects in the industry. Such laws may take various forms, and New Zealand is currently considering which form its new legislation should take.

2 Players in the Industry

Construction projects frequently involve many different parties and are described as taking on a “pyramid-style” structure. At the top of the project is the landowner who usually obtains finance, and then either becomes, or employs, the developer. The developer then commonly employs a head contractor who employs contractors, who employ subcontractors, who employ sub-subcontractors, and so on. At the bottom of the various contractual chains

\footnote{Firms in Jeopardy Article, supra note 3.}
subcontractors and sub-subcontractors employ individual workers, and purchase goods from material suppliers. Figure 1.1 represents a typical pyramid structure and illustrates the various different participants who may be involved in a single project.

Figure 1.1: Typical Pyramid-Style Construction Project
Figure 1.1 also illustrates some of the terminology commonly used in the construction industry, and shows how that terminology is used in flexible ways. Firstly, in formal terms a “contractor” is a party who has direct contractual relations with the “owner” or “developer”, and a “subcontractor” is a party who contracts with a contractor. Then, a “worker” is an individual whom a contractor or subcontractor employs, and a “material supplier” is a party who supplies building goods and materials to a contractor or subcontractor, for incorporation into the project.

However in less formal terms, the term contractor is also used to refer to specialist managers who contract with the head contractor as “structural”, “interior” and “mechanical contractors”. Furthermore, it is also common to include “sub-subcontractors” and “sub-sub-subcontractors” under the general heading of “subcontractor”, notwithstanding that their contracts are with subcontractors and sub-subcontractors respectively. And in addition, throughout this thesis and elsewhere it is also common both for references made to “protecting construction contractors” and “protecting construction subcontractors” to be intended to refer not just to contractors or subcontractors, but to both, as well as to sub-subcontractors, sub-sub-subcontractors, and usually even workers and material suppliers. Terms are used interchangeably and it is important not to place too much reliance on formal definitions.

In most commercial building projects the parties who perform 80 to 90% of construction work are the subcontractors, whether they be actual subcontractors, sub-subcontractors or sub-sub-subcontractors. This is of major significance because typically these subcontractors will be only small or medium sized businesses. For example in New South Wales, Australia

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there are about 25,000 firms involved in the building industry with about 65% of them being very small businesses with two employees or less. These businesses each have a turnover of less than AUS$500,000 annually, but together deliver more than 75% of industry turnover. Subcontractors from different trades will often be in quite different positions. For example some, like a masonry subcontractor, will work during the early stages of the project while others, like an interiors subcontractor, will work at the end. Mechanical and electrical subcontractors will have an ongoing presence on a project while painters will interface very little with anyone. Both these timing circumstances, and varying market demands for some trades over others, mean that individual subcontractors face different problems and some will be better off than others. However, it also appears that many of the problems that are faced are in fact common to all subcontractors, not just within particular projects, or even particular jurisdictions, but across much of the (western) world.

3 The Payment Problem

Figure 1.1 illustrates the number of parties involved in a construction project and the complexity associated with all of their different contracts. However, for the purposes of understanding the financial problems that contractors and subcontractors face it is possible to use a simpler diagram and to isolate the various relevant issues.

At the core of the financial problem there are three parties - the owner, the contractor and the subcontractor. The owner may or may not be a developer, the subcontractor may or may not have sub-subcontractors below him or her and there may or may not be an estate agent, an

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8 Hinze & Tracey, supra note 6 at 275.
architect and an engineer involved—these parties add complexity but do not change the essence. The important analytic point is that there are multiple contracts—"Contract 1" between the owner and the contractor, and "Contract 2" between the contractor and the subcontractor. Figure 1.2 illustrates these relationships.

**Figure 1.2: Simple Representation of Construction Contracts**

Disputes arise in construction either when the contractor is not paid under Contract 1, or when the subcontractor is not paid under Contract 2. An unpaid contractor will seek to enforce payment against the owner by using whatever devices the applicable law provides. Similarly, the subcontractor will seek to enforce payment against the contractor, and if the applicable law permits it, against the owner as well.

The "builder's lien" is a statutory device described in both Chapter I, Section 5.1 and Chapter II below, which is used across North America. It appears to provide a fair level of protection in the context of Contract 1 by allowing an unpaid contractor to register a charge against the owner's land, effectively freezing title so that the owner will be forced to account for the contractor's debt. There will still be a need to balance the rights of a secured lender against such lien rights, but this balancing can usually be achieved provided that there has been value added to the property as a result of the construction activity.⁹

⁹ The lender will require that the security increase in value before it will be prepared to make any further mortgage advances because that lender must receive some consideration for each advance that is made.
However while the lien provides good protection in the context of Contract 1, on its own it is not so satisfactory if the non-payment in question arises under Contract 2. If the debt at issue is that of a subcontractor who has not been paid by a contractor, then allowing that subcontractor to file a lien against the owner’s land raises privity of contract problems. Because the owner is not a party to Contract 2, he or she cannot enforce provisions in that contract to ensure that payment is made. However, that owner must nonetheless bear the burden of non-payment because the lien remains on his or her title.

The issue can therefore be summarised as being a question of where risk should lie in the event of non-payment by a contractor to a subcontractor. If the law provides no lien rights then that risk will lie with the subcontractor. This will require that subcontractor to inform him or herself about the financial stability and reliability of the contractor (as well as the owner and any other contractors higher in the chain) – something that may be difficult for him or her to do. However, if the law does provide lien rights then risk will lie with the owner. In an extreme case this will require the owner to ensure that payment is made to all parties lower in the chain. There is clearly no easy answer to this dilemma.

There are also other features of the construction industry that are relevant to the issue of financial protection. Firstly unlike contracts for the sale of goods, construction contracts cannot be easily reversed in the event of non-payment. In most cases construction contracts involve the provision of services, or the installation of items that subsequently become fixtures, so that nothing can ever be repossessed, whether for physical or legal reasons. Thus, contractors and subcontractors have no real remedies available to them.

Secondly, construction projects are usually one-off events that are individually tailored to the owner’s requirements. Unlike manufacturers, contractors and subcontractors do not work with processes that can be gradually refined over time, and must instead develop new and
untested designs, specifications and contracts for each project.

Thirdly, the considerable use of single purpose limited liability vehicles means that a contractor or subcontractor will often find him or herself claiming money from an insolvent "phoenix company", a term that will be explained and examined in Chapter IV.\footnote{An owner might also fall victim to the problems associated with phoenix companies if, for example, a limited liability contractor fails to pay its subcontractors and flees, leaving the owner with the problem of removing lien claims. However, note that North American lien systems have established holdbacks to reduce owners' risks in this area so that an owner's liability will typically be limited to 10% of the contract price, or whatever other percentage the holdback might be.} Contractors and subcontractors may stop work in an attempt to enforce payment but typically those with whom they contract will expressly prohibit this in the relevant contracts. This means that in addition to there being no \textit{real} remedies available to contractors and subcontractors, there are also effectively no \textit{personal} remedies available to them either.

Finally, the trend towards increased levels of the subcontracting out of construction work also shows that contractor and subcontractor protection is a relevant and substantial issue. Traditionally construction work was subcontracted out only when it was of a specialist nature, for example work performed by an elevator installation company. By carrying out large amounts of routine construction work in-house, companies could remain large and benefited from \textit{economies of scale}.\footnote{An economy of scale is a benefit that might, for example, enable a producer to lower the average cost of production by increasing the level of output – i.e. by producing more items, the producer would be able to produce each individual item for less (see R. Cooter & T. Ulen, \textit{Law and Economics}, 3\textsuperscript{rd} ed. (United States of America: Addison-Wesley Longman, Inc., 2000) [hereinafter "\textit{Cooter & Ulen 3\textsuperscript{rd} ed}" at 31.} However, more recently companies have tended to subcontract out some of this routine construction work in an attempt to offer a broader range of products to their clients. This diversification enables the companies to benefit from
economies of scope.\textsuperscript{12} Obviously construction companies need subcontractors to stay in business so that work will be performed, but an imbalance of power between the two usually ensures that the subcontractor remains in a position of dependency.\textsuperscript{13} Governments have created statutory protections in an effort to remove the inequalities associated with this imbalance of power, not always in ways that achieve a satisfactory means of sharing risk. Meanwhile, New Zealand construction contractors currently have no such specialist protection and are said to suffer as a result of this. The following Section 4 will examine some of the difficulties that New Zealand contractors face, as well the problems that their Australian, British, Canadian and American compatriots deal with.

4 Current Evidence of Payment Problems

The scurry of media attention associated with the GFF Ltd., Tauran Ltd., Hartner Construction and other recent New Zealand construction insolvencies has generally taken the view that there is a problem with New Zealand’s lack of specialist protection for construction contractors. Likewise, the New Zealand Law Commission examined the situation in its 1999 report entitled Protecting Construction Contractors\textsuperscript{14} and concluded that “[t]he need for protection is recognised in many jurisdictions. It seemed to the Law Commission that the

\textsuperscript{12} S.L. Gruneberg & G.J. Ive, The Economics of the Modern Construction Firm (London, England: MacMillan Press Limited, 2000) at 107. The term “economies of scope” refers to reductions in cost that result from combining two different activities (see Cooter & Ulen 3\textsuperscript{rd} ed, supra note 11 at 411). Thus, if a business has the ability to produce two different services, it can alternate these services as the market demand for each increases and decreases, and will thereby benefit from economies of scope.

\textsuperscript{13} Gruneberg & Ive, supra note 12 at 132.

position of construction contractors is sufficiently *sui generis* to warrant legislative intervention*. As Chapter IV explains, the Commission cited quantitative research to show that subcontractors were far less likely to be paid on time than head contractors. It also identified the nature of the pyramid structure and contractors' and subcontractors' inability to stipulate security for their work as being valid reasons to distinguish construction from other industries; warranting special protection.

*Protecting Construction Contractors* followed the same line that had taken by many Canadian, Australian, United Kingdom and New Zealand law reform commission reports before it. For example, the Law Reform Commission of Western Australia commented that:

Too often... money paid: “...to a contractor on one contract is siphoned off to pay creditors of another contract or used to invest in other projects”... Another cause of difficulty is the existence of the chain of contract linking the owner, head contractor, subcontractors, employees and material suppliers. The chain of contract is itself risky, with those at the end of the chain bearing the greatest risk.”

Meanwhile, the Newfoundland Law Reform Commission identified that: “[t]he necessity or justification for mechanics’ lien legislation lies in the inadequacy of ordinary contractual remedies to deal with the complex inter-related web of claims that characterize the typical construction project”.

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15 Ibid. at 4.

16 See below, note 509 and accompanying text.

17 *Protecting Construction Contractors, supra* note 14 at 3-4.


There have also been various commentaries and studies that have identified problems with the financial protection of contractors and subcontractors. Australian publications have noted the industry's "severe undercapitalisation" and "high gearing", as well as developers' inabilities to secure proper finance, and their inadequate levels of working capital. Because subcontractors are almost always required to provide their services on credit and have inadequate resources to perform the sort of financial checks that banks, financial institutions and other credit suppliers typically carry out, they appear to bear the brunt of these problems.

Empirical research carried out by J. Hinze and A. Tracey in 1994 also identified and described some of the issues that arise in this area. This research examined the problems faced by subcontractors in the Puget Sound area, Washington, U.S.A., although the authors' observations appear to reflect aspects not just of the construction industry in Washington, but also of construction industries throughout the U.S.A., Canada, Australia and New Zealand.

In particular Hinze and Tracey highlighted problems that arise from tendering and

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22 Hinze & Tracey, supra note 6. Hinze and Tracey interviewed 28 subcontractors from a variety of trades. They asked the subcontractors a standard set of questions so that they could draw quantitative conclusions. However, the questions were deliberately designed to be open-ended so that the research would also be of qualitative benefit as well. Therefore, while the sample size was somewhat small, conclusions drawn from percentages and numerical results could be backed up by the qualitative information.

23 And presumably many of the observations will also illustrate the situation in other jurisdictions around the world as well.
documentation processes and from "bid shopping".

Where subcontracting work is put to tender, as it frequently is, that tender will require there to be two stages of formal documentation. Firstly, upon the issue of an invitation to tender, each prospective subcontractor will prepare a "bid" in which they set out services and/or goods that they will supply in exchange for a specified fee. Secondly, upon contractor’s selection of one of these bids, the successful subcontractor will be required to enter into a formal “subcontract”, containing the terms of the bid and setting out other detailed and specific contractual terms.

As part of their research Hinze and Tracey asked subcontractors about their typical experiences in preparing the two tendering contracts, namely the bid and the subcontract. 28% of respondents reported that they would normally engage in no formal communications with their contractor prior to signing the subcontract and many said that they would sign standard form contracts with or without the contractor’s modifications. Only those whose work involved a greater level of specialization, such as elevator subcontractors, appeared to have much success in using their own documentation.

Added to this, 93% of the respondents reported that they signed provisions making them bound by the terms of the head contract, with a surprising 46% saying that they did this without having ever seen the terms of that head contract. Hinze and Tracey commented that:

24 Hinze & Tracey, supra note 6 at 278.
25 18 out of 28 (64%) said that they signed standard form contracts and a further 5 (18%) said they sign the contractor’s contract (Hinze & Tracey, supra note 6 at 279-280).
26 Hinze & Tracey, supra note 6 at 279-280.
27 Hinze & Tracey, supra note 6 at 281.
28 Hinze & Tracey, supra note 6 at 285-286.
Many subcontracts are awarded without any formal discussion taking place between the contractor and subcontractor. This may increase the probability of a conflict after the construction work has begun. Subcontractors appear to be at a decided disadvantage when entering agreements with general contractors. They appear to accept this disadvantage in many instances without sensing any recourse to change the circumstances. Perhaps this perspective is fostered by the fact that failure to accept the terms of the contracting posed by the general contractor will result in the selection of another subcontractor who is willing to accept those terms. As long as this attitude prevails, the practices are not readily subject to change.

It appears that, while courts enforce such contractual provisions as they would any others, there is an element of unfairness in doing so because of the nature of the construction industry. In 1994 W. Hughes identified this as being a problem in both the United Kingdom and the United States:

> Absolute liability can only be construed as fair when the parties to a contract have had time to negotiate the terms and identify the full extent of their liabilities. Although the legal doctrine of *consensus ad idem* (a meeting of minds) assumes that this is indeed the case, it is rarely true in the practice of construction contracting. Usually, construction contracts are based upon industry-wide standards which often are hastily modified and executed during a hurried tendering process.

Tendering also appears to be a hasty and, arguably under-resourced, process in Canada, Australia and New Zealand.

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29 Department of Construction Management and Engineering, University of Reading, United Kingdom.

30 W. Hughes, “Improving the Relationship Between Construction Law and Construction Management” (Charting the Course to the Year 2000 - Together; The First Multidisciplinary Conference on Co-operative Creative Problem Solving in the Construction Industry, University of Kentucky, October 1994), online: W. Hughes' University of Reading Homepage <http://www.rdg.ac.uk/~kcshuwil/publish/kentucky.html> (date accessed: 30 April 2001).

31 For Australia see *Western Australia Report, supra* note 18; for New Zealand see T. Kennedy-Grant, *Construction Law in New Zealand* (Wellington: Butterworths, 1999) at 314, 315-316 and for Canada see J.R. Sproat, “Construction Contracts, Tenders and the Ron Engineering Case” in The Canadian Bar Association, *The*
“Bid shopping” refers to what are generally considered unethical negotiations that sometimes take place between tendering parties. Such negotiations can arise at two stages in the contractual process, namely, before bids are made (“pre-bid shopping”) and after bids are made (“post bid shopping”). A subcontractor might instigate pre-bid shopping prior to the submission of his or her bid by obtaining information about other bids and attempting to gain the cooperation of the contractor. On the other hand, a contractor might instigate post-bid shopping after all bids have been made by using information from one bid to attempt to have a subcontractor change details or reduce the price of another bid. Although contractors are usually not obliged to accept the lowest bid that is made, this post-bid shopping enables a contractor to obtain what it perceives to be the best bid at the lowest price. The contractor may breach its obligations to other bidders in carrying out such communications but such bidders will have difficulty finding out, and proving, that any wrongdoing has occurred.

While not all forms of tender negotiations will be considered unethical, both pre and post-bid shopping are. And, while many of the respondents to Hinze and Tracey’s survey made efforts to submit their bids as late as possible so as to avoid pre-bid shopping, over half of them reported that they felt that bids they made could not be protected from bid shopping. Similarly, Australian law reform commission reports have reported a high incidence of both “bid cutting” and “bid shopping” in that country. The Australian Code of Tendering

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32 Hinze & Tracey, supra note 6 at 276-279.
33 Hinze & Tracey, supra note 6 at 276-279.
34 Hinze & Tracey, supra note 6 at 276-279.
35 These reports use the terms “bid cutting” to refer pre-bid shopping, and “bid shopping” to refer to post-bid shopping.
36 Western Australia Report, supra note 18 at 18 citing Victoria Parliament Report, supra note 20 at 23.
bans post tender negotiations but apparently that Code is “rarely applied”. Such negotiations severely disadvantage subcontractors because they force what are already competitive bids to be made even lower. They also often arise out of an imbalance of power where a contractor with full knowledge of all bids attempts to exert influence over a subcontractor with much less information.

The type of work, and the type of projects, performed in the construction industry also increase the risk faced by contractors and subcontractors. In July 2000 a New Zealand Construction Industry Working Group issued a report as part of the ongoing work towards that country’s reforms. That report referred to subcontractors facing difficulties because they generally supply “homogenous” or non-specialized services that could be performed by “any number of other people”, meaning that most subcontractors could be easily replaced should the need for this arise. The report also observed that the industry is typified by long-term projects, meaning that, at any one time, a subcontractor will often conduct almost all of his or her business for one head contractor on a single project. This leaves that subcontractor very vulnerable to matters in the control of those higher up in the chain.

When ones adds to this the reluctance that subcontractors appear to have to obtain the assistance of lawyers, identified by J.V. Tocco in a 1992 study, it appears that there is a

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38 Western Australia Report, supra note 18 at 18 citing Victoria Parliament Report, supra note 20 at 23.


40 Ibid. at 2.

41 Ibid.

substantial risk in almost every project that these people will not get paid. Tocco surveyed 72 subcontractors and material suppliers in the Detroit metropolitan area to ascertain how subcontractors were resolving and preventing legal disputes. He found that subcontractors had high levels of distrust in lawyers and rarely consulted them for assistance in negotiations or to review contract documents. This was despite the fact that the majority of respondents saw contracts as being more complicated and less fair than they had been in the past.\textsuperscript{43} It also appears to be despite the fact that owners, developers and head contractors will frequently engage legal representation to protect their interests.

Overall, there appears to be significant frustration across Canada, Australia, the United States, the United Kingdom and New Zealand with both the construction industry in general, and more particularly with subcontractors’ position in that industry. In the United States one writer commented that:\textsuperscript{44}

\begin{quote}
The industry is in fact notorious for its pay practices. It is chock full of nonpayers, partial payers and slow payers. Most are caught in an involuntary role, affected more by the actions of others. But there are also firms that use such tactics deliberately to their own benefit and to the detriment of the industry. The end result usually is a contractor “robbing” assets from one project to pay for another with pay problems. This is a recipe for disaster.
\end{quote}

There appears to be dissatisfaction amongst subcontractors with general contractors:\textsuperscript{45}

\begin{quote}
Today, general contractors on building projects perform little actual work. Many in the industry begin to question the real value added by GC’s. Nearly all generals rely upon subcontractors and suppliers, who are increasingly unhappy. Subs must furnish skilled workers at random times as dictated by a flexible schedule. They must coordinate activities with other crafts. Subs are required to finance their efforts, insure everything, indemnify and defend everyone (regardless of responsibility) and wait
\end{quote}

\textsuperscript{43} Ibid, at 8.

\textsuperscript{44} “Weighing Payment Risks” (18 August 1997) 239(7) E.N.R. 114.

\textsuperscript{45} J.V. Pollock, “Industry is at a Crossroad” (1 July 1996) 237(1) E.N.R. 57.
patiently for money, when – or if – it comes. Before being subjected to this, a specialty contractor
must offer one consideration: lowest price.

There is also frustration that contractors and subcontractors with specialized skills are not
properly compensated:46

Unlike manufacturing, our entire output is custom-made, yet we fight to give it away for little or no
reward. In the process, we beat up everyone below us in the food chain and alienate all whom we
depend upon to get anything done. The industry is at a crossroads. Its leaders must either act
responsibly or take responsibility for a difficult future.

In most situations subcontractors bear the brunt of problems in construction because those
above them are the most likely to have unpaid debts,47 and because they have inadequate
resources to protect themselves with proper contractual remedies.48 Therefore, law reforms
are most frequently designed to protect subcontractors. However, whether it makes
economic sense to afford such protection is another question, and one that will be examined
in Chapter V. In the meantime the following Section 5 will now examine the varying forms
that different countries have used to invoke the protection over time, as well as some of the
other legal issues that arise.

46 Ibid.

47 According to Western Australia Report, supra note 18 at 9, it is unusual for an owner to become insolvent
during a project even though that owner might cause substantial delays. Apparently it is more common for a
builder (or carpenter) to run into problems and it is also common for a head-contractor to apply payments that it
receives to other projects or to use them to reduce overdraft liabilities.

48 According to Hinze & Tracey, supra note 6 at 285-286, subcontractors lower their guard because of the high
number of bids that they put in each year and because of the added effort that would be required if they were to
submit each bid with a full understanding of all the inherent contractual risks.
5 Legal Responses to the Problem

5.1 The Lien and the Lien Systems

The origins and evolution of the North American lien systems are explained in Chapter II. The builder’s lien is a well-established protection mechanism. The two devices that are most commonly used to supplement it are the holdback and the trust. In essence the evolution of liens, and liens’ supplementary devices, has mirrored both the growth in complexity of the construction industry and the trend towards subcontracting out. Therefore, as contracts have increased in risk and complexity legislatures have developed retention fund, or “holdback”, requirements to prevent money being lost to contractors that have not fulfilled their work and/or payment obligations. Typically, these holdbacks require any party contracting another to retain approximately 10% of the contract price so that that amount can be used to satisfy any claims made by those lower down in the chain.

Similarly, as owners have become exposed to the risk of compensating unpaid subcontractors, some legislatures have introduced limited liability provisions to reduce their exposure to what are seen as more reasonable levels. Thus, the liability of a party retaining a holdback will often be limited to the amount of that holdback.

Finally, as both the use of phoenix companies and more general unethical behaviour have become seemingly more prevalent, statutory trust provisions have been created to impose some level of accountability on corporates, and particularly on individuals. Such provisions are commonly drafted to ensure that all money entering a construction project becomes trust funds held for the benefit of those in that project. This means that all common law and relevant statutory trust obligations will be imposed on trustees and, most importantly, the moneys may not be applied for purposes outside the project.
As modern construction industries have developed around the world, legislatures in jurisdictions outside of North America have also adopted lien systems. However at least in New Zealand and New South Wales these systems have not developed to the same extent that their Canadian and United States’ equivalents have. More recently these systems have increasingly been abandoned altogether and both those in the industry and legislatures are now commonly turning to other possible solutions, many of which incorporate aspects of alternative dispute resolution.

5.2 Alternative Dispute Resolution

Alternative dispute resolution or “ADR” encompasses a wide range of techniques that provide means to resolve disputes without the use of litigation. Many of the aspects of construction projects that were discussed above namely, their length and complexity, the fact that they are usually one-off, and the number of parties that they involve make litigation in this area very expensive and ADR increasingly attractive.

The trend away from construction litigation and towards the use of ADR was particularly evident during the 1980s.\(^49\) At that time arbitration was seen as a confidential, cheap and quick alternative to court proceedings. However, over time many in the industry became frustrated with it after arbitrated hearings became just as expensive and time consuming as parties perceived litigation to be.

In the United States there have been increasing moves away from arbitration and toward the use of what are called Dispute Review Boards.\(^50\) In the United Kingdom and New South Wales, Australia the move has been toward what is known as “adjudication”. In

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50 Ibid. at 475.
essence both of these things allow for a “quick and dirty” resolution to be found for a
collection dispute, with the parties remaining able to pursue the matter in more detail
later. Other techniques such as negotiation, mediation and expert determination, and in
the United States partnering “med-arb”, “med-then-arb”, “early neutral evaluation” and
the “mini-trial”, 51 are also used and encouraged in the various different jurisdictions.

5.3 Residential Construction

One noticeable feature of construction law is that reforms that are implemented to protect
contractors and subcontractors are usually aimed at parties working on commercial,
industrial and institutional projects, rather than those involved in residential construction.

In Canada and the United States residential contractors may use builder’s liens and
associated devices, but frequently do not. 52 In New South Wales, 53 and as well as under
certain parts of the United Kingdom legislation 54 and the new New Zealand Construction
Contracts Bill, 55 residential contractors have been excluded from the application of the

51 D.R. Mix, supra note 49 at 476-477.
52 Interview with M. Pratchett, Q.C. Ms Pratchett is a partner at the firm of Fasken Martineau DuMoulin LLP,
one of Canada’s leading national business and litigation firms. She practices in the Litigation and Alternative
Dispute Resolution Department at Fasken Martineau DuMoulin, predominantly in the area of construction and
engineering issues. Ms Pratchett agreed to participate in an interview about the British Columbia construction
industry, and that interview took place on 22 June 2001. References in this thesis to Ms Pratchett’s comments
come from that interview [hereinafter the “Interview with Marina Pratchett”]. For more information about
Fasken Martineau DuMoulin LLP see their website:
55 New Zealand Construction Contracts Bill, 2001 (1st reading 26 June 2001) [hereinafter “Construction
Contracts Bill”]. Pursuant to clause 8(2) the whole of the bill applies to “residential construction contracts” (as
that term is defined in clause 5) except for clauses 13 to 16, and Part 4. This means that residential construction
contractors may still use the bill’s dispute resolution mechanisms, and will still be immune from pay-when-paid
and pay-if-paid clauses, but may not suspend work or register charges against construction land.
reforms altogether.

Residential construction contractors are treated differently than commercial, industrial and institutional contractors because their industry is perceived to be different. For example, while commercial contractors use increasingly lengthy written contracts, contracts governing residential work are frequently oral or involve only simple standard works contracts when legislation requires them to be in writing.\textsuperscript{56} Similarly, commercial contracts are often awarded through a tender process, while residential contracts are not.\textsuperscript{57} And finally, commercial contractors and subcontractors often make payment claims on a monthly basis, while those in residential construction are paid weekly or fortnightly.\textsuperscript{58}

These differences lead many to believe that there is not the same need for residential contractors to have the ability to make progress payment claims, or for reforms to be enacted to render otherwise complicated and inequitable contractual provisions more fair. However, not everybody in the industry believes that this is correct. As will be seen in Chapter III, when the New South Wales \textit{Building and Construction Industry Security of Payment Bill} was before the House prior to its second reading, opposition members made substantial objections to the lack of protection that residential construction contractors were to receive under the bill because of the perceived inadequacies of their other protections. And, while the New Zealand \textit{Construction Contracts Bill} has been drafted to exclude residential contractors from certain sections, during the reform process many parties indicated that reforms should apply across all construction industries. In

\textsuperscript{56} \textit{Western Australia Report}, supra note 18 at 10. For example, in Western Australia contracts between owners and builders/carpenters for home building work are governed by the \textit{Home Building Contracts Act 1991} (W.A.) and must be in writing (section 4). The same applies in New South Wales pursuant to section 7 of the \textit{Home Building Act 1989} (N.S.W.).

\textsuperscript{57} \textit{Western Australia Report}, supra note 18 at 10.

\textsuperscript{58} \textit{Western Australia Report}, supra note 18 at 11.
particular, recent New Zealand law reform material has recommended that any scheme introduced into law should cover:\(^{59}\)

the same services as covered by the NSW legislation on which the Law Commission's recommendation was based, but should also extend to contracts with residential owners and residential construction generally. Residential construction constitutes a considerable portion of the industry's work and the same considerations should apply to residential construction as apply to commercial construction.

As Chapter IV, Section 5 will explain, drafters of the New Zealand Construction Contracts Bill have moved to put this into effect by providing for parts of the Bill to apply to residential construction work. To this extent the Construction Contracts Bill differs from the NSW Security of Payment Act and it will therefore have a broader scope. It is too early to determine whether this change will be beneficial to the industry and to consumers and it is noted that New Zealand researchers and drafters do not appear to have carried out any particular consultation with contractors who perform residential construction.

5.4 “Pay When Paid” and “Pay If Paid” Clauses

“Pay-when-paid” and “pay-if-paid” clauses are a feature of construction law that is hugely debated, in many jurisdictions. The first such provision, a “pay-when-paid” clause, means what it says. In a typical example, if a head contractor inserts such a clause into a subcontract then that head contractor will be under no obligation to pay the subcontractor until the owner or developer pays it, although it is usually assumed that payment will be made at some point. The second provision, a “pay-if-paid” clause, takes this one step further and requires the head contractor to pay the subcontractor only if the owner or developer pays it, so that if the head contractor is never paid the subcontractor will not be either.

\(^{59}\) Working Group Report, supra note 39 at 3.
There is a substantial body of commentary that argues that pay-when-paid and pay-if-paid clauses unfairly prejudice subcontractors.\textsuperscript{60} Typically the clauses are imposed at the second and subsequent tiers of a construction project and are used to spread the risk of non-payment by the owner, developer or any other party down through the contractual chains. Clearly a head contractor will seek to avoid any obligation to make progress payments in the event that it is not paid. Parties contracted by the head contractor can then insert the same provisions into subsequent contracts to ensure that they avoid, or at least share, that risk as well. However, difficulties arise for subcontractors at the bottom of the construction pyramid because pay-when-paid and pay-if-paid clauses can rarely be imposed against material suppliers and workers. Material suppliers are frequently medium-sized or large companies and presumably therefore have adequate degrees of bargaining power to ensure that they need not tolerate any allocation of risk. Similarly, workers will be protected by employment legislation, making it “not commercially feasible” to impose such risk on them either.\textsuperscript{61}

The question as to whether such clauses should be permitted or abolished typifies debates that exist in construction law between those who advocate “fair” or “equitable” government intervention, and others who favour “economically efficient” solutions. At present New Zealand appears set to adopt the former “equitable” line, with the \textit{Construction Contracts Bill} being set to abolish such clauses. \textit{Protecting Construction Contractors}\textsuperscript{62} presents an interesting illustration of the debate because in preparing it the

\textsuperscript{60} For some examples, see \textit{Protecting Construction Contractors}, \textit{supra} note 14 at 2, 5-8, \textit{Western Australia Report}, \textit{supra} note 18 at 19 and D. Glaholt & M. Rotterdam, “Getting Paid: Holdbacks and Other Selected Topics”, online: Glaholt & Associates Homepage <http://www.glaholt.com/getting_paid.htm> (date accessed: 7 May 2001) [hereinafter “Getting Paid Article”].

\textsuperscript{61} Explanatory note to the \textit{Construction Contracts Bill}, \textit{supra} note 55.

\textsuperscript{62} \textit{Protecting Construction Contractors}, \textit{supra} note 14.
New Zealand Law Commission consulted with both the Subcontractors’ Federation and the Master Builders Federation. Not surprisingly, the former organisation supported prohibition of pay-when-paid and pay-if-paid clauses, while the latter opposed it. Furthermore, the Federations’ arguments for and against prohibition typify comments that have been made elsewhere around the world.

The Subcontractors’ Federation argued that pay-when-paid and pay-if-paid clauses cause the risk of non-payment anywhere in a contractual pyramid to shift to those parties at the bottom, and that the transfer of such risk is unfair and unconscionable. In this Federation’s opinion a subcontractor should not be required to factor into its decisions risks to the solvency of both an owner and a head contractor. In addition, a subcontractor will never be in the best position to assess risks to the owner’s solvency. Firstly, he or she will often know little about the owner, or about contractual arrangements between the owner and the contractor. Secondly, he or she will have no ability to obtain security from, or to enforce proceedings against, that owner. The Federation contended that such clauses arise not because they are freely agreed upon, but because of “the present economic climate where there is intense competition for subcontractors’ work”.

These arguments correspond with comments made in other jurisdictions. Duncan Glaholt, a construction lawyer from Ontario, describes arguments that such clauses arise from free bargaining between the parties as non sequitur, because the parties rarely have equal bargaining power. Similarly, the United States commentator D.W. Gregory attributes

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63 Ibid. at 7.
64 Ibid. at 8.
65 Getting Paid Article, supra note 60.
such clauses to prime or head contractors “shirking risk”:66

Subcontractors are prepared to bear the risk of non-payment from contractors. All subs seek is that contractors do the same with respect to owners. Subs seek an equitable distribution of risk. Only then will the industry achieve the goals of “partnering” advocated by those who are tired of one-sided contracts, claims, disputes and litigation.

However, other commentary argues that rather than being the “source of all evil in the industry”, pay-when-paid and pay-if-paid clauses are an essential means of spreading risk that is inherent to construction, at least in a small industry like New Zealand’s.67 According to one New Zealand economist, proposals to outlaw such clauses in the Construction Contracts Bill display “simply a lack of understanding of how markets work and further, a blatant disregard of the economic consequences for this industry”.68 Similarly, the views of the Master Builders Federation in Protecting Construction Contractors also illustrate an attempt to justify pay-when-paid and pay-if-paid clauses. Of the three grounds on which this Federation attempted to justify such clauses it firstly submitted that there is nothing unconscionable about an agreement under which a head contractor and a subcontractor share the risk of an owner’s failure. Secondly, it saw such clauses as reflecting financial reality, because if a head contractor is not paid then they will be no funds to pay others. And thirdly, it saw a head contractor as being in no better position than a subcontractor to assess the owner’s solvency.69

In Hansard debate Stephen Franks, Act New Zealand’s spokesperson for the Construction

66 D.W. Gregory, “Pay-When-Paid is Main Issue” (1 July 1996) 237(1) E.N.R. 57.
68 Ibid.
69 Protecting Construction Contractors, supra note 14 at 7.
Contracts Bill, also identified potential problems with wholesale repeal of these clauses.\textsuperscript{70}

“Pay when paid” clauses mean that head contractors cannot lay off risk. It sounds fine until we realise that the risk has to go somewhere—there is no grandfather or Father Christmas who takes it. Someone has to carry it and that someone probably needs more capital. This will lead to a concentration of the industry in the hands of those who have capital, in the hands of overseas companies that will run the major contracts, in the hands of those who are close to and who can easily satisfy the requirements of the performance bond writers, and this will mean that there will be fewer employers competing and fewer employers to whom subcontracts can go when contracts are being let. It may be that is a price worth paying. We have yet to be persuaded on that, but it may be so.

He also identified that parties may get around prohibition, and referred to instances in New South Wales where “pay-when-certified” clauses have allegedly taken over from “pay-when-paid” clauses.\textsuperscript{71}

In the United States, courts have often ruled on issues relating to pay-when-paid and pay-if-paid clauses. In many places this has resulted in the creation of a “reasonable time” doctrine that applies to pay-when-paid clauses, so that such clauses are not seen as true conditions precedent, but instead as clauses that postpone payment for a “reasonable time”.\textsuperscript{72} Some legislatures, such as those in North Carolina and Wisconsin, have prohibited pay-if-paid clauses.\textsuperscript{73} In other states including New York and California the


\textsuperscript{71} Ibid.

\textsuperscript{72} Thos. J. Dyer Co. v. Bishop International Engineering Co., [1962] CA6-QL 105, 303 F.2d 655 is one application of the “reasonable time” doctrine. See H. Murphy, “‘Pay When Paid’ Clauses in Construction Subcontracts: Conditions Precedent or Terms of Payment?” (1992) 47 C.L.R. 288 (Getting Paid Article, supra note 60).

\textsuperscript{73} See E.S. Holbrook Jr., “Eliminate Pay-If-Paid Clauses” (2 March 1998) 240(9) E.N.R. 57.
courts have fulfilled this role, although their willingness to do so has been criticized.

The New Zealand Subcontractors' Federation is therefore not alone in its calls for prohibition of pay-when-paid and pay-if-paid clauses. Most noticeably, the New South Wales and United Kingdom statutes on which the Construction Contracts Bill is modelled prohibit such clauses and the New Zealand Bill contains similar provisions in clause 11. However, while it is submitted that such clauses should be abolished the question remains whether such prohibition will manage to solve all problems, without creating more.

One measure advocated by commentators in the United States as a solution for problems arising from prohibition is the bond. Both the concept of the bond, and some of the different forms that it can take, are described in Chapter II, Section 5.1. The bond’s major benefits arise from both its flexibility, and its ability to fill in legislative gaps as demands in the market arise. Therefore at least in theory, surety companies could provide something like a “guarantee of payment” bond that would protect a contractor with obligations to pay a subcontractor from non-payment by the owner. Questions about who would create, provide and pay for such a bond would need to be resolved in much more detail before parties could begin to rely on such an idea. However, as Chapter II Section 5.1 will indicate, it appears that surety companies are enthusiastic about playing a greater role in the Australasian markets provided that they receive the necessary government support to do so. As will be seen to be the case with many aspects of the Construction Contracts Bill, continuous efforts need to be put into examining what effects the abolition

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75 See S.J. Densmore, supra note 74.

76 Ibid.

77 See Chapter II, Section 5.1 and the comments made by Danny Patten referred to therein.
of pay-when-paid and pay-if-paid clauses has on the New Zealand construction industry, and if the need arises, further reforms may need to be carried out.

6 New Zealand’s Situation

Up until 1987 New Zealand contractors and subcontractors were afforded lien protection by Part II of the Wages Protection and Contractors’ Liens Act 1939. However, after a long history of dissatisfaction within the industry, and numerous unsuccessful attempts at reform, this legislation was repealed in December 1987. It appears that most owners, contractors, subcontractors and lawyers working in the New Zealand construction industry during the 1980s would have agreed that there were problems with the Wages Protection and Contractors’ Liens Act. However, it seems unlikely that they would have agreed that things would be better off if the Act were repealed and no special protection enacted in its place.

After the 1987 repeal the New Zealand construction industry continued to evolve in substantially the same manner that industries in Canada, Australia, the United States and the United Kingdom did. However unlike their counterparts in those other countries, during this time New Zealand contractors and subcontractors worked without special legislative protection and were forced to reply on general contractual and fair trading remedies for financial protection. Finally, in the late 1990s the New Zealand Law Commission turned its attention to the consequences of the 1987 repeal, firstly in a general insolvency law report, and subsequently in a report dealing with this specific problem.78

The main recommendation made by the second, more specific Law Commission report entitled Protecting Construction Contractors was that New Zealand should enact new legislation to protect construction contractors and subcontractors. However, the Commission

did not recommend re-enactment of the builder’s lien, and instead favoured a new adjudication system recently adopted in New South Wales, Australia. The Commission’s proposal was to adapt the New South Wales Building and Construction Industry Security of Payment Act 1999\(^7\) to New Zealand conditions and, where appropriate, to incorporate aspects of the United Kingdom Housing Grants, Construction and Regeneration Act 1996\(^8\). Both the National Party, New Zealand’s parliamentary opposition after November 1999, and the media quickly seized upon this idea as being a potential solution to all of New Zealand’s construction problems.

Since publication of Protecting Construction Contractors the government has been subjected to substantial pressure to enact legislation giving effect to the recommendations. Now a bill has been drafted and is being considered by the Finance and Expenditure Select Committee. In preparing this bill drafters were able to consider the New South Wales and United Kingdom acts but notably the limited time available precluded them from reviewing the North American situation in any detail, or carrying out any significant economic analysis of the reforms’ likely consequences.

7 An Outline of This Thesis

This thesis submits that New Zealand’s construction law reform process has not been thorough enough to produce legislation that will provide a comprehensive solution for construction contractors. The 1987 repeal of Part II of the Wages Protection and Contractors’ Liens Act 1939 left construction contractors with none of the special protective

\(^7\) Building and Construction Industry Security of Payment Act 1999 (NSW) [hereinafter the “NSW Security of Payment Act”].

\(^8\) Housing Grants, Construction and Regeneration Act 1996 (U.K.) c.53 [hereinafter the “UK Housing Grants Act”].
devices that apply in other countries. Whether as a direct result of this repeal or not, since 1987 there appear to have been increasing numbers of construction company insolvencies in New Zealand. Many of these insolvencies have received significant media attention, and in turn, this has put pressure on politicians to find a solution to the problems as quickly as possible. Research relating to potential solutions has therefore been hurried, focusing primarily only on New South Wales and United Kingdom protections, and arguably researchers have carried out consultations with interested parties with only these systems in mind. Meanwhile, little or no research has been carried out in relation to North American construction contractor protections, and nor has thought been put into the broader implications that New Zealand protections will, and should, have.

This chapter has already described aspects of the construction industry that make the protection of construction contractors a unique issue. The industry's failure to provide such parties with adequate real or personal remedies means that governments often introduce special legislative protections. However, the form that these protections take varies from one country to another, and some of these different forms are discussed in Chapters II and III.

Chapter II examines protections that are commonly used across Canada and the United States. These protections are based around the builder's lien, the holdback and the statutory trust. They attempt both to provide construction contractors with a powerful real remedy, and to balance such contractors' rights with those of owners and other parties. By way of example, Chapter II examines the British Columbia system in some detail and looks at that province's newly enacted Builders Lien Act. 81

Chapter III reviews the New South Wales and United Kingdom adjudication systems, which use alternative dispute resolution in order to decrease the time it takes to have a dispute

81 Builders Lien Act, S.B.C. 1997, c.45 [hereinafter "Builders Lien Act"].
heard. Chapter III also examines other associated research topics and reforms that New South Wales has been working on, and notes that New Zealand has carried out no such associated research and reform. In New South Wales legislative and policy changes that are likely to result from this associated work have the potential to improve the whole of the construction industry. They also aim to balance the rights of parties following enactment of the adjudication system. Obviously, if such measures are not carried out in New Zealand, no such improvements will be able to be made and no such balancing can to occur.

Chapter IV then examines the New Zealand situation in more detail. Firstly, it sets out the history of New Zealand’s previous contractor protections and their 1987 repeal. Subsequently, it tracks the progress to date of proposed reforms and analyses those reforms in terms of their likely legal and economic efficacy. The chapter notes that there are currently significant problems with the *Construction Contracts Bill*, relating to both major and minor issues. Select Committee proceedings and subsequent parliamentary debate are likely to resolve the minor problems. However, more major issues relating both to questions of how widely the legislation should apply, and to questions about security over land, are likely to be far more difficult to resolve.

Finally, Chapter V contains an analysis of the Canadian, New South Wales and proposed New Zealand systems in an effort to isolate the efficacy and the efficiencies of each system. The chapter outlines a law and economics model that describes seven assumptions about the *perfect contract*, and then applies that model to construction. It notes that the *perfect contract* model prefers the New South Wales method of protecting construction contractors, with the Canadian system and proposed New Zealand reforms receiving much favourable scores. However, it also notes that the model appears to fail to give proper consideration to the *transaction costs* of those methods, which means that that the New Zealand reforms may
not score as well as they should. Chapter VI then provides conclusions both about the systems, and about the efforts that New Zealand should continue to make prior to enacting the \textit{Construction Contracts Bill} as law.

Protecting construction contractors is an urgent issue in New Zealand, which appears to require immediate attention. However, it also an important enough issue to warrant reforms that will be truly effective. New Zealand’s current reform proposals have considered only certain aspects of certain systems, and have not considered the broader economic effects that proposed legislation might have. This thesis submits that legislators and those working for them have two options. Firstly, they could carry out more research and consultation before they enact the \textit{Construction Contracts Bill} as law. Alternatively, they should prepare themselves to monitor the law after the bill has been enacted, so that further changes can be implemented as and when they become necessary.
II THE CANADIAN SYSTEM

1 Builders’ Liens Across North America

Both the United States and Canada protect construction contractors by using what are variously termed “builder’s”, “construction” or “mechanic’s” liens. Each American state and Canadian province has created such a lien by enacting a particular statute, often containing additional devices considered necessary, either initially or after subsequent law reform. In America the different states vary widely in the level of protection and the types of additional devices that they provide. However, in Canada there are commonly only two additional devices, known as the “holdback” and the “construction trust”. British Columbia provides a fairly typical example of Canadian law, and one that is useful to examine because it was reformed relatively recently.

1.1 In America

The first builder’s lien statute was enacted in Maryland in 1791, following the end of the American Revolution. Prior to that time most Marylanders had been opposed to the British colonial policy and the state had aided the War of Independence by sending soldiers and supplies. Then after the war, Maryland continued to support the independence movement by contributing land, materials and trades-people to enable reconstruction of Washington, D.C. as the new national capital. However, these trades-people who went to Washington were unwilling to provide their services without some

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means of securing their wages. Accordingly, the Maryland legislature arranged for enactment of the United States' first builder's lien act on December 18, 1791, enabling construction land to be liened by any workers who were not paid. The concept appears to have been borrowed from civil law provisions for workmen's liens against land that were already common in Louisiana, Québec and those European countries having civil codes with Roman law origins.

Over time all of the other American states moved to enact builder's lien acts. This trend commenced in Pennsylvania in 1803 and spread throughout the country, so that by 1909 every state had a statute "creating and enforcing liens of this character". However, although the states' various statutes all had the same origins, the builder's lien laws are today "notorious for the extent to which they vary from each other in their application and operation".

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84 Arthur Close, Q.C., is the Executive Director of the British Columbia Law Institute. Mr Close agreed to participate in an interview about the British Columbia construction industry, and that interview took place on 6 October 2000. References in this thesis to Mr Close's comments come from that interview [hereinafter the "Interview with Arthur Close"]. For more information about the British Columbia Law Institute see its website: <http://www.lawreform.gov.bc.ca/> (dates accessed: 2000 – 2001).


87 Laws Penn., Act April 1, 1803. See Rockel, supra note 85 at 2-3.

88 Rockel, supra note 85 at 2.

89 American Jurisprudence, supra note 86 at 92. See the cases mentioned therein at note 51, and the following comment: "The Uniform Construction Lien Act recognizes that the mechanic's lien laws in the fifty states are extraordinarily varied in approach, substance, and language to the issues involved, and that variation, in fact,
The first feature that distinguishes the various American builder’s liens is that some states confer the lien by both constitution and statute, whereas others base it only on statute. Where the former applies and the equitable interest underlying the lien is constitutional, this interest cannot be lost by something such as a mere failure to commence proceedings within the specified timeframes. However where the latter applies, things like timeframes will be crucial and will mandate the existence or termination of the lien.\textsuperscript{90}

Another feature distinguishing the different United States liens examines whether they derive from the “New York system”, or the “Pennsylvania system”. Under the former only a head contractor can have an absolute lien, and a subcontractor cannot ever recover more than is due from the owner to that head contractor. However under the latter “Pennsylvania system” subcontractors and material suppliers may have direct liens, and the original contract between the owner and the head contractor will be no defence to a subcontractor’s claim.\textsuperscript{91}

These features are but two examples of the ways in which the various American builder’s liens differ. When one adds to this the frequent amendments and considerable changes that have been made to each of the various statutes over time, and the general liberalization of the whole procedure that has occurred,\textsuperscript{92} it becomes clear that builder’s lien law in the United States follows many divergent paths. Each of these paths uses construction trusts and bonds to varying extents and in differing ways,\textsuperscript{93} and each models among the states may be greater than in any other statutory area” (Prefatory Note, \textit{Uniform Construction Lien Act}).

\textsuperscript{90}\textit{American Jurisprudence, supra} note 86 at 89-90.

\textsuperscript{91}\textit{American Jurisprudence, supra} note 86 at 93-94.

\textsuperscript{92}\textit{American Jurisprudence, supra} note 86 at 96-97.

\textsuperscript{93}\textit{American Jurisprudence, supra} note 86 at 98; \textit{Construction Trusts, supra} note 82 at 12.
their reforms on those systems that are seen as most favourable. Meanwhile efforts made in 1989 to bring the states together through the *Uniform Construction Lien Act* have been largely unsuccessful, with few states adopting its provisions and the law seems set to continue to diverge. At least one author has commented that Canadian law in this area now bears more resemblance to that in Australia, than in the United States so that any further examination of the American systems runs the risk of becoming nothing more than an academic exercise for Canada’s, or New Zealand’s, purposes.

1.2 In Canada

The first Canadian builder’s lien statutes were enacted in Ontario and Manitoba in 1873.97

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94 For example, Wisconsin has recently been involved in the preparation of various builder’s lien reforms. It appears to have chosen to follow the general approach adopted in Michigan on the basis that this system is “an appealing model for a revised Wisconsin lien law”, but also to consider some of the features of the New Jersey laws (see Wisbar Construction and Public Contract Law Section, State Bar of Wisconsin, *Discussion Points for Lien Law Revisions*, online: Wisbar Homepage <http://www.wisbar.org/sections/construction/lienpts.html> (date accessed: 1 May 2001); Wisbar Construction and Public Contract Law Section, State Bar of Wisconsin, *Status Report: Lien Law Revision Committee January 1997*, online: Wisbar Homepage <http://www.wisbar.org/sections/construction/lienstat.html> (date accessed: 1 May 2001)) [hereinafter “Wisbar Status Report”].

95 For example, in the reforms mentioned in note 94 above, Wisconsin chose not to adopt the Uniform Act on the basis that: “[a]lthough promulgated in 1989, the Uniform Act has not been adopted in any jurisdiction. Its mechanisms for prioritizing claims among contractors, material suppliers, various classes of lenders and other encumbrancers or successor in title are complex and controversial. Most states, including Wisconsin, historically have taken simpler and less convoluted approaches” (*Wisbar Status Report, supra* note 94).

96 *Construction Trusts, supra* note 82 at 12. Although of course now that Australian states such as New South Wales are moving away from the builder’s lien and towards fast track adjudication this may not be the case for much longer, if at all.

These were modelled on United States’ legislation, and allowed “every mechanic, machinist, builder, contractor” (and in Ontario “miner”), as well as “any other person doing work upon, or furnishing materials to be used in construction” “a lien or charge for the price or value of such work…and the land occupied thereby”, provided that such person performed the work “at the instance or request of the owner” and so under a direct contract with the owner. The remaining common law provinces followed suit in enacting such legislation and for example, acts were passed in British Columbia in 1879, Alberta in 1906, Saskatchewan in 1907, Nova Scotia in 1879, New Brunswick in 1894, Newfoundland and Labrador in 1890, and the Northwest Territories in 1884.

Like their American equivalents, the Canadian builder’s lien statutes have been reviewed and reformed numerous times since 1873. However unlike their United States

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98 Although it is uncertain which state’s laws were used as a model. For example, an early Canadian leading writer in this area, W.B. Wallace, was only able to tell his readers that: “Ontario doubtless adopted the system of mechanics’ liens from the statutes prevailing in many of the states of the neighbouring Republic” (W.B. Wallace, Mechanics’ Lien Laws in Canada, (Toronto: Canada Law Book Company, 1905) [hereinafter “Wallace 1st ed”] at 2).

99 Although note that there was “a perilous perplexity and haziness about the scope of the word “owner”” (W.B. Wallace, Mechanics’ Lien Laws in Canada, 2nd ed. (Toronto: Canada Law Book Company, 1913) at 5).

100 Liens Act, S.B.C. 1879, c.24 [hereinafter “Liens Act”].


102 The Mechanics’ Liens Act, S.S. 1907, c.21. Although note that in actual fact the presence of lien legislation in both Alberta and Saskatchewan pre-dates their existence as provinces because they were previously part of the Northwest Territories at the time that The Mechanics’ Lien Ordinance was in effect (Construction Trusts, supra note 82 at 36).

103 The Mechanics’ Liens Act, S.N.S. 1879, c.31.

104 The Mechanics’ Liens Act, S.N.B. 1894, c.23.

105 The Mechanics’ Liens’ Act, S.N. 1890, c.18.

equivalents, the Canadian statutes' reforms have remained relatively coordinated so that
“[w]hile their provisions vary somewhat from province to province, the general scope and
effect of all the Acts are similar”.\footnote{Macklem & Bristow 5th ed, supra note 97 at 1.}

Possibly for reasons associated with changes in industry practice such as increases in the
size and complexity of projects, many of the Canadian builder’s lien reviews and reforms
that have occurred took place during the 1980s and 1990s.\footnote{See, for example, Newfoundland Report, supra note 19 at 1-2; and Northwest Territories Committee on Law Reform, Mechanics’ Lien Law in the Northwest Territories (Yellowknife: Northwest Territories Committee on Law Reform, 1988) [hereinafter “Northwest Territories Report”] at 6.} In addition to the
coordination in their approaches, these various law reform commission reports are
noteworthy for their unanimous affirmation of the builder’s lien. According to the
Newfoundland Law Reform Commission: “[t]he weight of Canadian authority is
overwhelmingly in favour of the retention of builders’ lien (mechanics’ lien)
legislation”;\footnote{Newfoundland Report, supra note 19 at 5.} while the Northwest Territories Law Reform Committee reported that:
“builders’ liens have become an integral factor in the provision of credit within the
industry”.\footnote{Northwest Territories Report, supra note 108 at 6. This report was referred to in the Newfoundland Report, supra note 19.} It appears that Canadian law reform commissions have generally only ever
been instructed to consider reforms that might be made to the applicable lien systems,
rather than to review the suitability of the system as a whole. Consequently, despite the
number of commission reports that discuss the lien system and possible reforms, there
have been few if any fundamental reconsiderations of the whole system.

Because these law reform commission reports have consistently discussed and supported
retention of the builder’s lien, they have had to create and devise both amendments to the
lien and supplementary devices to remedy perceived problems. The amendments to the lien have normally aimed to balance the rights of those within the industry, so as to remove the potential for injustices. Meanwhile, the supplementary devices have centred on the mandatory holdback and the statutory construction trust, precedents for which have been found in the Ontario legislation.

Whilst the largest quantity of both construction and consequently construction litigation arises in Ontario, British Columbia also provides a useful model for consideration because its legislation was reformed as recently as 1997. British Columbia law therefore provides some of the most up-to-date provisions with respect to the builder’s lien, as well the more modern mandatory holdback and statutory construction trust. This thesis will consider these three concepts in more detail, in the context of the 1997 Builders Lien Act.

2 The British Columbia 1997 Builders Lien Act

Following its enactment in 1879, the Liens Act\textsuperscript{111} continued in force in British Columbia in much the same form for the next 110 years. However, in 1997 after a lengthy period of review the then current act was repealed and replaced with the Builders Lien Act. This new act has two main purposes; firstly, to provide security and ensure prompt payment to creditors within the construction industry, and secondly, to ensure that money intended to finance a particular construction project stays within that project.\textsuperscript{112} Like most Canadian builders’ lien legislation, the Builders Lien Act is structured around the lien, the holdback and the construction trust.

\textsuperscript{111} Liens Act, supra note 100.

The *Builders Lien Act* regulates the rights and behaviour of certain players within a construction project, the most important of whom are described below. Each player’s relationships with another player will depend on whether the player is “engaged by” (employed/contracted by) the other player, “engaged under” (employed/contracted under the same contractual chain) the other player, or simply involved in the same construction project. It is also important to note that the act focuses on the concept of the “improvement”, a term that is broadly defined to include a range of alterations to land, and not just conventional buildings or structures.\(^{113}\)

### 2.1 Owners

The “owner” of a construction project is often the developer and the “prime mover in the project”.\(^{114}\) The definition of owner has been very widely drafted so that where work is done (or materials are supplied) in relation to an improvement, anyone who:

- has an interest in the land; and

- requested the work (and for these purposes the mere fact that someone knew of the action is enough to show they “requested” it); and

- either supplied credit, or had work done on their behalf, or who had direct knowledge of the work, or who directly benefited from the work,

\(^{113}\) Under section 1(1) of the *Builders Lien Act* “improvement” includes “anything made, constructed, erected, built, altered, repaired or added to, in, on or under land, and attached to it or intended to become a part of it, and also includes any clearing, excavating, digging, drilling, tunnelling, filling, grading or ditching of, in, on or under land”. See British Columbia Law Institute, *Questions and Answers on the New Builders Lien Act* (Vancouver: British Columbia Law Institute, 1997) [hereinafter “Questions and Answers”], at 12. Note that the remainder of section 1(1) and other relevant sections of the *Builders Lien Act* are included as the Appendix.\(^{114}\) *Ibid.* at 8.
will be an owner.\textsuperscript{115} By way of example, this means that a tenant who has ordered improvements to premises might be an “owner” because he or she has an interest in the land. It also means that a landlord might be an “owner” for the same improvements even if he or she did not request the work, but because he or she knew about it.\textsuperscript{116}

One exception to the broad scope of this definition is that despite having an interest in the land, the lender or “mortgagee” will almost always be excluded from the definition of “owner”.\textsuperscript{117} A mortgagee may elect to become an “owner” by retaining a holdback, or in certain circumstances may be held to have participated in the development to such an extent that it has become an “owner”. However, mortgagees will usually make strenuous efforts to avoid this happening to escape the liability that comes with this “ownership”.\textsuperscript{118}

2.2 Head Contractors

The “head contractor” is a contractor engaged to do substantially all the work relating to an improvement.\textsuperscript{119} The question of whether or not there is a head contractor is relevant

\textsuperscript{115} Section 1(1) 	extit{Builders Lien Act}.

\textsuperscript{116} Although, the law in British Columbia has been amended to remove some of the confusion in relation to the issue of the landlords as “owner”. The 	extit{Builders Lien Act} attempts to resolve this issue by providing a simplified procedure enabling landlords to protect their properties from liens arising out of unauthorized work ordered by tenants. Section 3(1) states that if an improvement is done with the prior knowledge of an owner it will be deemed to have been done at that owner’s request. However, section 3(2) enables an owner to file a “notice of interest” in the land title office, following which section 3(1) will no longer apply. Section 1(1) defines “notice of interest” to mean “a notice in the prescribed form warning other persons that the owner’s interest in the land described in the notice is not bound by a lien claimed under this Act in respect of an improvement on the land unless that improvement is undertaken at the express request of the owner” (see Introducing BC’s Builders Lien Act, supra note 112 at 17).

\textsuperscript{117} Section 1(1) 	extit{Builders Lien Act}.


\textsuperscript{119} Section 1(1) 	extit{Builders Lien Act, Questions and Answers}, supra note 113 at 7.
because it affects the way in which certain time periods under the act run. For instance, if there is a head contractor and no certificate of completion is issued then both holdback and lien claim timeframes will be measured from the time that the head contract is “completed, terminated or abandoned”. Alternatively, if there is no head contractor and no certificate of completion then timeframes will be measured from the time that the improvement is “completed, terminated or abandoned”. This is a new definition created by the new Builders Lien Act and for all other purposes there is no reason to distinguish a head contractor from an ordinary contractor.

2.3 Contractors, Subcontractors and Material Suppliers

A “contractor” is a person engaged directly by the owner to provide work and/or supply material in relation to an improvement. Similarly, a “subcontractor” is a person engaged by a contractor or other subcontractor to perform work and/or supply material in relation to an improvement. Finally, a “material supplier” falls within a subcategory of contractors and subcontractors because he, she or it is a person who supplies only material in relation to an improvement. “Material” is defined to mean “moveable property that is delivered to the land... and is intended to become part of the improvement... or is consumed or used in the making of the improvement...”.

Under the previous British Columbia act questions also used to arise as to whether a

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120 Sections 8(2), 20(2) Builders Lien Act.
121 Ibid.
122 Section 1(1) Builders Lien Act.
123 Ibid.
124 Ibid.
125 Ibid. See D.A. Coulson, Guide to Builders’ Liens in British Columbia, looseleaf (Vancouver: Thomson Canada Limited, 1994) [hereinafter “Guide to Builders’ Liens”], at 7 for a more detailed discussion of the previous and current definitions of “material man” and “material supplier”.
person was a "contractor" or what was previously termed a "material man", and one could not be both. This distinction would affect certain time frames under the act, as well as whether or not the person was a trustee under the trust provisions. Now the distinction is less important, particularly because material suppliers have been included within the definitions of "contractor" and "subcontractor". The distinction will only be relevant in relation to the trust provisions and in relation to whether a holdback is required or not. The policy of the act is that a material supplier should be at "the bottom of the chain", so that no holdback will be retained from him or her, and no person contracted or employed by him or her will receive the protection of the act.

2.4 Architects and Engineers

The act does not define the terms "architect" and "engineer" but such parties are nonetheless significant for two reasons. Firstly, these parties will usually act as the "payment certifier", providing the "certificate of completion" to show that work under a contract is complete. When the certificate of completion has been issued the (45 and 55 day) time periods under which lien claims must be made, and the holdback funds

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126 BC Builders Liens Practice Manual, supra note 118 at 2-35 – 2-36.

127 Section 10(4) Builders Lien Act provides that sections 10(1) and 10(2) creating the statutory trust do not apply to money received by an architect, engineer or material supplier.

128 Section 4(6) Builders Lien Act provides that no holdback shall be retained from a worker, material supplier, architect or engineer.

129 Questions and Answers, supra note 113 at 9. So, any person who employs a material supplier must retain a 10% holdback, and the material supplier will also be permitted to make lien claims and/or receive the benefits of the statutory trust provisions. However, where a material supplier employs or contracts another person (so that that party’s contract is one step further down the chain) no holdback need be retained, and that employee/contractor will not be permitted to make lien claims or receive the benefits of the trust provisions. The same will apply to a “worker”, and the employee of a “worker”.

130 Section 7 Builders Lien Act.

131 Section 1(1) Builders Lien Act.
must be retained,\textsuperscript{132} will commence. Secondly, the parties who work for, or are contracted by, an architect or engineer have been excluded from the definition of “subcontractor”. This means that while an architect or engineer may receive the protection of the act provided that certain requirements are met,\textsuperscript{133} any person whom that architect or engineer contracts or employs will not.\textsuperscript{134}

The architect or engineer’s role as “payment certifier” is a new feature of the Builders Lien Act.\textsuperscript{132} See below, Chapter II, Sections 3.2 and 3.3.

\begin{itemize}
\item\textsuperscript{133} Firstly, the architect or engineer must fit within the definition of “contractor”, “subcontractor” or “worker”.
\item\textsuperscript{134} Secondly, the architect or engineer must perform or provide “work”, as that term is defined. Thirdly, the “work” must be done in relation to an improvement. Under the previous act the most contentious aspect of these requirements was the second, namely that the architect or engineer had to perform or provide “work”. This issue arose because an architect or engineer would frequently not provide any actual on-site services while section 2, which granted lien rights, referred to doing “work on...to or for an improvement”.
\end{itemize}

Despite the possibility that section 2 could be interpreted to mean that an architect or engineer’s work would not qualify as “work”, British Columbia case law had tended towards the conclusion that it would, as had case law in Alberta (see \textit{Kettle Valley Contractors Ltd. v. Cariboo Paving Ltd.} (1986), 1 B.C.L.R. (2d) 236, 26 D.L.R. (4th) 422 (C.A.), \textit{Inglewood Plumbing & Gasfitting Ltd. v. Northgate Development Ltd. (No. 1)} (1965), 54 D.L.R. (2d) 509, 54 W.W.R. 225 (Alta. S.C.T.D.) and \textit{Peter Hemingway Architect Ltd. v. Abacus Cities Ltd.} (1980), 113 D.L.R. (3d) 705, 6 W.W.R. 348 (Alta. C.A.). D. Brindle states that it has yet to be decided whether the same will apply under the Builders Lien Act (see \textit{BC Builders Liens Practice Manual}, supra note 118 at 2-28) but D. Coulson asserts that this new act in fact makes it clearer that it will (see \textit{Guide to Builders’ Liens}, supra note 125 at 24-26). He submits that the change in wording of section 2 from “on an improvement” to “in relation to an improvement” makes this clear. The decision of \textit{Harmony Co-ordination Services Ltd. v. 542479 B.C. Ltd.} (1999), 45 C.L.R. (2d) 15, 64 B.C.L.R. (3d) 376 (B.C.S.C.) [cited to C.L.R.] at 21 supports his view:

\begin{quote}
The Act now entitles a contractor and sub-contractor to a lien for work “in relation to an improvement” which includes preparatory work performed off-site, provided that work forms a necessary and integral part of the actual physical construction of the improvement... There is no longer any requirement that architectural or engineering services be performed on-site in some supervisory role over the construction of the improvement, or that they directly contribute to the actual physical construction of the improvement.
\end{quote}

These changes in the legislation have clearly been an attempt to make the law more clear and to avoid arbitrary decisions. Although these are desirable motivations there is arguably still a danger that the legislation will be stretched to cover greater and greater amounts and types of work that in the end will have little or nothing to do with actual construction, and actual construction land.

\begin{itemize}
\item\textsuperscript{134} See the definitions of “subcontractor” and “worker” in section 1(1) \textit{Builders Lien Act}, as well as section 4(6). See also \textit{Questions and Answers}, supra note 113 at 8.
\end{itemize}
Lien Act,\textsuperscript{135} and represents a substantial increase in the potential liability of such parties. The act impresses a payment certifier with a duty to determine whether a contract or subcontract is “completed”,\textsuperscript{136} and creates a statutory cause of action against any payment certifier who fails to comply with that duty.\textsuperscript{137} The introduction of this role is likely to have certain consequences: “[t]here is no doubt that the practical and legal responsibilities of the consultants \textit{qua} payment certifier are enlarged under the \textit{Builders Lien Act}. Statutory liability now exists vis-à-vis parties to whom the consultant traditionally owed no contractual or other legal duties. This exposure, which is statutory in nature, cannot be limited by the traditional contractual vehicle”.\textsuperscript{138} At this stage it appears that architects and engineers do not yet fully understand all of the consequences of being a payment certifier. Abigail Fulton, vice president and legal counsel of the British Columbia Construction Association,\textsuperscript{139} has reported that such people frequently contact the Association seeking clarification about the new \textit{Builders Lien Act} and advice about their obligations under it.

\textsuperscript{135} See section 7(1) \textit{Builders Lien Act}.

\textsuperscript{136} As that term is defined in section 1(1) of the act. “Completed” does not mean absolutely complete, it means “substantially completed or performed, not necessarily totally completed or performed” and can be measured with reference to certain financial criteria set out in section 1(2).

\textsuperscript{137} See sections 7(8) and 7(9) \textit{Builders Lien Act}; and \textit{BC Builders Liens Practice Manual, supra} note 118 at 2-35, 5-4 – 5-5.

\textsuperscript{138} \textit{BC Builders Liens Practice Manual, supra} note 118 at 2-35.

\textsuperscript{139} The British Columbia Contractors Association represents construction contractors, many of whom are general contractors and some of whom are trades-people. Ms Fulton agreed to participate in an interview about the British Columbia construction industry, and that interview took place on 10 July 2001. References in this thesis to Ms Fulton’s comments come from that interview [hereinafter the “Interview with Abigail Fulton”]. For more information about the British Columbia Contractors Association see its website: <http://www.bccassn.com/> (date accessed: 1 August 2001).
2.5 Workers

A “worker” is an individual engaged by a contractor or subcontractor for wages.\textsuperscript{140} As with material suppliers, the policy of the act is that such a person should be at “the bottom of the chain” so that no holdback is retained from him or her, and no protection is afforded to anyone whom he or she employs or contracts. It should also be noted that workers receive special priority when funds are realized and distributed.\textsuperscript{141}

3 Builder’s Liens and Holdbacks in British Columbia

3.1 Introduction to the Lien

The common law lien has been defined as: “a right in one man to retain that which is in his possession belonging to another, till certain demands of him, the person in possession, are satisfied”.\textsuperscript{142} However, the builder’s lien is not a common law lien and is instead created by statute. Therefore, although it bears similarities to the common law (equitable) lien in that it enables one person certain power over another’s property,\textsuperscript{143} the scope of any particular builder’s lien will always depend on the statutory provisions that are in place and it will never entitle the holder to possession. In British Columbia a lien arises whenever a contractor, subcontractor or worker “performs or provides work, supplies materials, or does some combination of the two” on or at “an improvement”.\textsuperscript{144}

When a British Columbia contractor, subcontractor or worker fulfills the requirements by

\textsuperscript{140} \textit{Section 1(1) Builders Lien Act.}

\textsuperscript{141} \textit{Questions and Answers, supra note 113 at 10.}

\textsuperscript{142} \textit{Hammonds v. Barclay,} [1802] 2 East, 227, 235 quoted in \textit{Wallace 1\textsuperscript{st} ed, supra note 98 at 1.}

\textsuperscript{143} For a description of the nature of the equitable lien see \textit{Re Bernstein,} [1925] Ch. 12 at 18 and \textit{Canadian Encyclopedic Digest, CD-ROM: Chapter IV (Scarborough, Ontario: Carswell, 1995-)} “Equitable Liens”, section 81.

\textsuperscript{144} \textit{Section 2(1) Builders Lien Act.}
performing or providing work, or supplying materials, a lien will arise automatically and the party becomes a “lien holder”. However, the lien will not be of any actual effect until the lien holder activates or “preserves” it, thus becoming a “lien claimant”. A lien holder will do this if he or she has not been paid or has reason to believe he or she will not be paid. Because a claim must set out all sums that are in dispute\(^\text{145}\) it cannot be made in advance as a precautionary measure, although it will sometimes be made before final completion of the project or even the contract, on the basis that a progress payment, or payments, has not been made.

Making a lien claim is a relatively straightforward procedure. It is done by completing a standard form, paying $5.00, and filing the form at the land title office.\(^\text{146}\) However, a claimant needs to take care because a form that is erroneously completed may be nullified, depending on the nature and extent of the error and the surrounding circumstances.\(^\text{147}\) The form must contain the correct details of the parties and of the land\(^\text{148}\) and may only be in respect of amounts that have not been paid. The lien confers a right \textit{in rem} and not \textit{in personam}\(^\text{149}\) so that personal amounts owed, such as damages or interest, may not be

\(^\text{145}\) Guide to Builders’ Liens, supra note 125 at 28.5-28.6.


\(^\text{147}\) Ibid. Questions and Answers, supra note 113 at 37. Section 19 Builders Lien Act also imposes liability on any person who wrongfully files a lien, for the costs and damage incurred by the owner, and section 45 makes it an offence to knowingly file a lien that contains a false statement. However, because claimants file liens only to the best of their knowledge and ability, simple errors may arise and may be legitimately corrected without their claim being nullified or an offence committed.

\(^\text{148}\) See Chapter II, Section 3.2 below for the problems that can arise in identifying land that is subject to a lien, and in remedying defects in lien claims.

\(^\text{149}\) BC Builders Liens Practice Manual, supra note 118 at 3-3.
The Builders Lien Act contains strict timeframes that dictate the way in which lien claims must be made. If a certificate of completion has been issued, either for the whole project or for the particular contract or subcontract in question, then any lien must be filed no later than 45 days after the date of that issue. If no certificate of completion has been, or will be, issued then the lien must be filed no later than 45 days after the head contract (or the improvement if there is no head contractor and no head contract) has been either completed or abandoned. Once a claim has been made so that the lien is “preserved” the claimant then has one year in which to enforce the lien through a court action. If in that time the owner, or any other party, wishes to remove the lien, the act provides a procedure to enable this to be done. “Clearing” the lien in this way will usually require the party clearing to pay out the amount allegedly owing under the lien claim, or to post alternative security until the court action is heard.

3.2 Some of the Problems With the Lien

The central problem with the builders’ lien stems from the fact that it is slow and unwieldy. In an industry that depends on speedy payments in order for parties to remain solvent, the delays that arise in the lien procedure are argued by some to have the potential

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151 And presumably could be filed even before that issue provided that all preconditions were met (see section 20(1) Builders Lien Act).

152 See Chapter II, Section 2.2 above

153 Section 14 Builders Lien Act.

154 Introducing BC’s Builders Lien Act, supra note 112 at 10.
to bring down whole construction projects.\textsuperscript{155} Added to this is the fact that virtually every person in a construction project has something to lose from a lien claim. If a lien claim is made at any point in the contractual chain of a construction project, every holdback retained by or above the person against whom the claim is made will be "frozen".\textsuperscript{156} Until the issues surrounding the lien claim are resolved and the lien is removed from the title, none of these holdbacks may be paid out. This means that none of the contracts above that involving the lien claim can be completed until the claim is settled. Only those at the very bottom from whom no holdback is retained – i.e. the workers and the material suppliers – avoid the risk that their contract will be frozen by a lien claim relating to a different contract.

Canadian commentary has discussed problems with the lien procedure at length. In particular, in Ontario it has been noted that it can be very difficult to remedy minor defects in lien claims,\textsuperscript{157} to increase lien claims\textsuperscript{158} and to preserve liens after the cut-off dates.\textsuperscript{159}

\textsuperscript{155} Interview with Arthur Close, supra note 84. Mr Close also referred to delays that might arise from malicious or negligent lien claims. Although such lien claims would cause the normal delays that arise from any claim, if they were brought before the court and could be shown to be "frivolous or vexatious" they could be cancelled by virtue of being an abuse of process (section 25(2)(b) Builders Lien Act) (see Guide to Builders' Liens, supra note 125 at 28.7).

\textsuperscript{156} Section 8(4) Builders Lien Act (see BC Builders Liens Practice Manual, supra note 118, at 7-18 – 7-19).


For example, in *Venditti v. Petriglia*\(^{160}\) the respondent attached an affidavit that was intended to include the lien claim in question. However, because the affidavit was incomplete and because the relevant statutory provision permitting certain minor irregularities did not mention the number of the section that imposed the requirement for the affidavit, the lien could not be cured. Then in *Sefri Construction International Ltd. v. Jaltas Inc.*\(^{161}\) Master Sichy considered himself bound by the *Venditti* decision and consequently discharged a lien simply because the commissioner of oaths had, out of pure inadvertence, not signed the last of five copies of the affidavit of verification.\(^{162}\)

There have also been complaints about the uncertainty surrounding what kinds of land can be liened,\(^{163}\) who has lien rights,\(^{164}\) who is an “owner” for the purposes of the legislation,\(^{165}\) and how the lien interrelates with labour law and labour unions.\(^{166}\) For example, when the Toronto Skydome was constructed various disputes arose, including one relating to whether various lots surrounding the land on which the construction took place fell within the definition of “premises” so that they could be liened. In a 1992

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\(^{162}\) See Five Important Issues, *supra* note 157.


\(^{164}\) M.J. Kovach, “Marginal Liens” in Insight Educational Services, *Construction Liens in the 90s* (Toronto: Insight Press, 1992) [hereinafter “Kovach Marginal Liens Article”].


seminar Lori Roth, a Toronto lawyer, expressed the view that lots used for parking for parties other than patrons of the Skydome, landscaped lots to be used by the public and lots used as both railway rights of way and public streets were all non-lienable. However, such matters are likely to often remain contentious and parties will not be able to predict case outcomes with any certainty.\textsuperscript{167} At the same seminar M. Janine Kovach discussed various cases that considered whether lawyers, snow removers, commercial cleaners, parties carrying out site analysis and project marketing, surveyors, engineers, painters and parties renting out and repairing equipment could be lien claimants. She pointed out that some of the distinctions made in cases ruling on the status of such parties appeared to be arbitrary, leaving her with the view that there were many instances of what she termed to be “marginal liens”.\textsuperscript{168}

In British Columbia the \textit{Builders Lien Act} has resolved some of these problems, although questions as to form and procedure still arise. In one of these attempts British Columbia has tried to remove uncertainties that have resulted in Ontario cases relating to whether or not a landlord is an “owner” for the purposes of the act. The \textit{Builders Lien Act} provides a simplified procedure to enable landlords to protect their properties from liens arising out of unauthorized work ordered by the tenant.\textsuperscript{169} Similarly, there has also been uncertainty in Ontario as to the types of amounts that a debtor may set off within a construction project in the event that such amounts will reduce available trust funds\textsuperscript{170} but the \textit{Builders Lien Act} again attempts to resolve this problem. It does this by requiring that moneys paid

\textsuperscript{167}L.A. Roth, \textit{supra} note 163 at 13-31.

\textsuperscript{168}Kovach Marginal Liens Article, \textit{supra} note 164 at 18-19.

\textsuperscript{169}See Chapter II, Section 2.1 note 116 above, section 3 \textit{Builders Lien Act}, and \textit{Introducing BC's Builders Lien Act}, \textit{supra} note 112 at 3-10.

\textsuperscript{170}I. Bristow, Q.C., \textit{supra} note 165 at 1.10–1.15.
into the trust in respect of certain improvements must be used to against the debts of those improvements.  

However, despite British Columbia's efforts, certain problems with the lien still exist. For example, because the lien is of a slow and difficult nature, delays often occur in the provision of finance from the central lender to a construction project. Section 32(2) of the Builders Lien Act provides that any funds that a mortgagee provides after a lien claim has been registered will lose priority to that lien. This means that a mortgagee must search the title every time a payment is to be made to ensure that it is clear. If it appears that a lien claim has been registered, then the payment will not be provided until that lien has been removed. Since payments from the central lender are usually used to finance all other contracts within a construction project, it has been suggested that this "freezing" of payments could threaten to bankrupt the entire project.

3.3 Introduction to the Holdback

In general terms a holdback is a sum of money that one contractual party owes to another, but that is retained for a certain, specified period of time. Sometimes a holdback will be retained because the parties agree that it is appropriate but in the context of (British Columbia) construction projects, a holdback is retained because the Builders Lien Act requires it. This statutory holdback aims to serve two purposes; firstly, it provides a source of funds to enable unpaid lien claimants to be paid, and secondly, it defines the maximum liability of the person retaining the holdback in the event that a lien claim arises.

In 1956 British Columbia introduced the holdback into builders' lien legislation for the

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171 Section 12 Builders Lien Act.
172 Interview with Arthur Close, supra note 84.
first time. The main requirement of this “single holdback scheme” was that the owner under a construction project retained a certain percentage of money that would otherwise be paid to the head contractor. In the event that the head contractor failed to pay any parties lower in the contractual chain, the holdback was used to clear those debts. The scheme also provided that if the owner complied with the holdback requirements, that owner could not be held liable for any further amounts.173

Because the single holdback scheme limited the maximum liability of the owner, it had the (unforeseen) consequence of passing the risk for all outstanding debts down the chain, to the head contractor.174 To illustrate, the owner would only ever be liable for a specified percentage amount of any debt, but the head contractor might have paid out all required sums to those immediately below him or her in the chain, without those sums necessarily being fed down. Subcontractors at the bottom of the chain might then file a lien claim, which the owner would not have to pay out because of his or her limited liability. However, if the owner had inserted a clause into the head contract passing on liability to remove liens to the head contractor, then there would be a contractual obligation imposed on the head contractor to pay the subcontractor the outstanding amount. The head contractor would then be left to claim his or her losses from the defaulting party further down the contractual chain, regardless of how difficult that might be.

To counter the effect of this burden on the head contractor it became common for such parties to retain informal holdbacks from contractors, and consequently for contractors to retain further holdbacks from subcontractors. These informal holdbacks served one purpose in that they provided a source of funds for unpaid debts. However, they did not

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provide a complete solution because there was still no limit on the maximum liability of each party, particularly that of the head contractor. These problems were highlighted by the controversial decision of Denston v. Delta School District, following which general contractors lobbied hard to have the law amended.

One of the most important aspects of the 1997 Builders Lien Act was the enactment of the "multiple holdback scheme", which aimed to remove those problems created by the single holdback. Under this new scheme all persons who make a payment under a contract or subcontract are now required to retain a holdback of 10% of the total value of the contract, although only the owner need actually retain the funds in a separate bank

175 Questions and Answers, supra note 113 at 20-21.
176 Denston Co. v. Delta School District 37 (1958), 13 D.L.R. (2d) 494, 27 W.W.R. 141 (B.C.C.A.). In this case the British Columbia Court of Appeal refused to recognise any holdback other than that between the owner and the general contractor. This left general contractors in a disproportionately risky position as compared with others in the construction industry, and with general contractors in the other provinces (see BC Builders Liens Practice Manual, supra note 118 at 7-3 – 7-6).
177 BC Builders Liens Practice Manual, supra note 118 at 7-5.
178 The holdback must be of an amount equal to 10% of the greater of the value of the work or services actually provided, and the amount of any payments made (section 4 Builders Lien Act). The owner is required to retain his, her or its holdback from the head contractor in a separate bank account (section 5 Builders Lien Act). However, there is no requirement for other parties to hold separate accounts for holdbacks because in reality actual funds will not usually be held, and the holdback will be only a debt due (Questions and Answers, supra note 113 at 21). Furthermore, except for the owner's holdback, the 10% will not be impressed with the statutory trust that is described in the following Chapter II, Section 3.4. Amongst other things, this means that if the party required to retain the holdback enters into bankruptcy or insolvency, the holdback will be of little use because it merely becomes part of the general fund available for all creditors, and will not be reserved for the party that it was intended to benefit.

The fact that the holdback can be merely notional and may therefore be of little utility in the event of insolvency appears to have the potential to defeat the first stated purpose of the holdback – to provide a source of funds to enable unpaid creditors to be paid. However, given that the British Columbia Law Institute recognised that the holdback could be notional at the time that the act came into force, it appears that this was intentional. There is no express statutory recognition of this nationality, but it is noted in several commentaries including Questions and Answers, supra note 113 at 21. Commentators make it clear that the main function of the holdback is to
account. Each of the holdbacks is supposed to serve as a source of funds for eligible creditors if a contractor or subcontractor does not pay its debts, although because the moneys are often not actually “held” it can be difficult to access them. More importantly, they also serve to limit the maximum liability of those retaining them to that 10% sum. Without this limitation an owner, contractor or subcontractor might pay out all amounts due and owning, but those amounts might not be fed through the contractual chains. Then if a lien claim were filed, whichever party with the contractual obligation to remove such lien claims would have to pay out the remaining debts, despite the fact that this would require that party to “pay twice”.

Although the holdback provisions do (in theory at least) provide a source of funds for lien claims, it is the latter limited liability that is their main function. In order to obtain this limited liability, employers must ensure that any amounts from the remaining 90% of the contract price are advanced in good faith, and not after any lien claims have been filed. Then, when the requisite 45-day time period after the issue of the certificate of completion create a limitation of liability for owners, contractors and subcontractors in the event that lien claims arise and not to provide a tangible source of funds for lien claimants (see BC Builders Lien Practice Manual, supra note 118 at 7-2). Provided an owner, head contractor, contractor or subcontractor holds back the specified 10% of the contract price, he or she will not be liable for any amount over and above that 10%. Thus, even if a party lower in the chain has siphoned off money and not paid his or her debtors, the original party from whom the debt may now be claimed will not have to pay any more than the 10% holdback. In the case of parties other than the owner, this amount may not actually be physically held, but can be deducted from amounts that would otherwise be due to the defaulting debtor.

179 See section 5 Builders Lien Act.

180 The purchaser of a residential home is also entitled to retain a 10% holdback from the vendor to settle any liens that arise after settlement (Introducing BC’s Builders Lien Act, supra note 112 at 16).

elapses and provided that no lien claims have been lodged, the act allows the holdbacks to be released (after further 10 days, so after a total of 55 days\textsuperscript{182}).

### 3.4 Some Problems With the Holdback

There are two basic problems with the Canadian holdback provisions, the first being that they slow down the flow of payment within a construction project. As soon as any lien claim is preserved, this will prevent relevant holdbacks from being paid out\textsuperscript{183} so that all parties involved in a construction project, except for those at the very bottom from whom no holdback is retained, will have 10\% of their payments withheld until all relevant lien claims are lifted. This means that almost every contractor and subcontractor has something to lose from the holdback system.\textsuperscript{184} Thus, while the holdback limits parties’ liability and therefore provides a useful balance to subcontractors’ otherwise very powerful lien rights, it can be slow and somewhat cumbersome.

The second problem with the provisions is that over time they have become complicated and difficult. Glaholt and Rotterdam comment that: “[I]ike many fine ideas, the simple idea of holdback has lost its innocence and has evolved into something quite complex and unaccountably difficult in practice”.\textsuperscript{185} Often parties, and particularly subtrades, are misled about the actual function of the holdback, and have more faith in the fact that there will be funds available.\textsuperscript{186} Glaholt and Rotterdam refer to an Alberta task force that was established to review that province’s legislation having recommended elimination of the

\textsuperscript{182} Section 8 \textit{Builders Lien Act}.

\textsuperscript{183} Section 8(4) \textit{Builders Lien Act} provides that a holdback may only be paid out when all liens relating to the contract in question have been discharged.

\textsuperscript{184} Interview with Arthur Close, \textit{supra} note 84.

\textsuperscript{185} \textit{Getting Paid Article}, \textit{supra} note 60.

\textsuperscript{186} \textit{BC Builders Liens Practice Manual}, \textit{supra} note 118 at 7-2.
holdback. Apparently, the task force saw the holdback as providing little more than an interest free loan to those higher up in the construction pyramid.\footnote{Getting Paid Article, supra note 60. The authors of this article, Glaholt and Rotterdam, report that the Ontario Attorney General's Advisory Committee has also identified this problem.} It also appears that this was the same report put out by the Alberta Construction Association in the late 1990s, which Professor D. Percy, Q.C. from the University of Alberta reports as having initially recommended abolition\footnote{Email from Professor D. Percy, Q.C., received on 28 September 2001.} but which changed its mind after having met with substantial opposition from the subcontractors' lobby groups. Eventually, these recommendations resulted in the percentage of holdbacks being reduced from 15% to 10%.\footnote{Ibid.} It seems unlikely that this reduction will be able to resolve all the problems and complications relating to the holdback in Alberta.

4 Construction Trusts in British Columbia

4.1 Introduction to the Trust

The construction trust is the third supplementary device used in the Canadian builder's, construction and mechanic's lien acts. This trust aims to ensure that funds intended for a particular construction project remain within that project and more particularly, that they are directed to those who have earned them. The use of trusts in the construction context is not a new thing, but it is something that has received greater attention in recent times. It is thought by some that this attention has arisen at least in part because the lien provisions have become unduly complicated, and therefore inadequate as a complete remedy.\footnote{Construction Trusts, supra note 82 at 1. Likewise, the holdback does not provide complete solution to the problem. As has been discussed (see above note 178), the main purpose of the holdback is to limit the}
contrast the trust is seen (at least by some) as an all-encompassing and procedurally simple remedy.

Although the provisions creating it are contained within the various builder’s lien statutes, the trust actually arises independently of both the lien and the holdback.\textsuperscript{191} This means that trust rights may be asserted even if lien claims have not been made, if the requisite timeframes have expired, or if the claims have been invalidated. Also, unlike the lien, the trust confers rights \textit{in personam} that may be asserted against the trustees’ personal assets,\textsuperscript{192} and it has no connection with the construction land or buildings.\textsuperscript{193} The main provisions governing the trust can be found in each provincial statute, although the general law relating to trusts will also apply to the extent that it is not inconsistent with those statutes.\textsuperscript{194}

In British Columbia the main construction trust provisions are contained in sections 10 to 14 of the \textit{Builders Lien Act}. Under section 10(1) any money received by a contractor or subcontractor\textsuperscript{195} on account of the contract or subcontract price constitutes a trust fund.\textsuperscript{196}

\begin{footnotes}

\footnotetext[192]{\textit{Guide to Builders’ Liens}, supra note 125 at 129.}


\footnotetext[194]{\textit{BC Builders Liens Practice Manual}, supra note 118 at 8-3.}

\footnotetext[195]{But not an architect, engineer or material supplier. Section 10(4) provides that money received by these parties is not to be subject to the trust. As is explained in Chapter II, Section 2.4 above, the policy behind the act is that those employed or contracted by these three parties are not to receive the protection of the act.}

\footnotetext[196]{While moneys must be “received” before they will be impressed with the trust, they do not need to be actually \textit{physically} received by the contractor or subcontractor. For example, in \textit{Modular Products Ltd. v.}\

\textit{...}}
The contractor or subcontractor will be a trustee for that trust fund, and those who have contracted directly with the trustee will be the beneficiaries. The characteristics and responsibilities associated with the trust are set out in the act and are described in Chapter II, Section 4.2.2 below, and the general law relating to trusts also applies. If the trustee acts in contravention of the trust he or she will be liable for severe penalties both pursuant to civil claims and under the act, provided that any action under the Builders Lien Act is commenced prior to the expiry of the three-year limitation period.

4.2 Some Problems With the Trust

Despite certain people's view of the construction trust as being simple and efficient, it appears to have given rise to problems. As use of the trust has increased, so have the number of disputes, to the point where construction trust litigation has reportedly become

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*Aristocratic Plywoods Ltd. (1973), [1974] 2 W.W.R. 90, 42 D.L.R. (3d) 617 (B.C.C.A.)* a contractor paid money into court pursuant to a demand by Revenue Canada for excise and income taxes and this was sufficient to impress it with a trust in favour of subcontractors. In fact, section 13(5) *Builders Lien Act* expressly provides that if money is paid into court under an attachment under the *Court Order Enforcement Act*, R.S.B.C. 1996, c.78 then it will be subject to a trust as if it had been paid to the contractor or subcontractor, and the interest of the garnishor will be subordinate to the interest of the trust beneficiaries.

Similarly, in *Wall Brothers Construction Co. v. Canson Enterprises Ltd. (1986)*, 70 B.C.L.R. 243, 17 C.L.R. 157 (C.A.) [cited to B.C.L.R.] the court held that moneys paid on account of a contract will be deemed to have been "received" by the contractor even if they were actually paid into that account by someone other than the contractor. It does not appear that the actual payee need be an agent of the trustee, and nor will that payee become subject to the trust: "[I]f payment is made on account of the contract, the courts will hold that the payment was received by the contractor, when actually the payment was received by someone other than the contractor, if it was received for application to his account" (at 259).

197 Liability for breach for trust incurs penalties of up to $10,000, imprisonment for up to two years, or both. If the trustee is a corporation, any directors or officers who participated in the breach will also be guilty (see section 11 *Builders Lien Act* and *Questions and Answers, supra* note 113 at 63).

198 Section 11(5) *Builders Lien Act.*
one of the most frequently litigated areas of construction law. The problems that arise
with trusts span a number of issues, including questions about the trustee's duties, the
imposition of personal liability, the status of the trust upon bankruptcy and the particular
problems that banks face. Arguably, there are enough of these problems to question
whether the growing popularity is justified.

4.2.1 Privity of Trust
One important requirement of the British Columbia construction trust is that there be
"privity of trust". This requirement means that only those persons who have contracted
directly with the trustee will be beneficiaries, while those lower in the pyramid will
receive no trust protection. It also means that the trust differs in this respect from the
holdback, which provides security for all persons in a particular contractual chain, no
matter where they are situated in the pyramid. It is something that applies in other
Canadian provinces including Saskatchewan, Manitoba and Ontario, but not in

199 D. Glaholt, "Recent Developments in the Law of Trusts" online: Glaholt & Associates Homepage
<http://www.glaholt.com/Recent_Trust.htm> (date accessed: 7 May 2001) [hereinafter "Recent Developments
Article"].

sub-contractor was held not to be a trust beneficiary (see Construction Trusts, supra note 82 at 149).

201 Questions and Answers, supra note 113 at 59; section 10(1) Builders Lien Act.

202 Questions and Answers, supra note 113 at 59.

8 (Q.B.) where MacLeod J. concluded that the Builders' Lien Act (S.S. 1984-85-86, c. B-7.1) did require privity
(Construction Trusts, supra note 82 at 148).

supra note 97 at 371). Note however, that the Manitoba Builders' Lien Act does require the trustee to see that
provision is made for the payment of other affected beneficiaries of the fund (D.N. Macklem, Q.C & D.I.
Bristow, Q.C, Construction and Mechanics' Liens in Canada, 6th ed. (Toronto: The Carswell Company

205 Although the case law in Ontario has differed in the extent to which privity has been required, as noted in
Construction Trusts, supra note 82 at 147-148.
New Brunswick.\textsuperscript{206} However it is also something that can be avoided, provided that parties without privity are able to join those that do have privity in their action for breach of trust.\textsuperscript{207} For example, a subcontractor might be barred from enforcing trust provisions against the head contractor if there was another contractor between the two in the contractual chain. In those circumstances the subcontractor could not enforce a claim for breach of trust against the head contractor because the subcontractor’s contract was with the contractor. However, if the subcontractor could persuade the contractor to join him or her in the action then that contractor would have the necessary privity of contract, and consequently the necessary privity of trust, and the claim would be valid.

\textbf{4.2.2 The Trustee’s Duties}

As with any trust, the role of a British Columbia construction trustee carries with it certain duties, some of which are contained in the \textit{Builders Lien Act} and some in common law. Possibly the most important duty is that in section 10(2), which requires that a trustee not “appropriate any part of the fund for that person’s own use or to a use not authorized by the trust” before all beneficiaries have been paid. Although section 10(2) does not require that a trustee keep trust funds in a separate bank account, and section 11(7) provides that co-mingling trust funds will not of itself constitute a breach of trust,\textsuperscript{208} commentators

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{207} Construction Trusts, supra note 82 at 149. In addition, if the elements of a constructive trust can be established then the plaintiff will no longer be relying on the statutory trust and accordingly will not have to satisfy the statutory requirements as to privity (see Chapter II, Section 4.2.3 for a discussion of constructive trusts).
\item \textsuperscript{208} The exact words of section 11(7) are “[i]f a contractor or subcontractor commingles, with other money, any part of the fund referred to in section 10, that, of itself, does not constitute a breach of the trust created under section 10(1) or a contravention of section 10(2)”. See Guide to Builders’ Liens, supra note 125 at 130.
\end{itemize}
\end{footnotesize}
advise potential trustees to maintain a different account for each construction project.\textsuperscript{209}

Section 11(7) presumably attempts to clarify what is arguably an uncertain question at common law, namely whether the co-mingling of separate trust funds constitutes a breach of trust.\textsuperscript{210}

Also, given that judges hearing construction trust cases appear to impose an onus on the trustee to prove that all amounts dispensed have been properly used,\textsuperscript{211} contractors should be very careful to monitor all payments made, particularly because, at least in Ontario, this has become a heavily litigated area of the law.\textsuperscript{212} The majority of cases relate to whether the common practice of making overhead payments out of the fund constitutes a breach of trust. It appears that such payments do create a breach although such case law has done


\textsuperscript{210} In the United States it appears that the co-mingling of separate trust funds does constitute a separate trust fund: “[i]t is the duty of the trustee who holds property under separate trusts to separate the property into several trusts (W.F. Fratcher, \textit{Scott on Trusts}, 4th ed., Vol. IIA (Boston: Little Brown & Company, 1987) at 502 citing cases from Illinois, Maine, Massachusetts, New Hampshire, New Jersey, New York and Rhode Island).

E.L. Gillese states that:

\begin{quote}
It is prudent for trustees to keep trust property separate from their own – that is, to refrain from co-mingling trust assets with other assets. It is unclear whether there is a duty not to co-mingle, however. If it is a duty, failure to keep trust assets separate would be a breach of trust. However, I do not accept that co-mingling of funds is an automatic breach; rather, I am of the view that it is a highly desirable practice, but not a duty. There are some who believe that the obligation to refrain from co-mingling is a duty that flows from the duty of loyalty. However, it is my view that the case law implicitly accepts that co-mingling of trust funds takes place and that it is not an automatic breach. For example, in the recent Supreme Court of Canada case \textit{Air Canada v. M & L Travel Ltd}, the court considered the issue of co-mingling in determining whether a trust relationship or one of debtor and creditor had been established. The court found that a trust relationship had been established and that co-mingling had taken place. There is no finding that the co-mingling was a breach per se, reinforcing my view that segregation of funds is prudent but not mandatory.
\end{quote}


\textsuperscript{211} \textit{Getting Paid Article}, \textit{supra} note 60.

\textsuperscript{212} In Ontario section 8(2) of the \textit{Construction Lien Act} R.S.O. 1990, c.30 prohibits payments “to the contractors or subcontractor’s own use or to any use inconsistent with the trust”. Some argue that this allows the trustee greater scope than the wording in the previous \textit{Mechanics’ Liens Act} (R.S.O. 1980, c.261, s3(1)), which prohibited payments: “to his own use or to any use not authorized by the trust” (\textit{Construction Trusts, supra} note 82 at 178-179).
little or nothing to change industry practice and some of the courts’ findings have been
criticized.\textsuperscript{213}

Some commentators have referred to the three main cases in this area as the “overhead
trilogy”.\textsuperscript{214} They have held that payments of wages, office expenses, rent, and fees to
lawyers,\textsuperscript{215} accountants, landlords and other parties;\textsuperscript{216} and even payments of project-
specific overheads made in good faith,\textsuperscript{217} all constitute a breach of trust. One might think
that such decisions would dramatically change the way in which construction businesses
are carried out, but they have not. It still appears to be common practice for developers to
blend bank accounts across a number of projects, and for varied and numerous overheads
to be paid out of these accounts, on a regular basis.\textsuperscript{218} While from a simple trust
perspective these would appear to be relatively straightforward cases with predictable
outcomes, in construction they are significant because the outcomes negate what is
common practice in the industry very strongly.

\textsuperscript{213} Construction Trusts, \textit{supra} note 82 at 178-179.

\textsuperscript{214} See for example, D. Glaholt and M. Rotterdam “How Will \textit{Structural v. Westcola} Affect the Practice of Real
Estate Law?” online: Glaholt & Associates Homepage <http://www.glaholt.com/Westcola.htm> (date accessed:
7 May 2001) [hereinafter “\textit{Structural v. Westcola Article}”]. The trilogy is made up of \textit{Rudco Insulation Ltd. v.
While there are no clear cases from British Columbia on this point the Ontario “overhead trilogy” do appear to
apply there. In their summaries of Canadian law Macklem and Bristow cite these cases interspersed with cases
from other provinces and make no mention of there being any different law applying outside of Ontario (see
\textit{Macklem & Bristow 6\textsuperscript{th} ed, supra} note 204 at 9-41 – 9-42).

Superior Court of Justice) and \textit{Recent Developments Article, supra} note 199.

\textsuperscript{216} \textit{Rudco, supra} note 214 (see \textit{Structural v. Westcola Article, supra} note 214).

\textsuperscript{217} \textit{Dietrich Steel, supra} note 214.

\textsuperscript{218} \textit{Structural v. Westcola Article, supra} note 214.
4.2.3 Personal Liability
Clearly any statute that imposes personal liability on an individual for acts done by a company will be controversial; so that it is not surprising that builders' lien provisions doing this have been unpopular. The Builders Lien Act and other more general Canadian statutes have the potential to impose liability on individuals in three ways, all of which are often hotly contested when attempts are made to enforce them. The BC Builders Lien Act Practice Manual\(^{219}\) summarises these three ways by stating that a breach of trust may give rise to civil liability, a quasi-criminal offence or a criminal offence.

Firstly as is the case with any statutory trust, non-compliance with the provisions of section 10 of the Builders Lien Act, which establish the trust, will impose civil liability on corporate and individual trustees.\(^{220}\) Section 10 creates a distinct cause of action, which trust beneficiaries may pursue whether or not they have a valid lien claim.\(^{221}\) Secondly, section 11 of the Builders Lien Act creates the quasi-criminal offence, which a contractor or subcontractor will commit if he, she or it appropriates or converts any part of a trust fund in contravention of section 10. Currently this offence is punishable by a fine of not more than $10,000, imprisonment of not more than two years, or both.\(^{222}\) Section 11(3) provides that any director or officer of a corporate contractor or subcontractor “commits the offence in addition to the corporation” if that director or officer “knowingly assents to or acquiesces in an offence”. Finally, section 336 of the Criminal Code\(^{223}\) creates a criminal offence for breach of trust. This offence imposes liability on any individual

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\(^{219}\) Supra note 118 at 8-11.

\(^{220}\) Minneapolis-Honeywell v. Empire Brass, supra note 191.


\(^{222}\) Section 11(2) Builders Lien Act.

trustee who converts trust property, provided that subjective intent to defraud can be proven. It is punishable by imprisonment for a term not exceeding fourteen years.

The different ways in which liability can be imposed require lesser degrees of knowledge and intent as the seriousness of the liability diminishes. For example, to be guilty of a criminal offence under the Criminal Code, an individual must be proven to have had subjective intent to defraud, while to be guilty of a quasi-criminal offence under section 11 an individual need only be proven to have “knowingly assented to or acquiesced in” the offence. Section 11(3) is said to codify common law cases that impose liability on individuals for corporate breaches of trust, although this is not the same as vicarious liability. Quasi-criminal and criminal offences therefore require a quite substantial degree of actual advertence to the offence and will not be imposed lightly, but of course the more serious criminal offence will require proof of a greater degree of intent.

By contrast, civil liability can arise completely unbeknownst to an individual. It can also be imposed on the basis of a “constructive trust” even if that individual is a “stranger to a trust”, provided that certain requirements are met. This last fact introduces a whole area of complicated and still developing trust law into the construction area. A brief summary of the law is given below, along with a discussion of some relevant Canadian cases. However, it should be noted that the cases are examples only, and it is beyond the scope of this thesis to consider this area of trust law in any substantial detail.

The “constructive” liability of a stranger to a trust will arise either by way of “knowing assistance” or “knowing receipt”; the former dealing with the situation where a “stranger” merely assists a fraudulent or dishonest trustee, and the latter with the situation where the

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stranger actually receives trust property. “Knowing assistance” occurs where the stranger assists the trustee and in doing so, acts with actual knowledge - that is, in a way that is either reckless or wilfully blind.\footnote{Air Canada v. M & L Travel, [1993] 3 S.C.R. 787, 108 D.L.R. (4th) 592 [hereinafter “Air Canada v. M & L Travel” cited to S.C.R.].} By contrast, “knowing receipt” involves a lesser standard of knowledge so that constructive knowledge of the fraud or dishonesty will be sufficient.\footnote{In Air Canada v. M & L Travel (ibid. at 812), constructive knowledge was defined as being: “knowledge of circumstances which would indicate the facts to an honest person, or knowledge of facts which would put an honest person on inquiry”. Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805, 152 D.L.R. (4th) 411 was an important case regarding “knowing receipt”. The Supreme Court decided that constructive knowledge would be sufficient to impose liability for such receipt. The law is set out in more detail in E.E. Gillese, supra note 210.\footnote{ Supra note 226.} This means that any individual who merely aids a trustee while turning a blind eye to the fact that the property in question is somehow connected with a construction project, or who receives property in circumstances where he or she ought to have made inquiries, may be held liable for breach of the trust.

\textit{Air Canada v. M & L Travel}\footnote{Supra note 226.} provides one illustration of a case in which “knowing assistance” was proven. Here, the individual directors of a travel agency had set up a trust account for moneys held on behalf of Air Canada. However, when the directors knowingly failed to use this account and instead placed funds in their general account, the funds were subjected to seizure by their bank and this prejudiced the rights of Air Canada. The directors were also found to have deliberately stopped payment to Air Canada to protect their own interests; actions that eventually also precipitated seizure by the bank. The Supreme Court held firstly, that the travel agency had committed a breach of trust and secondly, that the directors had had sufficient actual knowledge of this breach in order for them to be personally liable.
Then, in *E.B. Horsman v. Hong Kong Bank of Canada*\(^\text{229}\) a lesser degree of knowledge was required to impose liability for what was effectively "knowing receipt" on a bank. Here contractors paid sums of money into the respondent bank, including one $5,000 deposit, which the bank received at a time when it that the contractor in question had gone out of business and had a number of outstanding liabilities. When the bank used this amount to reduce an outstanding loan a breach of trust arose because the circumstances were such to put the bank on inquiry and the bank had not made those necessary inquiries. Similarly, in *Perlmutter Shore Ltd. v. Bank of Montreal*\(^\text{230}\) the court held that in the circumstances of this particular case Bank of Montreal knew or ought to have known that the contracting company in question was in serious financial difficulty when it transferred a $50,000 deposit into a separate loan account:\(^\text{231}\)

Furthermore, the bank knew that it was taking that money away from unpaid and unsecured suppliers and trades and putting it into the pockets of the guarantors, and that the company would have to cease doing business immediately or even go bankrupt. Even if the bank did not know that the company was on the verge of bankruptcy, the facts and circumstances of which it did have knowledge placed the bank under a duty to inquire before simply appropriating the trust money. The bank failed utterly to discharge this duty.

These and many other cases from various Canadian provinces make it clear that both corporations and individuals that are connected in any way to a construction trust (no matter how remotely) need to take special caution to protect themselves from liability. Courts may impose liability for breach of trust on parties to a construction project for any serious criminal or quasi-criminal offence. However, they may also impose liability on individuals through the statutory quasi-criminal offence provisions, and through civil

\(^{229}\) (1993), 80 B.C.L.R. (2d) 12, 28 B.C.A.C. 308 (C.A.).


\(^{231}\) Case summary of *Perlmutter Shore Ltd. v. Bank of Montreal*, online: QL (QC).
liability on any corporations or individuals associated with the trust, even if their connection with the project is seemingly remote.

4.2.4 Bankruptcy
One of the main benefits that is perceived to flow from the Builders Lien Act and other provinces’ construction trust provisions is that the trust remains in place even if the trustee becomes bankrupt.\textsuperscript{232} Normally upon bankruptcy the creditors of a contractor or subcontractor would rank alongside all other unsecured creditors, with little chance of being paid. However, the construction trust provisions are designed to fit within section 67 of the federal Bankruptcy and Insolvency Act,\textsuperscript{233} which provides that property that is subject to a trust is exempt from bankruptcy proceedings. However, the question still remains whether a construction trust actually qualifies as a trust for the purposes of section 67.

Prior to 1989 it was thought that moneys held in trust under any Canadian builder’s, construction or mechanic’s lien act would not be available to creditors upon the bankruptcy of the trustee.\textsuperscript{234} However, British Columbia v. Henfrey Samson Belair\textsuperscript{235} brought this issue into serious doubt in the context of trust funds that are created when social service tax is collected from the public, and then held (in trust) for payment to the government.

Section 67(1)(a) of the Bankruptcy and Insolvency Act provides that “the property of a bankrupt divisible amongst his creditors shall not comprise property held by the bankrupt...
in trust for any other person”. In *British Columbia v. Henfrey* the province submitted that it was to be given priority to amounts of social service tax collected by the bankrupt because of section 18(1) of the provincial *Social Service Tax Act*. That section provided that: “[w]here a person collects an amount of tax under this Act he shall be deemed to hold it in trust for Her Majesty in right of the province”.

Unfortunately for the province, the majority of the Supreme Court of Canada did not accept this submission. Instead, the Court held that where provincial legislation deems funds to be held on trust this does not mean that the trust automatically fits within section 67(1)(a) of the *Bankruptcy and Insolvency Act*. In order for a trust to qualify under section 67, it must be a “true” trust, and must satisfy the common law trust requirements. In the social service tax context a major hurdle with these common law requirements appears to arise in satisfying the “certainty of subject matter” requirement, because businesses collecting this tax are so likely to commingle it with other money. As has been seen, such co-mingling also occurs frequently in the construction context.

At least in Saskatchewan, *British Columbia v. Henfrey* now appears to apply well outside of the social services tax context, and into construction trusts and other areas of the law. For example, in *Duraco Window Industries (Sask.) Ltd. v. Factory Window & Door Ltd. (Trustee of)* the Saskatchewan Queen’s Bench held that construction proceeds

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236 *Social Service Tax Act*, R.S.B.C. 1979, c. 388, s. 18.

237 Note 210 above discusses the question of whether co-mingling of trust funds is of itself a breach of trust. Despite the fact that it is in the United States, it appears from *Air Canada v. M & L Travel (supra note 226)* that the same does not apply in Canada. Therefore, while businesses collecting social services tax (and construction companies receiving progress payments) are strongly advised not to commingle such trust funds with other funds, this will probably not, of itself, constitute a breach of that trust.

commingled with other moneys in a single bank account were not “identified” as being held in trust so that the trust was not effective against the trustee in bankruptcy.\textsuperscript{239} Similarly, in \textit{Roscoe Enterprises Ltd. v. Wasscon Construction Inc.}\textsuperscript{240} the Saskatchewan Queen’s Bench held that moneys paid into court to vacate various lien claims were not part of a trust for the purposes of the \textit{Bankruptcy and Insolvency Act}. Relying on \textit{British Columbia v. Henfrey} the court held that the \textit{Bankruptcy and Insolvency Act} prevailed over the provincially created trust, and accordingly ordered that payment be made to the trustee in bankruptcy.\textsuperscript{241}

In theory it is arguable that construction cases differ from social service tax cases firstly, because construction contracts set out exactly how funds are to be allocated to the various parties so that tracing would be possible, and secondly, because at least in British Columbia the \textit{Builders Lien Act} provides that co-mingling does not of itself constitute a breach of trust.\textsuperscript{242} However, at present these arguments seem set to remain theoretical because cases such as \textit{Duraco Window Industries v. Factory Window & Door}\textsuperscript{243} and \textit{Roscoe Enterprises v. Wasscon Construction}\textsuperscript{244} show that the courts are prepared to apply \textit{British Columbia v. Henfrey} principles to construction trusts. This means that while a

\textsuperscript{239} \textit{Guide to Builders’ Liens}, supra note 125 at 141.

\textsuperscript{240} (1998), [1999] 2 W.W.R. 564, 161 D.L.R. (4\textsuperscript{th}) 725 (Sask. Q.B.) [hereinafter “Roscoe Enterprises v. Wasscon Construction”].

\textsuperscript{241} \textit{British Columbia v. Henfrey} has also been applied in other contexts. For example, in \textit{British Columbia v. National Bank of Canada} (1994), 99 B.C.L.R. (2d) 358, 119 D.L.R. (4\textsuperscript{th}) 669 (C.A.) the British Columbia Court of Appeal applied the case in the context of the \textit{Tobacco Tax Act} R.S.B.C. 1979, c.404, s.15; and in \textit{Bassano Growers Ltd. v. Diamond S. Produce Ltd. (Trustee of)} (1998), 66 Alta. L.R. (3d) 296, 216 A.R. 328 the Alberta Court of Appeal applied it in the context of the \textit{Marketing of Agricultural Products Act}, S.A. 1987, c. M-5.1, s.31.

\textsuperscript{242} Section 11(7) \textit{Builders Lien Act}. See note 210 above and accompanying text.

\textsuperscript{243} \textit{Supra} note 238.

\textsuperscript{244} \textit{Supra} note 240.
statutory construction trust may stand up against claims by provincial Crown agencies,\textsuperscript{245} in order for there to be a trust that is sufficient to invoke the protection of the \textit{Bankruptcy and Insolvency Act} funds must be clearly identifiable or traceable.

\textbf{4.2.5 Problems Faced By Banks}

Some of the problems that Canadian banks encounter with the builders' lien system are not relevant to New Zealand because they arise as a result of differences between the differing provincial statutes and practices. However other problems, such as the risk that a bank runs in being implied to be a constructive trustee, and the uncertainty surrounding a bank's right to apply trust funds to reduce debt, are relevant.

Chapter II, Section 4.2.3 above has already outlined the ways in which civil liability might be imposed upon a "constructive trustee" in the context of personal liability. However, individuals are not the only parties who face being found liable for their actions relating to either "knowing receipt" or "knowing assistance". Organisations, and particularly banks, also face the imposition of such liability and \textit{E.B. Horsman v. Hong Kong Bank of Canada} and \textit{Perlmutter Shore Ltd. v. Bank of Montreal} are but two examples of the numerous cases in the area of constructive trustees that relate to banks.

In particular, cases in this area surround questions about the liability of a lender who receives trust funds. Problems arise where a bank receives a progress payment or any other deposit from a party to a construction project and, out of concern regarding that party's level of debt, applies the payment to reduce the debt. As \textit{E.B. Horsman v. Hong Kong Bank of Canada} and \textit{Perlmutter Shore Ltd. v. Bank of Montreal} illustrate, the Canadian case law in this area is complicated. However, it appears that where the lender can meet a series of stringent requirements, it will not be held liable for breach of trust.

\textsuperscript{245} See \textit{BC Builders Liens Practice Manual}, supra note 113 at 9-36.
notwithstanding the fact that that money should have been held for those lower in the contractual chain. Therefore, the defendant bank in *John M.M. Troup Ltd. v. Royal Bank of Canada*\(^{246}\) was held not to be liable for breach of trust, notwithstanding that it applied $77,000 deposited in a construction company’s current account to the company’s overdraft. The bank had no notice, actual or constructive, of any breach of trust committed by the construction company and it received the deposit in good faith and as part of the ordinary course of business.

In British Columbia section 11(6) of the *Builders Lien Act* also attempts to simplify the law in this area by codifying the common law. Under that section the lender must receive the money in good faith, in the ordinary course of business.\(^{247}\) It is not yet known whether this provision will simplify the law in British Columbia to avoid the debates that have previously arisen. Because the section appears to merely codify case law, it appears that it will merely act to preserve the existing law, rather than improve it.

5 Other Devices

Over time, and possibly out of frustration with the problems discussed above, participants in the Canadian construction industry have begun to make use of devices other than those provided in the builder’s, construction and mechanic’s lien acts. Some of these devices, such as bonds, insurance and the *Personal Property Security Act*, operate independently of the builders’ lien legislation. However others, such as the growing use of alternative dispute resolution techniques, have been formulated to operate in conjunction with the lien statutes. Although the devices have each been designed to either plug the gaps, or resolve certain problems, they have the disadvantage of making the law more complicated and more


\(^{247}\) *Questions and Answers*, supra note 113 at 62.
5.1 Bonds and Insurance

A bond is a contract issued by a “surety” to a “principal” to ensure the performance of an “indemnitor’s” obligations. Usually in the construction industry the surety will be a bonding company, the principal an owner or contractor, and the indemnitor a contractor or subcontractor. The obligation or event to which the bond relates will also usually be one of four things; namely, the performance of tendered work following a defaulting bid (under a “bid bond”), the performance of contractual obligations (under a “performance bond”), the performance of labour or the provision of material (under a labour and material bond”), or the payment of a lien claim (under a “lien bond”). The important thing to note is that the bond is not a form of insurance - it is more a provision of credit. The surety will always expect to be reimbursed by the indemnitor and will therefore issue a bond only after carrying out detailed investigations into the indemnitor’s financial strength, and after obtaining such corporate and personal indemnities as are considered necessary.

In recent years it has become common practice for those in the Canadian construction industry to obtain, and insist on others obtaining, various types of insurance to provide for such things as damage to property, damage to or loss of contractors’ equipment, delays in opening, professional liability, as well as more general comprehensive liability


250 BC Builders Liens Practice Manual, supra note 118 at 11-3.
protection.\textsuperscript{251} It is also common for those in the industry to require the provision of one or more bonds. In particular, the Canadian Construction Document Committee Stipulated Price Contract\textsuperscript{252} provides for insurance in General Condition 11.1,\textsuperscript{253} and bonds in General Condition 11.2.\textsuperscript{254} This has resulted in the development of a body of case law surrounding these issues relating mainly to procedural problems, subrogation issues and the interpretation of exclusion clauses,\textsuperscript{255} as well as the writing and re-writing of contracts.


\textsuperscript{252} Hereinafter “Stipulated Price Contract”.

\textsuperscript{253} Under GC 11.1 the Contractor shall provide, maintain and pay for “general liability insurance”, “automobile liability insurance”, “aircraft and watercraft liability insurance”, “property and boiler and machinery insurance” and “contractors’ equipment insurance” as applicable.

\textsuperscript{254} Under GC 11.2 the Contractor to provide to the Owner “any surety bonds required by the Contract”. Furthermore, such bonds are to be “issued by a duly licensed surety company authorized to transact a business of suretyship in the province or territory of the Place of Work and shall be maintained in good standing until the fulfilment of the Contract”.

and amendments by the various parties. It is outside the scope of this thesis to consider case law relating to bonds or contractual drafting issues in any more detail but it should be noted that these matters do not appear to be unduly complicated or problematic. Bonds appear to be used increasingly, not just in their traditional market of public construction projects, but also in private construction.\textsuperscript{256} Mark Dumerton,\textsuperscript{257} who runs a large painting company in British Columbia, now estimates that he provides bonds for 35% of his jobs, and that those bonds are split 60% to 40% between public and private jobs respectively.\textsuperscript{258}

There appear to be several advantages to bonds, the first of which is that they can have lower premiums than insurance because all money that the surety spends will be recouped from the indemnitor. Danny Patten, a bond broker with Jardine Lloyd Thompson, therefore suggests that the cost of bonds will not be prohibitive, even to very small (but


\textsuperscript{256} Danny Patten works for Jardine Lloyd Thompson, one for the world's largest insurance brokers, in their Canadian construction specialty team. Mr Patten agreed to participate in an interview about the British Columbia construction industry, and that interview took place on 25 July 2001. References in this thesis to Mr Patten's comments come from that interview [hereinafter the "Interview with Danny Patten"]. For more information about Jardine Lloyd Thompson Canada see its website: <http://www.jardine.ca/index.htm> (dates accessed: May – August 2001)).

\textsuperscript{257} Mark Dumerton runs M & L Painting Ltd., one of British Columbia's largest painting companies. Mr Dumerton agreed to participate in an interview about the British Columbia construction industry, and that interview took place on 30 July 2001. References in this thesis to Mr Dumerton's comments come from that interview [hereinafter the "Interview with Mark Dumerton"].

\textsuperscript{258} Danny Patten asserts that the bid depository system that is used fairly widely in British Columbia (as well as in other provinces) also encourages the use of bonds. Under this system a contractor or subcontractor who submits a tender lodges that tender in a central depository and the party who invited the tenders collects all responses at the same time. The system is designed to prevent pre-bid shopping. It encourages bonds because often tenders above a certain value (usually $50,000) will be required to provide bonds (Interview with Danny Patten, \textit{supra} note 256).
The second advantage is that the bonding market acts as an informal screening process because a surety will only provide bonds for parties that are reputable, properly financed and technically able. Typically, sureties will examine the size, type, location, and technical and other aspects of each contract for which a bond is required, so that they become quite involved in the construction industry. Such sureties are therefore usually better in touch with both industry participants and the market than standard insurance companies are. Bonds will only be provided in circumstances where the surety can be reasonably certain that the indemnitor has the capacity to perform the contract and/or to reimburse the surety for losses suffered. However, because a surety is granted the ability step in to complete an unfinished contract, such reimbursement will generally only require the repayment of the additional costs of such “stepping in”, and not the total cost.
of the contract.\textsuperscript{265}

Finally, the third advantage is that bonds are able to fill in gaps where the law does not provide parties with adequate protection. Therefore, although the \textit{Builders Lien Act} provides protection to contractors and subcontractors in the form of the lien, the holdback and the trust, and the owner and developer in the form of the holdback's limits on liability, gaps in these protections arise from time to time. While it would be difficult to implement legislative reforms to fill these gaps each time that they arose, surety companies can create new forms of bonds to minimise different risks each time that the parties require it. Satisfaction levels with bonds therefore appear to be relatively high and surety companies are looking to expand their markets, both within North America and overseas.\textsuperscript{266}

\subsection*{5.2 The \textit{Personal Property Security Act}}

The \textit{Personal Property Security Act}, or "PPSA", governs priorities between all the different kinds of security interests that exist in personal property.\textsuperscript{267} To do this it provides for the establishment of a central computerized registry in which a secured party may register its interest to obtain priority over other unregistered, or subsequently registered, interests. Some in the construction industry believe that the PPSA has little to offer contractors, subcontractors and material suppliers by way of protection because it applies only to personal property. However, because certain construction items do retain their status as personal property, and because the PPSA makes provision for other items that become fixtures,\textsuperscript{268} the act does have some potential to provide protection to these

\textsuperscript{265} \textit{Ibid.}

\textsuperscript{266} Interview with Danny Patten, \textit{supra} note 256.

\textsuperscript{267} Personal property security acts have been enacted in all of the Canadian common law provinces and territories.

\textsuperscript{268} \textit{BC Builders Liens Practice Manual, supra} note 118 at 9-32.
D. Glaholt and M. Rotterdam are some of the proponents of contractors, subcontractors and material suppliers using the PPSA to protect their interests. They refer to the fact that:

...Suppliers and installers of stand-alone heating, ventilation and air conditioning units, component parts of manufacturing, processing or packaging equipment, items of interior decoration or recreational use such as pools, saunas or gymnasium equipment, safes or security systems, irrigation or drainage systems, portable or modular structures such as sheds, barns, garages, and even schoolrooms and trailers in some cases, as well as certain lifting, elevating and freight handling equipment contractors...

may all be better off if they take security over these items, register their interests in the personal property security registry and then use the provisions of the PPSA to enable them to repossess the items, rather than making a lien claim, relying on the holdback or otherwise taking action for the price.269

In addition, any party who supplies an item that becomes affixed to the construction land or buildings so such an extent that it becomes a fixture,270 may register a security interest in that item in the land title registry.271 Such registration will enable the supplier priority over any unregistered or subsequently registered interest in the land, and against subsequent advances made by an existing mortgagee.272 However, it is important to note

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269 Getting Paid Article, supra note 60.

270 A long history of common law helps the courts to determine whether an item has become a fixture. In Canada various tests have been devised to assist with this matter, although the law remains somewhat uncertain and at times it can be difficult to predict the outcome of a fixture case. See R.C.C. Cuming, British Columbia Personal Property Security Act Handbook, 2nd ed. (Toronto: Carswell, 1993) and Cuming’s other books on the topic.

271 In British Columbia and most other western Canadian provinces the sections allowing for such registration are sections 36 and 49.

272 See section 36 of the British Columbia Personal Property Security Act, R.S.B.C. 1996, c.359 [hereinafter the “BC PPSA”].
that security interests of this kind may not be taken in any items that fall within the
definition of “building materials”.

Therefore, while the PPSA provides what some see as a cleaner and simpler form of protection than that in the Builders Lien Act, it will only be of use in respect of items that remain personal property following their installation into a construction project, or that become affixed to the project but are not “building materials”.

5.3 Arbitration and Summary Judgment Procedures

As is the case in almost all areas of the law, rising costs and delays have increasingly led those in the Canadian construction industry to seek alternatives to litigation. Canadian construction contracts now commonly refer to the parties using mediation, negotiation and/or arbitration to resolve their disputes. These practices work within the confines of the provincial builders’ lien acts but are generally driven by judges, lawyers or those within the industry, rather than being statute based. It is submitted that they reflect a growing trend towards a use of alternative dispute resolution that is similar to that in the United States, the United Kingdom, New South Wales and New Zealand.

For example, in 1994 mediation and arbitration provisions were added to the standard

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273 “Building materials” are defined as “materials that are incorporated into a building and includes goods attached to a building so that their removal

(a) would necessarily involve the dislocation or destruction of some other part of the building and cause substantial damage to the building apart from the loss of value of the building resulting from the removal, or

(b) would result in the weakening of the structure of the building or the exposure of the building to weather damage or deterioration,

but does not include

(c) heating, air conditioning or conveyancing devices, or

(d) machinery installed in a building or on land for use in carrying on an activity inside the building or on the land” (section 1(1) BC PPSA, supra note 272).

274 Interview with Arthur Close, supra note 84.
form “Stipulated Price Contract” in an attempt to encourage the quick and inexpensive resolution of disputes.\textsuperscript{275} That Stipulated Price Contract now sets out a procedure to be followed in the event that a dispute arises over a decision made by the consultant.\textsuperscript{276} Firstly the contract contemplates a period during which notice of the dispute will be given. Following that, there will be a further period in which the parties are required to make reasonable efforts to resolve the dispute through negotiation.\textsuperscript{277} Failing resolution by negotiation, a qualified “project mediator” will be appointed to manage a mediation process in accordance with prescribed rules.\textsuperscript{278} Finally, failing resolution by mediation the parties may proceed to arbitration or, if neither party favours arbitration, to court.\textsuperscript{279} Amongst other things the rules governing arbitration expressly proscribe all timeframes, a procedure for appointment of the arbitrator, provision of the claimant’s statement and the respondent’s reply, the arbitrator’s powers, the making of the final award and payment of costs.\textsuperscript{280} The procedure bears significant similarities to that under the New South Wales Security of Payment Act, although it is more complicated, and results in a decision that is final.

There are also certain changes that have been made to the general law that encourage

\textsuperscript{275} \textit{BC Builders Liens Practice Manual, supra} note 118 at 10-60, see clause GC 8.2 Stipulated Price Contract.

\textsuperscript{276} Under the Stipulated Price Contract the consultant is usually the architect or engineer. Each contract will stipulate who the consultant is (Definitions, clause 7).

\textsuperscript{277} Clause 8.2.3, \textit{BC Builders Liens Practice Manual, supra} note 118 at 10-61.

\textsuperscript{278} A project mediator must be qualified in accordance with the Rules for Mediation and Arbitration of Construction Disputes (see clauses 8.2.1 and 8.2.4 of the Stipulated Price Contract and \textit{BC Builders Liens Practice Manual, supra} note 118 at 10-62).

\textsuperscript{279} See \textit{BC Builders Liens Practice Manual, supra} note 118 at 10-61 and clause 8.2.7 Stipulated Price Contract. One party may invoke arbitration unilaterally but if neither party supports it they will be permitted to proceed to court.

\textsuperscript{280} \textit{BC Builders Liens Practice Manual, supra} note 118 at 10-64, 10-66.
parties to a construction dispute to make use of alternative dispute resolution. One of the changes that is unique to British Columbia is the Notice to Mediate (General) Regulation\(^{281}\) that came into force under the Law and Equity Act\(^{282}\) on 15 February 2001. This Notice sets up a procedure whereby any party to a Supreme Court action to require the other parties to attend a mediation session.\(^{283}\)

Another change that applies more generally across Canada is the growing support for arbitration in the construction context. The support has appeared in Alberta in the decision of *Bird Construction Co. v. Tri City Interiors Ltd.*\(^{284}\) where the Alberta Court of Appeal was prepared to stay lien proceedings to allow arbitration to proceed, notwithstanding that the *Builders' Lien Act*\(^{285}\) provided that an agreement by any person that the remedies under that Act would not be available was "against public policy and void".\(^{286}\) This support has also appeared in Saskatchewan in the decision of *BWV Investments Ltd. v. Saskferco Products Inc.*\(^{287}\) that was similar to *Bird Construction Co.*

Finally, it is reflected in many of the provinces’ courts’ tendency to uphold contractual arbitration clauses on grounds of public policy. Previously, courts often struck down mandatory arbitration clauses on the basis that it was against public policy to deny a party

\(^{281}\) B.C. reg. 4/2001.


\(^{283}\) BC Builders Liens Practice Manual, supra note 118 at 10-33.


the right to have his or her dispute heard in court.\textsuperscript{288} However, more recently the courts have tended to recognise the public policy in requiring parties who contracted to submit to arbitration to be bound by their contract.\textsuperscript{289} There is growing support for mediation, negotiation and arbitration within the Canadian construction industry despite the fact that the builder's, construction or mechanic's lien acts have not introduced them. However unfortunately it appears that because of problems inherent in the construction industry none of these provisions and devices are being used to their full potential. In a 30 July 2001 interview Mark Dumerton, the head of a large British Columbia painting company, reported that he would like to make greater use of alternative dispute resolution but that, even where standard form contracts are in place, general contractors will frequently refuse to use such devices.\textsuperscript{290} As with so many issues relating to construction, inequality of bargaining power makes it difficult for those at the bottom of the chain to enforce their rights against those at the top. The law and the contract may provide any number of devices to enable a subcontractor to use alternative dispute resolution but if that subcontractor must sue the general contractor in order to force him or her to use the alternative dispute resolution then the devices are virtually useless.

6 The Law in Québec

As the only civil law province in Canada, Québec's laws differ substantially from those of the other provinces and territories. It is therefore interesting to examine how Québec deals


\textsuperscript{289} See \textit{Shirley Ford Sales Ltd. v. Franki Canada Ltd.} (1965), 55 W.W.R. 34 (Alta S.C.) and the other cases cited in \textit{Macklem & Bristow 6th ed, supra} note 204 at 10-41.

\textsuperscript{290} Interview with Mark Dumerton, \textit{supra} note 257.
with the protection of construction contractors to see whether the civil law has anything to offer the rest of Canada, and the rest of the world.

6.1 Prior to 1994

On January 1, 1994 the new Civil Code of Québec came into force, resulting in significant changes to construction lien rights in that province. Prior to that time participants in the Québécois construction industry were protected by a “privilege”. However in 1977 a draft Civil Code proposed that all privileges be abolished and, while such absolute abolition was never adopted, the rights provided to those in the construction industry were scaled back from being a privilege to what is known as a “legal hypothec”.

Under general principles of Québécois law the whole of a person’s property is liable for fulfilment of his or her obligations except for items that have specifically been declared exempt. Moreover, where the person’s property is insufficient to satisfy his or her debts creditors will share rateably, except where there are causes of preference between them. Under the former Civil Code these causes of preference were known as the privilege and the hypothec. The privilege conferred a right on a creditor to be preferred because of the nature of his or her claim, and was said to be an “exceptional right”, and a real right to the debtor’s property. It could arise only from the law itself. By contrast, the hypothec conferred a right on the creditor to follow or trace property and to

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292 Ibid., article 1981, Macklem & Bristow 5th ed, supra note 97 at 592.
293 Québec CC, supra note 291, article 1983. A privilege could only exist where the law conferred it and could not be conferred by a private agreement (Québec CC, supra note 291, articles. 1981, 1983).
294 Macklem & Bristow 5th ed, supra note 97 at 592.
295 Macklem & Bristow 5th ed, supra note 97 at 597.
have preference to the proceeds because of the personality of the creditor. It could, and hypothecs still can, arise either from the law, from a decision of the courts or from a contract - so that hypothecs might be “legal, “judicial”, or “conventional” (contractual). Under the former Code articles 2009 to 2015 granted the worker, the material supplier, the builder and the architect a privilege to all “immoveable” construction property. This allowed any of these parties who had registered his or her contract a right against the land and buildings, but only to the extent of any additional value given to the site by the work and materials of all of those parties. The privilege only extended to the immoveable construction property and not to the rest of the debtor’s assets. It was also given in the order of preference listed above, namely to workers first, then to materials suppliers, then builders, and finally to architects.

296 Macklem & Bristow 5th ed, supra note 97 at 592, Macklem & Bristow 6th edn, supra note 204 at 13-2, (new) Québec CC, supra note 291, article 2660.
298 The term “builder” was defined by Québec CC, supra note 291, article 2013a to include “both contractor and subcontractor”, Macklem & Bristow 5th ed, supra note 97 at 606.
299 The term “architect” included only those architects who complied with the provisions of the Architects Act (R.S.Q. 1964, c.261, s.12). However, at least one judge was prepared to include “engineer” within this meaning (Fraser-Brace Enrg. v. Chassé, Tremblay & Associés, [1970] C.S. 342 (Québec Superior Court)). See Macklem & Bristow 5th ed, supra note 97 at 608.
300 Or a notice thereof.
301 Québec CC, supra note 291, article 2013, Macklem & Bristow 5th ed, supra note 97 at 595-597. The Québec Court of Appeal decided that each creditor should be allocated value on the basis of all work and materials provided, and not solely as regards the additional value he or she had personally given. See Duval & Gilbert Inc. v. Réjean Lapierre Inc., [1974] C.A. 483 (Québec C.A.); Pipon v. Goldsten (1940), 46 R.L.N.S. 431. At 596-597 Macklem & Bristow 5th ed, supra note 97 refer to the Court adopting the theory expounded by Giroux (in Giroux, Le Privilège Ouvrier (1933) at 393 et seq.) as opposed to that of Marler (in Marler, The Law of Real Property, at 362-363, 377-378).
302 Macklem & Bristow 5th ed, supra note 97 at 596.
303 Québec CC, supra note 291, article 2013c.
6.2 The 1977 Draft Code

In 1977 the Civil Code Revision Office published a report containing substantial proposals for reform of the Québec Civil Code. Amongst other things this report made significant efforts to render the law relating to security on property more complete, more flexible and more in line with the approach contained in both Article 9 of the Uniform Commercial Code and the personal property security acts.

In the construction lien context the most significant recommendations contained in the report were that all forms of security be grouped together under the single concept of “hypothec”, and that the “privilege” be abolished. The report noted that there had been substantial criticism of the privilege system, and it decided that the concept of favouring certain privileges over others had become outdated:

Today, emphasis is on equality, contrary to what was the custom in the nineteenth century. All creditors are expected to be equal and to divide their debtor’s property among themselves in proportion to their claim. This statement does not necessarily eliminate all notions of preference among creditors. Conventional security must retain its place in modern economic activity. What is found arbitrary are legal preferences, attributable to the mere quality or cause of the claim. There is no reason to retain the concept of privilege as a legal real right and it is recommended that it be simply abolished.

In the context of the construction industry the report noted that construction privileges had "undoubtedly given rise to the greatest number of difficulties in Québec law", so that

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305 Ibid. at 347.
308 1977 Québec Report, supra note 304 at 354.
309 1977 Québec Report, supra note 304 at 357.
"[i]t could even be said that construction privileges are now more a source of conflicts and suits than a real security for those entitled to them... The history of construction privileges in Quebec law can be compared to a perpetual tug of war between privileged creditors and hypothecary creditors". 310 According to the report this tug of war had led hypothecary creditors to develop new, inconsistent and sometimes underhand techniques to retain priority. 311

By way of solution to the problems in the construction industry, the report proposed that creditors be protected by a hypothec that would rank ahead of other hypothecs, provided that all statutory requirements were met. Similar to the construction privilege before it, this hypothec would be limited to the market value of labour and materials used in the construction312 but the previous ranking of construction creditors would be abolished so that all ranked equally. The hypothec would need to be published, or registered, within 90 days of the contract being signed, and certain notices would need to be given. 313 It was to be the "sole exception to the principle by which hypothecs are given priority according to their date of publication and hypothecary creditors are considered equal". 314

311 1977 Québec Report, supra note 304 at 358.
312 1977 Québec Report, supra note 304 at 362. However, the aim was that this market value would be easier to determine than the "value added to the immovable" (at 362-363).
313 Clauses 461d, 461e, 1977 Québec Report, supra note 304 at 363-364. Under previous (and now current) Québec law a privilege or prior claim is a "claim to which the law attaches the right of a creditor to be preferred over other creditors, even the hypothecary creditors..." (Québec CC, supra note 291, article 2650) and a hypothec is "a real right on a movable or immovable property made liable for the performance of an obligation" (Québec CC, supra note 291, article 2660) (Macklem & Bristow 6th ed, supra note 204 at 13-1 – 13-2). Thus, in contrast to this reform proposal neither the prior claim nor the hypothec needed, nor now needs, to be expressly granted or published in order for it to exist.
6.3 Post 1994

As was undoubtedly the case in all subject areas, the final version of the reformed Civil Code of Québec\textsuperscript{315} contained some but not all of the 1977 draft Code’s recommendations vis-à-vis the construction privilege. The reformed Code did downgrade the priority provided to those in the industry from a privilege to an hypothec. It also did away with any internal priority systems, so that those who receive priority will all now rank equally. However, it did not amalgamate all securities under the broad hypothec umbrella, and instead retained a separate class of legal cause of preference, which has been renamed the “prior claim”.\textsuperscript{316}

The Québécois equivalent to the builder’s lien is now created by Québec CC article 2724(2) and is classified as a “legal hypothec”.\textsuperscript{317} It exists in favour of an “architect, engineer, supplier of materials, workman, and contractor or subcontractor” to a construction project” but only “in proportion to the work requested by the owner of the immovable or to the materials or services supplied or prepared by them for the work”.\textsuperscript{318}

It will not be necessary to publish an hypothec in order for it to exist but publication will be needed if rights are to be asserted as against any third parties.

Macklem and Bristow refer to the downgrade in status of the protection provided to construction contractors under the reformed Civil Code, as compared with that under the former Code. This downgrade of status to an hypothec means that any claims made by

\textsuperscript{315}L.Q. 1991, c.64 as amended by L.Q. 1992, c.57.

\textsuperscript{316}Macklem & Bristow 6th edn, supra note 204 at 13-2.

\textsuperscript{317}Macklem & Bristow 6th edn, supra note 204 at 13-5. The draft Code recommended the abolition of the legal, as opposed to the conventional, judicial and testamentary hypothecs (1977 Québec Report, supra note 304 at 348), although this abolition was rejected.

\textsuperscript{318}So that the previous “value added” test has been amended but the same idea has been retained.
those in the construction industry will always be relegated to what are now known as prior
claims. Examples of particular prior claims that have been cited are: “1) legal costs and
all expenses incurred in the common interest; 2) the claim of a vendor who has not been
paid the price of a movable sold to a natural person who does not operate an enterprise; 3)
claims of the State for amounts due under fiscal law; and 4) claims of municipalities and
school boards for property taxes on taxable immovables”. It is therefore arguable that
the construction contractor’s protection has been diminished, although its status as a legal
hypothec will ensure that such claims still rank above other more threatening claims.

7 Analysis of the Canadian Systems

To the outside observer the Canadian system for protecting construction contractors presents
a contradiction. On the one hand commentary and case law, particularly from Ontario,
makes it appear that the system is complicated, commonly misunderstood to one extent or
another, and heavily litigated. Many cases have arisen that relate to procedural problems
with the system and although the British Columbia Builders Lien Act has attempted to
remove such problems it may be too early to say whether this has been successful.
Construction is an area of the law that always appears to attract litigation, but there are still a
large number of cases and commentary that deal with problematic aspects of the builder’s
lien system.

However on the other hand, the Canadian system has survived numerous law reforms, is
widely used and seems to meet with the approval of almost all parties in the industry. New
Zealanders and Australians look at the lien as being heavy handed and antiquated, and at the
use of the accompanying holdback and trust provisions, bonds and alternative dispute

\footnote{Macklem & Bristow 6th edn, supra note 204 at 13-7.}
resolution devices as being complicated and over regulated. However in fact, the resulting system seems to achieve a surprisingly successful balance of protection for subcontractors, workers and material suppliers, but still maintain sufficient freedom for owners and developers to carry out their business.

Arthur Close heads the British Columbia Law Institute and holds a view about the Canadian system that New Zealanders and Australians might relate to. Although Mr Close was heavily involved with reforms that led to enactment of the 1997 Builders Lien Act, he generally does not support the lien system. In his opinion the system is unwieldy, slow and leaves material suppliers as being the only parties with “all to gain and nothing to lose”. He cites political reasons to explain why the lien has remained in force in British Columbia, and claims to see no benefit in a country re-implementing lien legislation after it has previously repealed it.

However by contrast, while construction contractors and subcontractors appear to have differing complaints about the British Columbia system depending upon where in the pyramid they are situated, they otherwise use the act with relative success. The 1997 reforms appear to have dramatically improved the position of head contractors, who now enjoy the holdback’s 10% limited liability and are no longer required to shoulder anywhere near the

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320 Mr Close was involved with the British Columbia builder’s lien reviews in both 1997, and earlier in 1972. In his opinion the 1972 reforms came about for political reasons. Apparently, at the time the government wanted to implement certain labour legislation that it foresaw the building industry would not support. It therefore implemented the lien reforms as a form of panacea, even though ironically the labour legislation never took effect. Now he believes that the lien seems set to remain in force for some time because repealing it will never be a vote-winner. In Mr Close’s words, much of the lien legislation is “the government giving the construction workers what they want” (Interview with Arthur Close, supra note 84).

321 Ibid.
same degree of risk that they used to.\textsuperscript{322} Subcontractors such as Mark Dumerton complain that those at the bottom of the chain are now forced to shoulder that risk and are consequently put at a great disadvantage.\textsuperscript{323} Nonetheless, Mr Dumerton claims that the system is relatively easy to use,\textsuperscript{324} and that he finds liens to be a useful device in the approximately 2\% of jobs that involve disputes serious enough to warrant them.\textsuperscript{325}

Lawyers also show relatively strong support for the British Columbia system, particularly for those changes implemented as part of the 1997 reforms. Derek Brindle\textsuperscript{326} cites the multiple holdback as having substantially improved the system, because it permits payments to be made as each stage of a project is completed, rather than requiring them to be held till the end. He also sees the new system as balancing parties' interests fairly because the lien and the holdback enable subcontractors to be paid, but equally the 10\% limit on liability protects owners and head contractors. Marina Pratchett also cites the requirement that the owner maintain its holdback in a separate account as being an improvement.\textsuperscript{327}

Aside from the

\textsuperscript{322} Head contractors apparently lobbied hard for the holdback reforms and this major change may have been implemented without subcontractors fully understanding the consequences that it would have (Interview with Marina Pratchett, \textit{supra} note 52).

\textsuperscript{323} Interview with Mark Dumerton, \textit{supra} note 257.

\textsuperscript{324} Mr Dumerton said that he would be able to file a lien himself but that he prefers to pay a lawyer the approximate $350 that it costs to do it (\textit{ibid.}).

\textsuperscript{325} Mr Dumerton estimated that while 20\% of his company's jobs involve some negotiation over payment, only 2\% result in lien claims (\textit{ibid.}).

\textsuperscript{326} Derek Brindle, Q.C. is a partner at Singleton Urquhart, one of the foremost litigation firms in Western Canada. He has a broad range of both civil and criminal litigation experience, including work in the areas of construction, insurance and commercial litigation. Mr Brindle agreed to participate in an interview about the British Columbia construction industry, and that interview took place on 18 July 2001. References in this thesis to Mr Brindle's comments come from that interview [hereinafter the "Interview with Derek Brindle"]. For more information about Singleton Urquhart see their website: <http://www.singleton.com/> (dates accessed: May-August 2001).

\textsuperscript{327} Interview with Marina Pratchett, \textit{supra} note 52.
privity of trust requirements that prevent a party enforcing trust provisions against another unless the two have a contractual relationship with each other, which she finds difficult, Ms Pratchett supports the *Builders Lien Act* and favours retention of the lien in British Columbia.\(^\text{328}\)

Abigail Fulton also presents an interesting perspective on the *Builders Lien Act* from her position as vice president and legal counsel of the British Columbia Construction Association—a not-for-profit organisation representing construction contractors, many of whom are general contractors and some of whom are trades-people.\(^\text{329}\) She points out that industry participants have differing levels of understanding about the act and while large companies with their own legal counsel can make full use of its provisions, other much smaller traders may not.\(^\text{330}\) She sees many of her members as not having an in-depth understanding of the system, and this is something that she is trying to remedy. However, in general Ms Fulton sees the act as creating a fair balance between parties and, like Derek Brindle and Marina Pratchett, she supports retention of the lien.

From this brief survey of different industry participants it appears that the British Columbia *Builders Lien Act* holds a substantial degree of support. Therefore, while at first glance the lien, holdback and trust provisions may seem complicated, they manage to provide a system that works well in Canada. Aspects of this system may be heavily litigated\(^\text{331}\) and not everyone may understand exactly how it works, but construction parties seem happy with it, and quickly become suspicious at the mention of any alternative system that does not provide for the lien.

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\(^{328}\) As does Mr Brindle (Interview with Derek Brindle, *supra* note 326, *ibid.*).

\(^{329}\) See Interview with Abigail Fulton, *supra* note 139.

\(^{330}\) Danny Patten also supports this view—see Interview with Danny Patten, *supra* note 256.

\(^{331}\) At least in Ontario, where arguably the legislation is not as up-to-date as in British Columbia.
III THE NEW SOUTH WALES AND UNITED KINGDOM SYSTEMS

1 Introduction

The history and structure of the Canadian and American lien, holdback and trust systems differ substantially from the adjudication systems in place in Australia and the United Kingdom. This is very significant for New Zealand because the Construction Contracts Bill seems set to ensure that New Zealand construction contractors will go from having the protections of the North American-style system, to having the protections of no system whatsoever, and finally to having the protections of a totally different Australian/United Kingdom-style system. While in principle this Australian and United Kingdom-style system seems sensible and has significant potential to improve payment practices, New Zealand’s modifications of the system, along with its failure to recognise the need for any further reforms, appear to be problematic.

Researchers charged with preparing the Construction Contracts Bill have based the majority of their recommendations on the provisions of the NSW Security of Payment Act only. It is submitted that the researchers have been short-sighted in doing this, because New South Wales construction industry reforms relate to a much wider range of issues, of which the NSW Security of Payment Act is only one small part. Other reforms relate to industrial relations, occupational safety, health and rehabilitation, the environment, the use of information technology, tendering, education and other things that are also all relevant to New Zealand.

New Zealand is also likely to encounter difficulties following its adoption of the New South Wales-style legislation, both because the NSW Security of Payment Act has yet to be properly tested, and because supplementary measures are still up in the air. In particular, New
Zealand legislators should bear in mind firstly, that the New South Wales government has always intended to adopt mandatory insurance and contractor registration measures to supplement the act, and secondly, that those measures are currently on-hold with their future being somewhat in doubt. Legislators in both New Zealand and New South Wales will need to ask themselves whether insurance and registration measures should be adopted and, if not, whether security of payment legislation can be effective without them.

Other aspects of the New Zealand Construction Contracts Bill have been borrowed from the UK Housing Grants Act. In particular, the scope of the bill has been extended to apply to all construction disputes, in the same way that has been done under the United Kingdom act. As a result of this New Zealand will also need to follow the progress of the UK Housing Grants Act and commentary thereon. The final section of this chapter examines limited aspects of that act, as well as commentary about it, which so far has been notably critical of certain aspects of the act including the broadness of its scope.

2 The Australian States’ Rejection of the Builder’s Lien

The enduring and consistent reliance on the lien system and the creation of devices to supplement it, which has occurred across North America is not evident in Australia. While law reform commissions in Canada have faithfully adhered to the lien, commissions in Australia have generally criticized it, so that the system has either not been adopted at all, or


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has been repealed.\textsuperscript{333} In New South Wales repeal of the lien has prompted the government to develop broad new measures, which attempt to reform the whole of the construction industry. Other states have taken various different approaches and many are still grappling with the form that protection of subcontractors should take.

Australian law reformers' criticism of the lien system is one feature that has been fairly consistent across the different states. For the main part it has been based on the fact that the lien may be detrimental to a landowner who is in no way at fault, that it can create difficulties in financing, and that it does not "materially assist subcontractors and would tend to create more difficulties than it seeks to solve".\textsuperscript{334} It has led law reform commissions from many of the states to carry out research projects at various times during the 1980s and 1990s.\textsuperscript{335} The federal government has also become involved, with a Construction Industry Development Agency ("CIDA") committee having reported in 1994.\textsuperscript{336}

As a result of these law reform commission reports, many areas of construction law have been identified as being in need of reform by the different states. In particular, levels of training and education, tendering processes, certain standard form contracts and proof of

\textsuperscript{333} Builders' lien legislation has been in force at different times in at least South Australia, Queensland and New South Wales (see Protecting Construction Contractors, supra note 14 at 4. Such legislation was never enacted in Western Australia (see Western Australia Report, supra note 18 at 23).

\textsuperscript{334} These particular criticisms were made in Law Reform Commission of Western Australia, Contractors' Liens (Project No 54, 1974) at para 35, and was cited in Western Australia Report, supra note 18 at 23.

\textsuperscript{335} For example, major law reform projects were undertaken in Western Australia in 1998, in New South Wales in 1991, 1996 and 1997, in Victoria in 1994, in South Australia in 1990 and in Queensland in 1991.

\textsuperscript{336} CIDA was established to report on security of payment in the construction industry. Its report, Construction Industry Development Agency, Security of Payment (Final Report, 1994), contained recommendations relating to corporate governance, project funding, tendering, contractual provisions and security under the contract (see Western Australia Report, supra note 18 at 25-26).
payment declarations have all given rise to concern. In addition, although the measures that have been taken by each of the states vary to a substantial degree, the commonwealth, state and territory ministers have endorsed a common set of principles to improve security of payment in the building industry. These principles include the following:

- the right of participants to receive full payment as and when due;
- the need for all construction contracts to make provision for alternative dispute resolution;
- the need for all contracts to be in writing;
- the need for participants to have the necessary financial, technical and business management skills to complete their obligations;
- the need for all cash security and retention moneys to be secured; and
- the need for payment periods to be consistent throughout contractual chains.

The aim of these ministers has been to build a foundation for a national code of practice.

In Canada, Australia’s departure from the lien has been viewed with some suspicion. For example, in 1990 the Newfoundland Law Reform Commission commented that:

It was noted, however, that since doing away with these statutes a number of Australian jurisdictions have opted for new legislation, the effect of which is to augment the ordinary common law contractual remedies which are not entirely effective within the complex web of relationships characteristic of the construction setting with new rights for subcontractors and their workmen.

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337 These issues have been discussed predominately in New South Wales, South Australia, Queensland and Victoria (see Western Australia Report, supra note 18 at 32-44).

338 Western Australia Report, supra note 18 at 28-29.

339 Ibid.

340 Newfoundland Report, supra note 19 at 5.
However, in New Zealand there has been support both for the departure and for the subsequent alternative reforms. In particular the New South Wales system has been identified as having the potential to serve as a useful model for New Zealand. Consequently that model will now be considered in more detail.

3 The New South Wales Reform Process

New South Wales' share of total national Australian construction varies between 32 and 35%. In 1991 measures to reform this industry commenced when the Business and Consumer Affairs Agency published an issues paper inviting comments on a proposal advocating mandatory trust provisions, extension of an existing insurance scheme and an increase in funding for education programmes. The idea of the trust arose because there were already retention fund trust clauses in many building industry standard form contracts at that time. The use of insurance and aims to increase education were, and have continued to be, advocated in New South Wales as potential means to improve industry practices, both in relation to security of payment issues and more generally.

Subsequently Andersen Consulting, which was engaged by the government to review the

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341 Protecting Construction Contractors, supra note 14 at 11.


343 The Business and Consumer Affairs Agency, alternatively known as the Department of Business and Consumer Affairs, dealt with issues of consumer protection that are now termed “fair trading” in both Australia and New Zealand. In 1996 it amalgamated with various other departments to form the Department of Fair Trading New South Wales (see email from Christie Stewart, Assistant Customer Service Officer for Director-General, received on 9 October 2001).

344 Western Australia Report, supra note 18 at 32.

345 Ibid.
Consumer Affairs Agency's proposal, recommended that it not be adopted.\textsuperscript{346} Andersen Consulting instead recommended further consideration of the government's code of practice, greater use of alternative dispute resolution and increased training of members by industry associations. These recommendations led to the establishment by the government of a Construction Policy Steering Committee (the "CPSC"), which has thereafter been charged with implementing these, and subsequent, proposals.\textsuperscript{347} Some of these proposals relate to payment issues but, as will be seen, New South Wales' construction reforms have always been directed at a very broad range of issues.

At present the CPSC is made up of eight members,\textsuperscript{348} and has numerous "member agencies" including the Treasury, the Department of Housing, the Olympic Co-ordination Authority, Rail Services Australia, the Roads and Traffic Authority, the Sydney Water Corporation, the Premier's Department, and the CPSC's chair — the Department of Public Works and Services.\textsuperscript{349} Since its establishment the CPSC has carried out three years of intensive consultation, helped the government to publish two green papers in 1996\textsuperscript{350} and a discussion paper in 1997,\textsuperscript{351} and produced \textit{Construct New South Wales}\textsuperscript{352} — a continually updated web

\begin{footnotesize}
\begin{enumerate}
\item Andersen Consulting, \textit{Feasibility Study into the Proposal Prepared by the NSW Security of Payment Committee} (1993).
\item \textit{Western Australia Report}, supra note 18 at 32-33.
\item All of whom can be viewed at online: About the CPSC from the CPSC Homepage <http://www.cpsc.nsw.gov.au/about-cpsc/> (date accessed: June 20 2001).
\item \textit{Ibid}.
\end{enumerate}
\end{footnotesize}
based document that is to serve as the framework for reform of the New South Wales construction industry.

The CPSC’s aim is to achieve a construction industry that is “outwardly focused, innovative, competitive and safe”.\(^{353}\) *Construct New South Wales* focuses on four core goals, namely that the construction industry should be:

- seamless;
- profitable and efficient;
- innovative; and
- environmentally responsible.\(^{354}\)

These goals are to be manifested in ten different actions that have been termed “security of payment”, “industrial relations”, “occupational safety, health and rehabilitation”, “towards an ecologically sustainable industry”, “information technology”, “strategic information”, “business ethics and practice”, “management and workforce development”, “continuous


\(^{353}\) *Construct New South Wales*, supra note 352.

\(^{354}\) On this page the New South Wales government elaborates on the goals by setting out that it is committed to achieving enterprises that have specific characteristics. Firstly, enterprises should be client and service focused, and should deliver seamless services through alliances between contractors, subcontractors, consultants and suppliers. Secondly, enterprises should be financially robust, employing a skilled and flexible workforce so as to be profitable and efficient. Thirdly, enterprises should be innovative and clever; using “today’s and tomorrow’s technology and integrated processes”. Finally, enterprises should be committed to achieving ecologically sustainable development and environmentally responsible. Characteristics of the Industry from the CPSC Homepage, online: <http://www.cpsc.nsw.gov.au/ConstructNSW/charact.html> (date accessed: 20 June 2001).
improvement” and “encouragement and recognition”.  

These actions are clearly very wide ranging and encompass far more than the mere financial protection of subcontractors. As one article has put it:

The key elements of reform and the Government’s vision for the industry are better business and management planning where durable long-term relationships between consultants, contractors, subcontractors and suppliers are formed, achieving better cost structures and better response to client preferences.

However, New Zealand has so far only concentrated on one area of the Australian reforms, namely the security of payment issue. This is probably the area that has been worked on the most in New South Wales following the coming into force of the NSW Security of Payment Act on 26 March 2000. This act was drafted in consultation with various industry groups and aims to create fair and balanced payment standards for construction contracts. Unlike the Builders Lien Act, it does not provide an entire comprehensive system for contractors and subcontractors. Instead it sets out a procedure to enable payment to be enforced and that procedure and the associated provisions will now be considered so that the background to the New Zealand Construction Contractors Bill can be best understood.

4 The NSW Security of Payment Act

The NSW Security of Payment Act regulates contracts and arrangements, whether written or

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356 Building Innovation Article, supra note 7.

oral, relating to the carrying out of “construction work” within New South Wales. These include contracts for the construction work itself and contracts for the supply of “related goods and services”. “Construction work” is broadly defined and includes all work done to land or buildings, from construction, to maintenance, to demolition, as well as associated or peripheral activities. “Related goods and services” includes any architectural, design, engineering and surveying services performed in relation to construction work.

The act’s primary purpose is to ensure that all progress payments under a construction contract are made on time. It does this firstly by establishing that even if a contract does not provide for progress payments to be made, a party to a construction contract has the right to claim payment for work done every four weeks. Secondly, it provides that where a party has not been paid in accordance with the terms of the contract, or if the contract makes no provision for progress payments, after four weeks, that party may serve a “payment claim” on his or her debtor. For the purposes of the act the party is then known as the “claimant” and the debtor as the “respondent”. The act does not contain any of the distinctions between “contractors”, “subcontractors”, “workers” and/or “material suppliers”


359 See the definition of “construction contract” in section 4 NSW Security of Payment Act, supra note 79, and the definition of “related services” in section 6. See also C. Lithgow, supra note 358.

360 Section 5 NSW Security of Payment Act, supra note 79; see also C. Lithgow, supra note 358.

361 See section 6 NSW Security of Payment Act, supra note 79.

362 Section 3(1) NSW Security of Payment Act, supra note 79.

363 Section 8, and in particular, s8(2)(b) NSW Security of Payment Act, supra note 79; C. Lithgow, supra note 358. If the contract does provide for progress payments then those provisions will apply.

364 See sections 11 and 13 NSW Security of Payment Act, supra note 79.

365 Section 4 NSW Security of Payment Act, supra note 79.
that are found in the *Builders Lien Act*.\(^{366}\) Any person, who has undertaken to carry out construction work or to supply related goods and services,\(^{367}\) is entitled to become a "claimant" in the event that they are not paid.

If the respondent agrees with the amount or amounts claimed under the payment claim, he or she must pay them\(^{368}\) with failure to do so entitling the claimant to obtain judgment for these amounts, or to suspend construction work.\(^{369}\) However, if the respondent does not agree with all or any amounts claimed, he or she must provide a "payment schedule" within ten business days of receiving the payment claim.\(^{370}\)

Details surrounding the payment schedule are set out in the act but in essence the schedule need only be an informal document setting out all amounts that the respondent believes are, and will be, due and owing under the contract, at what times. The purpose of the schedule is to enable the claimant to ascertain exactly when and what he or she can expect to be paid.

The act also provides that if the claimant disagrees with any of the amounts or dates

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\(^{366}\) *Supra* note 81.

\(^{367}\) As those terms are defined in sections 5 and 6.

\(^{368}\) Where the contract has provided for progress payments to be made, amounts will be due and owing on those dates set out in the contract. Where the contract has not provided for progress payments to be made but a payment claim has been served in accordance with the act, the amounts claimed will become due and owing two weeks after the payment claim is made (section 11 *NSW Security of Payment Act*, *supra* note 79).

\(^{369}\) Section 15 *NSW Security of Payment Act*, *supra* note 79. Note that the right to suspend work is contingent on the claimant following the procedures set out in the act, in particular relating to the giving of two business days' notice (see sections 15 and 27 *NSW Security of Payment Act*, *supra* note 79). As yet there has been nothing to indicate whether the suspension of work provisions are being used, and if they are, how successful they have been. While the act aims to make such suspension of work possible, anecdotal evidence indicates that the construction industry has a history of either not tolerating or contractually barring it. Like many aspects of the New South Wales reforms, it remains to be seen how realistic these suspension of work provisions are.

\(^{370}\) Or within the time period set out in the contract, whichever is the earlier (section 14 *NSW Security of Payment Act*, *supra* note 79).
specified, he or she may apply to have them adjudicated.371

The process of adjudication is the central feature of the *NSW Security of Payment Act* and early commentary has been quick to point out the differences between it and arbitration.372 The most major of these differences is that adjudication is a simple isolated determination of rights by a person who need not have any particular expertise.373 The whole process essentially consists of the adjudicator being appointed, receiving copies of the contract, the payment claim, the payment schedule (if any) and submissions from the parties, and making a decision. Parties may obtain reasons for a decision but apparently only if they request them prior to the determination being made.374

The adjudicator will either be a person chosen by the parties, or someone appointed by an “authorized nominating authority”.375 After accepting the adjudication application, he or she will usually receive the necessary documents within a maximum of five business days376 and

371 Provided that this application is made within five business days of receipt of the payment schedule (section 17 *NSW Security of Payment Act*, supra note 79).


373 Although regulations may be enacted at a later date to proscribe particular “qualifications, expertise and experience” that an adjudicator will be required to possess. See section 18 *NSW Security of Payment Act*, supra note 79; Davenport ADRJ Article, supra note 372 at 175.

374 Davenport ADRJ Article, supra note 372 at 178.

375 Section 17(3) *NSW Security of Payment Act*, supra note 79. An “authorised nomination authority” is a person authorised by the Minister to nominate other persons to act as adjudicators and determine adjudication applications (section 4 *NSW Security of Payment Act*, supra note 79).

376 An adjudication application must be made within five business days after the claimant receives the payment schedule. The claimant must provide any submissions that are relevant to the application at the time that that application is made (section 17 *NSW Security of Payment Act*, supra note 79). The respondent may then lodge an “adjudication response” with the adjudicator, but must do so within either five business days after receiving a copy of the adjudication application, or two business days after receiving notice of the adjudicator’s acceptance of the application, whichever time expires later (section 20(1) *NSW Security of Payment Act*, supra note 79).
will the have option of calling for further submissions, holding a conference between the parties, and/or making any inspections.\textsuperscript{377} Once these things have been completed the adjudicator will be required to make his or her determination within ten business days,\textsuperscript{378} with that decision being binding on the parties, so that any amounts that are determined to be owing must be paid or put up as security, even if the dispute will later be raised in the courts.\textsuperscript{379} Thus while the determination is binding, because either party may raise the matter in the courts later it is not completely final.

Some of the only commentary that has been published about the \textit{NSW Security of Payment Act} is aimed at potential adjudicators. From the initial list of authorized nominating authorities set out in the act it appears that such people will be either those affiliated to an industry related organisation,\textsuperscript{380} or those already operating as arbitrators or mediators.\textsuperscript{381}

\begin{footnotesize}
\begin{enumerate}
\item Section 21(4) \textit{NSW Security of Payment Act}, supra note 79.
\item Although the claimant and the respondent may agree to grant the adjudicator further time to make a decision, provided that the application is nonetheless determined “as expeditiously as possible” (section 21(3) \textit{NSW Security of Payment Act}, supra note 79).
\item If the adjudicator determines that the respondent must pay some amount to the claimant then the respondent is required to either pay that amount or give security for that amount in accordance with the requirements under the act (section 23(1) \textit{NSW Security of Payment Act}, supra note 79).
\item Such as the Master Builders’ Associations and the Electrical and Communications Associations (see both \textit{Building and Construction Industry Security of Payment Bill 1999 Authorisation of Nominating Bodies Discussion Paper}, online: CPSC Homepage \textlt;http://www.cpsc.nsw.gov.au/docs/sop/ana-paper.pdf\textgt; (date accessed: 21 November 2000) and the list of authorised nominating authorities effective from the commencement of the act contained in section 28, online: CPSC Homepage: \textlt;http://www.cpsc.nsw.gov.au/docs/sop/sop-ana-01.pdf\textgt; (date accessed: 21 November 2000).
\item Such as the Chartered Institute of Arbitrators and LEADR (Lawyers Engaged in Alternative Dispute Resolution – an Australasian not-for-profit membership organisation formed to: “serve the community by promoting and facilitating the use of consensual dispute resolution processes”, see LEADR Homepage \textlt;http://www.leadr.com.au/\textgt; (date accessed: 5 December 2000)).
\end{enumerate}
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Adjudicators will be entitled to be paid for their work, and will be generally immune from liability for any decisions made in good faith. Accreditation courses have already commenced in New South Wales.

5 Responses to the NSW Security of Payment Act

At this early stage in its life, responses to the NSW Security of Payment Act have been limited to the Parliamentary debates that occurred prior to enactment, and to a small quantity of initial commentary. Although opposition members supported the principle of the bill during Parliamentary readings, they were concerned about residential contractors' exclusion from the act's protection, about potential conflicts with federal legislation and about the shortness of the act's timeframes. Following the act's coming into force commentators have emphasised the need for both lawyers and those in industry to give proper attention to those timeframes.

The opposition was particularly critical of what it perceived to be inadequacies that other legislation dealing with residential building contracts has. In fact, this criticism was some of the strongest received in relation to the bill about any matter. Under section 7(2)(b) the NSW Security of Payment Act does not apply to any construction contract for the carrying out of

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382 Provided that all the time and other statutory requirements are met (section 29 NSW Security of Payment Act, supra note 79). Fees may be of an amount agreed between the adjudicator and the parties or, if no amount is agreed, an amount that is reasonable having regard to the work done and expenses incurred by the adjudicator (section 29(1)).

383 Section 30 NSW Security of Payment Act, supra note 79. P. Davenport states that it is up to each individual adjudicator to decide whether he or she needs professional indemnity insurance. However, because the decision will only be of binding effect until the matter is heard in the courts, and because the most that any respondent will be required to do is post security, the parties are unlikely to suffer any material loss (Davenport ADRJ Article, supra note 372 at 178).

384 Davenport ADRJ Article, supra note 372 at 178-179.
"residential building work", as that term is defined in the *Home Building Act 1989 (NSW).*\(^{385}\)

While the New South Wales government believed that Department of Fair Trading provides adequate protection for persons performing such work, both the Master Builders Federation and the Housing Industry Association strongly opposed this.\(^{386}\) In particular, the Master Builders Federation gave evidence of serious delays that were frequently associated with residential building disputes, despite the recent increase in the monetary value of claims that may be heard by the small claims court.\(^{387}\) However, consistent with the line of thought discussed in Chapter I, Section 5.3 above, the government decided to maintain the exception, albeit in a slightly different form.

The opposition also highlighted as a major concern conflicts that may arise between the *NSW*

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\(^{385}\) Under section 3 "residential building work" means any work involved in, or involved in co-ordinating or supervising any work involved in:

(a) the construction of a dwelling, or

(b) the making of alterations or additions to a dwelling, or

(c) the repairing, renovation, decoration or protective treatment of a dwelling.

It includes specialist work done in connection with a dwelling and work concerned in installing a prescribed fixture or apparatus in a dwelling (or in adding to, altering or repairing any such installation). It does not include work that is declared by the regulations to be excluded from this definition. "Dwelling" is also a term that section 3 defines, although that definition follows common sense and has therefore not been set out. As Chapter I, Section 5.3 described, the logic behind excluding those who carry out residential construction work from security of payment legislation protections is that such people and such work is better suited to fair trading and consumer protection protections. However as Chapter IV, Section 5 explains, drafters of the New Zealand *Construction Contracts Bill* have chosen to deviate somewhat from this position


\(^{387}\) The local court sitting in its small claims division now has jurisdiction to hear and determine actions for the recovery of any debt, demand or damage in which the amount claimed is not more than $10,000. Formerly, this amount was not to be more than $3000 (see *NSW Parliamentary Debates 22 Sept 1999*, supra note 386 and section 12 of the *Local Courts (Civil Claims) Act 1970* (N.S.W.)).

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Security of Payment Act and federal legislation. In particular, the Hon C.J.S Lynn reported that the bill did not properly take into account the existing insolvency and bankruptcy legislation.\textsuperscript{388} Problems could therefore arise where a respondent put up security for an adjudicated payment but then subsequently became bankrupt or insolvent. In this situation the trustee in bankruptcy would have the power to re-open the respondent’s transactions and reclaim the security. If this were done, the claimant would be left without the payment in question and the purpose of the \textit{NSW Security of Payment Act} would be defeated. There was also concern that the requirement to put up security would actually hasten bankruptcy or insolvency because it would reduce cash flow.\textsuperscript{389} However, it appears that the fact that a party is having difficulty raising security might be a good indicator that the party will suffer financial problems ahead. An argument based on the idea that the legislation should not require security to be posted for a debt determined to be due and owing because to do so would inhibit the debtor’s financial position does not appear to carry much merit.

When the outstanding New South Wales construction industry reforms have been carried out problems relating to bankruptcy and insolvency may be resolved. In particular, the proposals to make security of payment insurance mandatory for all contractors that are described in Section 5.1 below may provide a source of funds to enable otherwise unsecured creditors to be paid. However the delays that have so far occurred in implementing these proposals, and the fact that these reforms may never be implemented at all, mean that at present insolvency and bankruptcy issues remain real problems.

The final concern that the opposition rose, and the issue with which commentators have so far been very much concerned, was the short time frames contained within the \textit{NSW Security

\textsuperscript{388} These concerns originally came from the Housing Industry Association, see \textit{NSW Parliamentary Debates} 22 Sept 1999, \textit{supra} note 386.

\textsuperscript{389} \textit{Ibid.}
of Payment Act. The Property Council was particularly concerned that adjudicators would not always be able to reach a satisfactory decision within ten business days and the other timeframes were also questioned. It is submitted that the workability of these timeframes cannot be predicted and they may need to be amended over time. Commentators have emphasised that lawyers need to take immediate action when claims under the act arise and that they should also urge their clients to amend standard form contracts in advance in order to avoid disputes arising at all. Figure 3.1 illustrates the time frames that apply under the NSW Security of Payment Act. The act is designed so that an entire dispute may be dealt with in only four weeks, and even the adjudicator cannot extend the times that are specified.

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390 These concerns originally came from the Master Builders’ Association and the Property Council, see NSW Parliamentary Debates 22 Sept 1999, supra note 386.

391 The Property Council of Australia represents “the interests of the property community, principally those who use land or invest in the built environment to generate economic returns”. Its members include institutional investors, pension funds, property trusts, private investors and developers. Asset managers, the professions and trade suppliers also participate in its activities. See the Property Council of Australia Homepage [http://www.propertyoz.com.au/data/organisation/fs_org.htm] (date accessed: 5 December 2000).


393 Ibid. at 46.
Figure 3.1: Timeframes Under the *NSW Security of Payment Act*

Claimant

Claimant not paid. Serves payment claim. Respondent must respond within 10 business days.

Respondent

Respondent provides payment schedule.

Claimant

If claimant disputes amounts then claimant must make an adjudication application within 5 business days. Claimant must provide any submissions he or she considers relevant.

Adjudicator

Adjudicator serves notice of acceptance.

Respondent

Respondent may lodge an adjudication response within the later of either 5 business days after the adjudication application or 2 business days after adjudicator's acceptance.

Adjudicator

Adjudicator must determine the adjudication within 10 business days after accepting the adjudication.

Determination against claimant: respondent need not pay.

Claimant

Determination against respondent: respondent must pay or post security within 2 business days.

Respondent

Either party may appeal the decision to the courts.

Claimant

Claimant may serve notice of suspension of work.

Either claimant may serve notice of suspension of work.

Respondent

Respondent fails to pay or provide payment schedule within 10 business days.

Claimant

If no action within 2 business days claimant may suspend work.

Court

Claimant suspends work

Adapted from *Security of Payment Brochure*, supra note 357.
6 Other Aspects of the CPSC Actions

In New South Wales the CPSC has been charged with implementing ten different actions in order to reform the whole of the state's construction industry. One of these actions is the security of payment issue, and in turn the NSW Security of Payment Act deals with one part of that issue. However, there are other parts of the security of payment action that still remain incomplete and there are also the other nine remaining actions, some of which have been implemented but others of which are also incomplete. Other jurisdictions that choose to model their reforms on aspects of the New South Wales system need to look at that system in totality in order to obtain the best results. However, it will be difficult for any such jurisdiction to do this when aspects of that whole remain unresolved.

6.1 Security of Payment

There are three further aspects of the security of payment action that aim to go beyond the NSW Security of Payment Act. The first of these relates to industry registration, the second to compulsory insurance and the third to encouraging employers to assess the financial capability of the contractors and subcontractors whom they engage. However unfortunately, the first two of these three aspects currently remain at the consultation level and it will be some time, if ever, before any formal mechanisms are put in place.

In 1998 a New South Wales Parliamentary Joint Standing Committee issued a report on security of payment in the building industry.\(^{395}\) That report recommended establishment of a Building Registration Authority with compulsory registration for all contractors and enactment of a building industry code of conduct. Later that year an Independent Pricing

and Regulatory Tribunal ("IPART") was asked to examine the effectiveness, costs and benefits of various proposals both for industry registration, and compulsory security of payment insurance.396

As a result of the analyses relating to the issue of registration, a working party made up of individuals from the Cabinet Office, and the Departments of Public Works and Services and Fair Trading was established in June 1999. This working party outlined four proposals, which it listed as the following:

(1) a compulsory registration scheme with a central industry register. This register would contain details about four types of people – firstly, all registered contractors and developers and their directors, secondly, all de-registered contractors and developers and their directors, thirdly, all parties who had at any time defaulted under the NSW Security of Payment Act (whether they were required to be registered or not), and fourthly, all parties under review for default and/or de-registration;

(2) a notification and disqualification scheme with a publicly administered register. This register would record details about contractors, including directors of any corporate contractors, who had failed to comply with the NSW Security of Payment Act, as well as all insolvent persons, bodies corporate and wound up companies that had outstanding debts owed to subcontractors. These people would be "notified" on the register, and if they failed to pay their debts after a set period of time they would be disqualified from operating within the industry;

(3) a deterrent scheme. This scheme would not involve any central register but would nonetheless ban all bankrupts, directors of companies in liquidation, and parties

396 Ibid.
and directors of corporate parties who had failed to pay amounts as required by the

*NSW Security of Payment Act* from the construction industry; and

(4) a registration scheme linked to compulsory insurance. This might either be by way of "positive registration" or "negative registration". Under the former, contractors performing work over a certain limit would be required to obtain registration before they could obtain insurance. Under the latter, insurance would become a form of de facto registration, so that if a party lost its cover it would also lose its registration, and suffer all penalties associated with that.\(^{397}\)

The most expensive and complicated of the proposals was predicted to be those requiring compulsory registration, namely proposal (1), which would register all contractors; proposal (2), which would register only defaulting or bankrupt contractors; and proposal (4), which would involve a register that was somehow linked to insurance records. However, in the case of proposal (1) most of the costs could be recouped by the charging of fees, and in the case of proposal (4) the costs would be linked to keeping the insurance records rather than the registration records. The working party saw a registration scheme based on any of the above proposals as a means of removing "repeat security of payment offenders" from the industry and a way to prevent losses due to phoenix companies.\(^ {398}\) At the time of publication its aim was to collect comments from the public about the proposals, and to issue subsequent recommendations. However while comments were called for to be made by 17 March 2000, even in November 2001 it is not yet clear what conclusions that working party had drawn.

Likewise, the issue of compulsory insurance remains unresolved. On 15 June 2000

\(^ {397}\) *Ibid.*

\(^ {398}\) *Ibid.*
IPART published *Security of Payment in the NSW Building Industry: Compulsory Insurance*. This report followed two studies prepared for IPART on the issue – one by a firm of insolvency specialists, Ferrier Hodgson,\(^{399}\) and the other an actuarial review of Ferrier Hodgson’s report, by Ernst and Young.\(^{400}\) In its report IPART weighed up both the benefits and costs of imposing compulsory insurance.

Potential benefits of compulsory insurance were seen as being that it would treat parties within a project equally and that it would ensure that the losses that subcontractors and sub-subcontractors currently suffer would be spread more evenly throughout a project. However, there would also be costs associated with the insurance and these were described as including estimated rises in building costs of 2-3%, the likely subsequent decline in building activity, the possibility that parties might become less careful in their work as they relied increasingly on insurance to cover their errors, and the fact that insurance companies would be free to raise premiums as they saw fit. On balance IPART concluded that these costs outweighed the benefits and recommended that compulsory insurance should not be imposed.\(^{401}\) IPART instead hoped that the new code of conduct and the *NSW Security of Payment Act* would go some way to reducing insolvencies in the industry.\(^{402}\)


\(^{402}\) *Ibid.*
In emails received on both 25 June and 16 October 2001 Phil Armessen, a New South Wales Department of Public Works and Services employee, advised that to date neither the issue of industry registration nor that of compulsory insurance had been resolved. Both matters were being considered by an interdepartmental working party, which was awaiting the results of external advice about the costs of the four registration options. Ms Armessen commented that there had been some industry support for a registration scheme, but little or no support for compulsory insurance. However, arguably the two issues are inextricably linked so that the adoption of one without the other may not be possible. It appears that the interdepartmental working party is waiting to judge the success or otherwise of the NSW Security of Payment Act before it introduces any further regulation. It has been noted that whatever the scheme that is eventually devised, it must be carefully drafted so as to avoid being anti-competitive.

Finally, the third remaining aspect of the security of payment action is also worth noting in light of comments made by the New Zealand economist Gareth Morgan that are discussed in Chapter IV, Section 6.1. Like most the CPSC measures, the publication entitled Financial Assessment of Construction Contractors sets out procedures that so far only the government will be obliged to follow in employing construction contractors, but that it is hoped will form a practice that others in the industry will follow. Under these procedures New South Wales government agencies now examine the level of

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403 For example, the IPART Compulsory Insurance Report comments that the government may have seen compulsory insurance as a means of reducing the costs of a registration scheme because the insurance industry would force building industry participants to meet minimum standards as a requirement for receiving insurance. However, insurance companies may refuse to cover losses that arise from insolvencies unless the government has in place a strong registration system that forces all building industry participants to meet minimum financial and management skill criteria (IPART Compulsory Insurance Report, supra note 401 at 7).

404 JSC Report, supra note 395.
capitalization of all contractors that they propose to engage. This is done to ensure that
the contractors engaged have sufficient resources to ensure that they can withstand any
adverse financial events that might occur during the course of a contract. To ensure
consistency the government has put in place a system of common financial assessment for
all examinations.405 These measures bear some similarity to those recommended by
Gareth Morgan, although they relate more to assessing the financial strength of
construction contractors, rather than subcontractors and this, it is submitted, makes them
fundamentally different.

6.2 The Remaining Nine Actions

*Construct New South Wales* contains certain information about all of the nine remaining
CPSC actions.406 The aim behind the nine actions is for the government to establish
practices that only its agencies will be bound to comply with, but with the expectation that
those in industry will follow suit. To help industry participants to do this, the CPSC has
set out its goals in various online publications that are designed to be accessible and easily
read.407

Firstly, the government is trying to encourage industry to adopt a more strategic approach
to industrial relations and to integrate industrial relations management into project

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405 See online: Security of Payment Publications/Documents from CPSC Homepage
Assessment of Construction Contractors, online: Security of Payment Publications/Documents from CPSC

406 These actions are called “strategic areas”. See online: Strategic Areas from CPSC Homepage

June 2001) provides an easy link to these publications.
planning. To achieve this, the government has made a commitment to only use service providers who have a demonstrable capacity to effectively plan and manage industrial relations, and will require all of its service providers to achieve an effective industrial relations focus.

Secondly, an attempt is being made to lift occupational safety, health and rehabilitation ("OSH&R") levels in the construction industry. Injury and accident rates are disproportionately high in New South Wales and as a consequence workers’ compensation premiums are also well above average. By using only contractors who have demonstrated OHS&R management system capability, and focusing on OHS&R issues to optimize safety management for the site workforce, the government aims to establish practices that will reduce those rates.

Thirdly, the government has made a commitment to achieve "ecologically sustainable development". It has prepared a set of Environmental Management Systems Guidelines and introduced the concept of the "environmental management plan".

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410 For example, in 1998 the state average for workers compensation premiums was 2.8% while the average rate in New South Wales is 9.36%. See online: OSH&R from CPSC Homepage <http://www.cpsc.nsw.gov.au/ohsr/> (date accessed: 19 June 2001).

411 Ibid.


aim to encourage industry participants to take a systematic approach towards the management of environmental impacts, so that all contractors and subcontractors comply with the environmental conditions of approval for the project and manage environmental risks properly.\footnote{CPSC Environmental Management, supra note 412.}

Fourthly, the government aims to increase the use of information technology in the construction industry. Up until now such use has been quite limited\footnote{Online: Information Technology from CPSC Homepage <http://www.cpsc.nsw.gov.au/infotech/> (dates accessed: 19-20 June 2001).} but it is hoped that this increase will improve communication, reduce coordination errors and increase construction workers’ understanding of their work.\footnote{Ibid.}

Fifthly, the government intends to increase the use of strategic information in construction, in order to “shift business enterprise from a project focus to a more strategic and longer-term perspective”.\footnote{Online: Strategic Information from CPSC Homepage <http://www.cpsc.nsw.gov.au/strategic-info/> (date accessed: 20 June 2001) [hereinafter “CPSC Strategic Information”].} In particular, the CPSC now displays construction industry activity forecasts on the web,\footnote{Construction Industry Activity Forecasts, online: Strategic Information from CPSC Homepage <http://www.cpsc.nsw.gov.au/strategic-info/#ActivityForecasts> (date accessed: 3 July 2001).} surveys CEO’s from the industry, and tries to establish certain key performance indicators to assist small and medium sized businesses.\footnote{CPSC Strategic Information, supra note 417.} Finally, the government has established the concept of the “construct improvement roundtable”, which enables organizations that are interested in improving their performance to exchange ideas and experience and to share knowledge and learning.
with one another.\textsuperscript{420}

Sixthly, an industry Code of Practice and Code of Tendering have been established in an attempt to improve business ethics, practices and standards of behaviour.\textsuperscript{421} The CPSC also aims to exchange information about contractors' compliance with the Codes, and to monitor price movements for material.\textsuperscript{422}

Seventhly, as part of the “management and workforce development action” the CPSC has established training courses in numerous areas in an attempt to increase the levels of education of industry participants.\textsuperscript{423} Many of these courses relate to aspects of the reforms, including an effort that is being made to increase aboriginal participation in construction.\textsuperscript{424}

Finally, the eighth and ninth actions have been termed “continuous improvement” and “encouragement and recognition”.\textsuperscript{425} The continuous improvement action requires government agencies to maintain contractor and consultant performance records that will be prepared in accordance with common criteria. These will be used and exchanged between government agencies to assess contractors and consultants for future engagements.\textsuperscript{426} The rewards and incentives action has not been fully established but it

\textsuperscript{420} Ibid.


\textsuperscript{422} Ibid.


\textsuperscript{425} This action is also known as “rewards and incentives”.

involves the government selecting service providers in the delivery of its capital works program “in a way which encourages industry participants to commit to long-term continuous improvement”.

This will involve the creation of some yet to be decided form of rewards programme.

7 So, What Happens in New South Wales Now?

The New South Wales government’s construction industry reforms have been extensively planned, consulted and researched. Work has commenced on all of the ten CPSC actions, and the results of these actions should become apparent over the next few years. At first changes are likely to occur only in construction projects that government agencies undertake, but the aim is that over time all industry participants will adopt the improved practices.

However, while work has commenced on the CPSC actions, much of this work has not yet been completed. In particular, aspects of the security of payment action currently remain unfinished while the government waits to assess the success or otherwise of the *NSW Security of Payment Act*. Despite the fact that the issues of industry registration and compulsory insurance will arguably affect the potential that the act has to protect construction subcontractors, these matters will not be finalised until the act has operated for some time.

At the same time that the New South Wales reforms remain as work in progress, other Australian states continue to struggle to find the best means to protect their construction subcontractors. While the states appear to agree that some form of protection is warranted, they have each examined different ways in which to structure the protection. Different combinations of trusts, insurance, education, improved licensing schemes, tribunals, standard

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form contracts and tendering reforms have all been considered\textsuperscript{428} and no doubt these states are also watching the New South Wales reforms with interest to see how they progress.

The protection of construction subcontractors in Australia therefore remains as an issue that is very much up in the air. Processes have been designed and changes have been implemented with the best of intentions but with no certainty of success. Amidst all this uncertainty New Zealand has chosen to isolate one aspect of the reforms in the hope that it will resolve its construction problems. And what is more, New Zealand has chosen to modify the \textit{NSW Security of Payment Act} to include features of the \textit{UK Housing Grants Act}, which as the following Section 8 will show, are potentially troublesome in their own right.

\section*{8 Aspects of the United Kingdom System}

The \textit{UK Housing Grants Act} contains many of the same concepts and principles as those in the \textit{NSW Security of Payment Act}, although there are some material differences between the two. Part II of the United Kingdom act contains the provisions that relate to "construction contracts",\textsuperscript{429} but these do not apply to contracts with a residential occupier,\textsuperscript{430} or to contracts

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428 See \textit{Western Australia Report}, supra note 18 at 32-44.

429 Section 104 defines "construction contract" to mean an agreement with a person for any of the following:

(a) the carrying out of "construction operations";

(b) arranging for the carrying out of construction operations by others, whether under sub-contract to him or otherwise;

(c) providing his own labour, or the labour of others, for the carrying out of construction operations, and states that it includes "an agreement to do architectural, design, or surveying work, or to provide advice on building, engineering, interior or exterior decoration or on the laying-out of landscape in relation to construction operations". Section 105 defines "construction operations" to mean operations of a wide variety of sorts, which are very similar to the definition of "construction work" under the New Zealand \textit{Construction Contracts Bill}.

430 Section 105 provides that "a construction contract with a residential occupier means a construction contract which principally relates to operations on a dwelling which one of the parties to the contract occupies, or intends to occupy, as his residence".

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Section 108 enables any party to a construction contract to refer a dispute to adjudication, and that adjudication should take place within 28 days although time periods may be extended.\footnote{In particular, section 108(2)(c) enables the parties to agree to extend the time (presumably indefinitely) that the adjudicator has to reach a decision after the dispute has been referred, and section 108(2)(d) enables the adjudicator to extend that time by up to 14 days provided that he or she has the consent of the parties to do so.} The act also provides that except in limited circumstances a party to a construction contract is entitled to progress payments, but that the parties are free to agree between themselves the amounts of these payments and the intervals at which, or circumstances in which, they become due.\footnote{Section 107. However, note that the writing requirements are flexible so that an exchange of written communications will suffice.} Section 112 grants a party to whom a payment is due the right to suspend work upon giving at least seven days’ notice. Section 113 prohibits “conditional payment” provisions, or pay-when-paid and pay-if-paid clauses. Finally, section 114 provides for the Minister to establish a “Scheme for Construction Contracts”, setting out contractual provisions that will apply in the event that parties fail to include the details that the act mandates in their contract.

For New Zealand’s purposes the most significant feature of the \textit{UK Housing Grants Act} is that it applies to all disputes arising under a construction contract, and not just to payment disputes. In this respect the act is the same as the New Zealand \textit{Construction Contracts Bill},\footnote{Logically, since this feature of the \textit{Construction Contracts Bill} was borrowed from the \textit{UK Housing Grants Act}.} but different from the \textit{NSW Security of Payment Act}. It means that to the extent that United Kingdom case law and commentary discusses the nature of a “dispute”, and the workings of section 108, New Zealand will be able to learn from those discussions. No such questions and issues will arise in New South Wales because the scope of that act is much more limited.
Because the *UK Housing Grants Act* received royal assent on 24 July 1996 there has now been sufficient time for a small body of case law, and a larger body of commentary, to arise. With regard to the case law, in his 2000 article Sydney lawyer Phillip Dawson identified certain United Kingdom cases that interpret aspects of the act, which might be relevant in New South Wales - and consequently New Zealand. In particular, United Kingdom courts have stated that a purported determination of an adjudicator will not be binding on the parties if the construction contract was never subject to the act, that adjudication is a speedy, interim measure, and is not analogous to arbitration, that the decision of an adjudicator may be enforced as a summary judgment and that the courts will expedite cases which concern the enforcement of adjudicators’ determinations.

With regard to commentary, the United Kingdom situation is noteworthy because of the substantial criticisms that have been made of the act. One writer, I. N. Duncan Wallace Q.C. - an experienced construction lawyer and commentator, has been particularly critical of aspects of it, and in particular of that feature discussed above, namely an adjudicator’s broad scope to determine any construction “dispute”. Mr Duncan Wallace’s criticisms are of such a nature and extent that they have led a judge to describe him as having “achieved the

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remarkable position of being a controversialist in the dry area of construction law".440

Mr Duncan Wallace’s primary criticism is that the UK Housing Grants Act’s adjudication scheme has been “mandatorily imposed on all construction contract” and that the categories of dispute so to be regulated are (expressly) entirely unrestricted”.441 He comments that “[t]he Act, with alarming insouciance, mandates adjudication of any dispute of any kind” and notes that “[w]ith equally alarming confidence it also requires an adjudicator’s decision within only 28 days of referral”.442 Then, in a later article he states that:443

The 1996 Act itself represents a careful and deliberately targeted tactical attack, exposed by the detail of the Latham Report on which it was based, against deductions or setoff, even with support of the contract certifier, by owners or other paymaster parties… Few will disagree that the real besetting problems of the construction industry in the United Kingdom are the widespread prevalence of defective work and under-performance generally, far higher building costs than in the rest of Europe; and aggressive and highly sophisticated litigiousness by the industry in which all normal considerations of customer goodwill or budgetary out-turn seem to be disregarded…

For New Zealand’s purposes, Mr Duncan Wallace has three major and relevant complaints about the UK Housing Grants Act. Firstly, he complains about the fact that either party to a contract can apply the act’s adjudication scheme in relation to any dispute. This gives the act

440 Discain Project Services Ltd. v. Opecprime Development Ltd. (11 April 2001), United Kingdom, HT 00-277 (High Court of Justice, Queens Bench Division, Technology and Construction Court) per Judge Bowsher Q.C.
442 Ibid. at 22 [emphasis in original].
(and correspondingly the *Construction Contracts Bill*) much broader potential scope than the *NSW Security of Payment Act* has, and gives rise to the possibility that it might be used in ways for which it was not intended and that are not appropriate. Secondly, he believes that the time limits under the act are unrealistically short and that they will often prevent adjudicators from making fair and properly reasoned determinations. Thirdly, he criticises the fact that the act does not mandate any particular accreditation for adjudicators so that almost anyone may act in this capacity. Both the New Zealand *Construction Contracts Bill* and the *NSW Security of Payment Act* make provision for accreditation requirements to be specified in regulations and Mr Duncan Wallace’s comments should perhaps serve as a warning that such regulations should be prepared.

It is also important to note another article written about the *UK Housing Grants Act* – by Humphrey Lloyd, a judge of the Technology and Construction Court in London. This article was originally presented at a conference in Hong Kong in November 2000 and attempts to advise countries that might be considering adopting United Kingdom style-legislation about the potential benefits and detriments of doing so.\(^{444}\)

Mr Lloyd made reference to several studies that have been conducted in relation to aspects of the *UK Housing Grants Act*, the results of which were not all positive. For example, in one survey of contractors, consultants, subcontractors and employers the respondents reported that nearly 60% of adjudicators’ decisions were not “good” but were “poor” or “moderate”, and 64% of those respondents thought that the adjudication process favoured claimants.\(^{445}\)

Meanwhile 65% of respondents in another study that was carried out at Wolverhampton


\(^{445}\) The study was carried out by *Building*, which Mr Lloyd describes as “a leading construction industry journal in the United Kingdom”, and a “well-known firm of solicitors”, CMS Cameron McKenna. There were over 100 respondents to the survey. (See *ibid.* at 439.)
University described the relationship between parties following adjudication as having a "total lack of trust". The authors of that study commented that "[w]hat is most detrimental to trust is a growing attitude among payees the contractual chain that there is no longer any need to enter into negotiations. In the words of one respondent 'why negotiate when you can just call in the adjudicator?'".

However, other United Kingdom commentators have been more optimistic. In particular, a Glasgow lawyer and commentator has indicated that while it is easy for lawyers to find fault with the UK Housing Grants Act, in practice it works reasonably well. In a 16 September 2001 email Mark Macauley stated that:

...as far as lawyers are concerned, it is easy to argue that the legislation is flawed. A number have argued this to be the case, myself included... It is also easy to criticise some of the judgments made by adjudicators... However, adjudication does produce some effective results and I think that it is probably welcomed by most contractors and in particular sub-contractors, i.e. those people who it was intended to benefit.... Whilst it is not perfect though, there are a number of merits in it and it seems that it is being used more and more in order to resolve disputes. I think that it will be refined over time in order to iron out some problems; whilst it may continue to throw up a number of odd decisions, I think that it is here to stay and probably has more to commend it than to criticise it.

In considering some of the potential problems with the Construction Contracts Bill Chapter IV, Section 6.3 discusses the dangers of the Bill’s broad scope. It appears that while New Zealand researchers have been happy to adopt aspects of the UK Housing Grants Act to provide for this scope, they have carried out little investigation into United Kingdom commentary. At the end of his article H. Lloyd makes several recommendations aimed at any country that might be considering adopting a United Kingdom-adjudication system. The

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446 This survey was entitled "A Study of Emerging Practice" and was authored by I. Ndekugri, R. Yeoman and T. Shaw. See H. Lloyd, supra note 444 at 439-440.
following list borrows some of these recommendations and incorporates other relevant information about the UK Housing Grants Act in order to draw together a list of things that New Zealand should consider:

(a) The origins of adjudication in the United Kingdom construction industry date back to the 1970s when it was introduced for limited purposes between contractor and subcontractor. Over the years the system has evolved and been modified in response to both comments from the industry itself, and reports prepared about the industry - most notably the Latham Report of 1994. It may be unrealistic to think that the New Zealand construction industry will be able to, and will want to, adopt such a major system without having had the same history of it that the United Kingdom has.

(b) The United Kingdom system is also much larger, with better developed legal systems in place than the New Zealand system. For example, Mr Lloyd works as a judge in the Technology and Construction Court, a specialist court of the High Court of Justice of England and Wales. Amongst other things, this court has developed procedures to enable proceedings to enforce adjudicator’s decisions to be heard very quickly. New Zealand has no such procedures in place. In fact, delays in having summary judgment procedures heard have been identified as a real problem in New Zealand construction law.

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447 H. Lloyd, supra note 444 at 440.


449 See Chapter IV, Sections 3 and 6.4 for comments made by the Contractors Federation.
(c) It is important to consider what kind of disputes should be covered by adjudication. It appears that a large number of the disputes that occur in the United Kingdom relate to payment issues, and that at the same time most concerns that have given rise to the perceived need for law reform in New Zealand relate to payment disputes. Given these things, it might be more sensible for New Zealand to follow the limited adjudication scheme provided by the *NSW Security of Payment Act* and for it to not include the broad concept of a "dispute", at least initially. If such limited adjudication proved to be particularly successful in resolving the disputes that it related to, after the legislation had been in place for some time the scope of it could be broadened to accord with the *UK Housing Grants Act* then.

(d) It may be necessary to enact regulations setting out accreditation procedures for adjudicators. In the United Kingdom there appears to be suspicion about the calibre of both adjudicators and their decisions, which presumably threatens to undermine parties' trust and compliance with the system.

As is the case with all relevant aspects of the *NSW Security of Payment Act*, it is essential that New Zealand researchers and legislators pay more serious attention to the United Kingdom commentary, as well as to case law and any legislative amendments to the *UK Housing Grants Act*.

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450 H. Lloyd notes another study, this time prepared by the Adjudication Reporting Centre at the Department of Building and Surveying at Glasgow Caledonian University, about which he comments: "the overwhelming number of disputes recorded in Glasgow Report No 3 were about payment of which 28 per cent were about the valuation of the final account" (see H. Lloyd, *supra* note 444 at 438 and 454).
IV THE NEW ZEALAND SYSTEM

1 The Law Before 1987

Before 1987 Part II of the *Wages Protection and Contractors' Liens Act 1939* protected New Zealand construction contractors from non-payment by providing them with both a lien and a charge. However, the provisions of the act that governed this lien and charge gave rise to a range of problems and led to numerous reforms. Initially these reforms were made without too many difficulties, but over time parties within the construction industry were less and less able to agree about what changes should be made. Ultimately in 1987, after one reform attempt that spanned around twenty years, Parliament repealed all parts of the act that were still in force. In turn this led to a further fifteen-year period during which construction contractors had no special statutory protection whatsoever. Finally now, the New Zealand government has determined that some protection is necessary and Parliament is in the process of determining what form that protection should take.

Part II of the *Wages Protection and Contractors' Liens Act* arose as a result of numerous legislative amendments to the original New Zealand statute to protect construction contractors – the *Contractors' and Workmen’s Liens Act 1892*. The main purpose of Part II was to create the two forms of security, namely the lien and the charge, and it did this in

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451 Part I of the *Wages Protection and Contractors' Liens Act* contained industrial provisions unrelated to the protection of construction contractors that were repealed and replaced with the *Wages Protection Act* in 1964. The current version of this legislation is the *Wages Protection Act 1983*, which provides certain protections to workers including provisions that disallow deductions from wages otherwise than in accordance with the act (see section 4), that prevent an employer from specifying how wages should be spent (see section 12), and that require wages to be paid in money, except in certain circumstances (see section 7).

only half a dozen sections. Any “contractor”, “subcontractor” or “worker” who wished to protect his or her right to be paid for services performed or materials provided was entitled to register a lien against the land or chattels on which the work was done, and/or to register a charge against moneys payable to his or her “employer”, but not against that employer’s money generally.

The two securities created by the *Wages Protection and Contractors Liens Act* gave rise to various complications that required judicial interpretation, particularly because the securities were - as the courts came to term it - “floating”. This meant that while the statute actually created them, they did not become effective until the claimant gave notice that he or she

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454 Definitions were presumably intended to have a similar effect to the North American legislation on which the act was based, and were contained in section 20. This section provided that: “‘contractor’, as regards an employer, means a person who contracts directly with the employer to perform any work; as regards a subcontractor it means a person with whom the subcontractor contracts to perform any work; and ‘subcontractor’ means a person who contracts with a contractor, or with another subcontractor, to perform any work” and “‘worker’ means a person employed in doing work, whether his remuneration is to be according to time or by piecework, or at a fixed price, or otherwise” (J.N. Wilson, *supra* note 452 at 7 and 11). Over time various case law arose in relation to the definitions, which for example determined that an architect was a ‘contractor’ (*Brown v. E. K. Laurie Ltd (in liquidation)*, [1930] N.Z.L.R. 23) and that a consulting engineer could be a ‘subcontractor’ (*Baylis v. Wellington City Corporation*, [1957] N.Z.L.R. 836) (see J.N. Wilson, *supra* note 452 at 7).


456 Section 21(1) *Wages Protection and Contractors’ Liens Act*. Section 20 stated that “‘employer’ means any person who contracts with another person for the performance of work by that other person, or at whose request, or on whose credit, or on whose behalf, with his privity or consent, work is done; and includes all persons claiming under him whose rights are acquired after the work is commenced; but a mortgagee who advances money to an employer shall not by reason thereof be deemed to be an employer” (see J.N. Wilson, *supra* note 452 at 7).

intended to enforce the lien or the charge. Where a claimant intended to lien land or chattels, that notice was to be given both to the owner and to all other parties above the claimant in the chain. Where the claimant intended to charge moneys payable, that notice was to be given to the employer who had the obligation to pay the moneys.

These mandatory notices were significant because once one of them was given, section 31 required the recipient to thereafter retain sufficient money with which to pay the claim and a failure to do so resulted in the imposition of personal liability. However, the notice had to be given while there was still money owing to the defaulting party. Therefore as appears to be the case under all legislation in the area, it was of crucial importance to carry out all of the procedures as quickly as possible.

Another cause of complaint about the act, which was eventually one of the main reasons

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458 For examples of the problems that confronted the courts, see In re Williams (ibid. at 723) where the Court of Appeal grappled with the issue of whether or not a lien or charge was created automatically by the statute, or whether it arose when notice was given in accordance with that statute. Also, in J.J. Craig Ltd. v. Gillman Packaging Ltd (ibid. at 210-211) the Court of Appeal discussed what was the required in order for funds to constitute "moneys payable" in accordance with the act. See also, Farrier Waimak Ltd. v. Bank of New Zealand, [1965] N.Z.L.R. 426 at 442 and Martin Ormandy Ltd. v. McSkimming Industries Ltd. and Others, [1966] N.Z.L.R. 205 at 210-211.

459 Section 20 stated that "Owner" means the person to whom the land and chattels upon or in respect of which any work is to be done belongs; and, in the case of land, includes a person having a limited estate or interest in land" (see J.N. Wilson, supra note 452 at 9).

460 Section 28, Wages Protection and Contractors' Liens Act.

461 Section 29, Wages Protection and Contractors' Liens Act.

462 Section 31 Wages Protection and Contractors' Liens Act.

463 Section 31(2), Wages Protection and Contractors' Liens Act. It was also desirable to register liens against all relevant certificates of title. This is done by lodging a copy of the statement of claim with the land title office who would then register it as if it were a caveat (see section 41, Wages Protection and Contractors' Liens Act and J.N. Wilson, supra note 452 at 70-71).

464 J.N. Wilson, supra note 452 at 70.
given to justify its repeal, was the further retention fund requirements. While section 31 required special funds to be held in the event that a lien or charge was claimed, section 32 required that employers and contractors retain funds of a substantial amount from every contract. It appears that parties found the section 32 requirements arduous, and attempts were made to have the section repealed. According to Wilson: "[p]robably no section of the act or its predecessors has presented such difficulty both in practice and in interpretation as this section. Certainly no section has been amended so frequently".

The various complications associated with Part II of the Wages Protection and Contractors' Liens Act meant that the act was amended numerous times throughout its life, including in 1940, 1951, 1952, 1958 and 1961. These amendments related to a broad range of the act's sections including, amongst others, the retention fund requirements, the definition of "completion of work" and the act's limitation periods. Then in 1964, because of continuing dissatisfaction with its practical workings, a committee chaired by D.F.

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465 See Sir Geoffrey Palmer's comments in Section 2 below.

466 For example, in 1976 section 32 required every employer or contractor to retain the following amounts:

(a) 10% of the first $200,000 or part thereof;
(b) 5% of the next $800,000 or part thereof;
(c) 2.5% of the next $1,000,000 or part thereof;
(d) 1% of the next $2,000,000 or part thereof; and
(e) 0.25% of any amount in excess of $4,000,000 (J.N. Wilson, supra note 452 at 44-45).

467 J.N. Wilson, supra note 452 at 44.

468 The Dugdale Report, supra note 21 at 73.

469 See the Statutes Amendments Act 1951 and the Wages Protection and Contractors' Liens Amendment Act 1961.

470 See the Wages Protection and Contractors' Liens Amendment Act 1958.

471 See the Wages Protection and Contractors' Liens Amendment Act 1961.
Dugdale\textsuperscript{472} was appointed to examine the act and make recommendations. The committee released its findings in 1965, in a publication that came to be known as the "\textit{Dugdale Report}\textsuperscript{473}"

The \textit{Dugdale Report}'s first finding was that although the \textit{Wages Protection and Contractors' Liens Act} allowed for liens to be made against chattels, and for claims to be made by head contractors and workers, these things occurred very rarely.\textsuperscript{474} It appeared that liens against chattels were not seen as being particularly useful and that neither head contractors nor workers used the protections very often. It was estimated that subcontractors made 95\% of all claims, either through a lien over land or a charge over money. According to the committee: "[the statute’s] commonest application by far is to claims by subcontractors (including suppliers of materials) arising out of the financial failure of master builders".\textsuperscript{475}

The second finding was that the act gave rise to problems but that these had not reached such a level to warrant repeal of the legislation. Amendments were recommended to make legislation that the Commission thought could never be perfect but which could be made to be as satisfactory as possible. The Committee gave the following summary of the act’s problems, and suggestions for what action should be taken:\textsuperscript{476}

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\textsuperscript{472} At the time that the \textit{Dugdale Report}, supra note 21 was published Mr D.F. Dugdale was a solicitor from Auckland. Throughout his career he has been senior partner at one of New Zealand’s large commercial firms, President of the Auckland District Law Society, a longstanding member of the Contracts and Commercial Law Reform Committee and the author of several books and article. He is currently a Commissioner with the New Zealand Law Commission Te Aka Matua O Te Ture, and has amongst other things helped to publish \textit{NZLC Report on Insolvency}, supra note 21 (New Zealand Law Commission Te Aka Matua O Te Ture, \textit{Annual Report 2000}, (Wellington: New Zealand Law Commission Te Aka Matua O Te Ture, August 2000)).

\textsuperscript{473} The \textit{Dugdale Report}, supra note 21.

\textsuperscript{474} The \textit{Dugdale Report}, supra note 21 at 74.

\textsuperscript{475} \textit{Ibid.}

\textsuperscript{476} The \textit{Dugdale Report}, supra note 21 at 74-75.
\end{flushright}
It was said that the present statute in its practical working can on occasion lead to odd results. We agree that this is so... It was said that the present statute is fruitful of litigation, with consequent expense and delay in winding up of the estates of insolvent head contractors. We agree that this is so. Any body of law wholly statutory in origin and dealing with an insolvency situation is bound to give rise to litigation...so that while accepting that litigation is an inevitable part of the administration of the present Act or any successor, we do not regard this fact as a convincing argument for total repeal. We do regard this fact, however, as a reason for aiming at as lucid draftsmanship as possible and for trying to devise as speedy and simple a court procedure for determining questions arising under the Act as we are able.

While the committee's representative from the Master Builders' Federation supported absolute repeal of the act, the remaining members did not. This representative saw the potential that an absence of legislation would have to weed out financially weaker parties as a good thing but the majority saw protection as being warranted and did not recommend such a "leap in the dark".\textsuperscript{477}

As part of the decision not to recommend repeal the committee also weighed up, and rejected, various alternatives to the lien and charge. Firstly, it viewed any system of mandatory registration and bonding of head contractors as being too inconvenient.\textsuperscript{478} Secondly, it saw trust funds and trust requirements as having little to offer as an improvement to the New Zealand system.\textsuperscript{479} Thirdly, it considered the option of requiring the consent of

\textsuperscript{477} The \textit{Dugdale Report, supra} note 21 at 76-77.

\textsuperscript{478} The suggestion was that "head contractors should be licensed and bonded in the same way as land agents and motor vehicle dealers". The conclusion was that "we have no doubt that the objects of the statute can be achieved without adopting so manifestly inconvenient a course". Following this, the Committee carried out no further discussion about what the inconveniences of registration and/or bonding might be (see the \textit{Dugdale Report, supra} note 21 at 77).

\textsuperscript{479} The objects of the statute were thought to be attainable "without doing such violence to the existing law of contract as the proposal under discussion envisages". It was acknowledged that trusts used in Canada but the authors commented that "those statutes have retention provisions substantially different from ours".
every subcontractor to be given prior to progress payments being released to the head
contractor as having the potential to put too much power in the hands of subcontractors.\textsuperscript{480} Finally, the committee also considered requiring an owner to check that all subcontractors
had been paid before paying the head contractor, but saw this as being too onerous on the
owner.\textsuperscript{481} As an alternative to all of these schemes the \textit{Dugdale Report} instead recommended
that further minor changes be made to the act, and that it remain in force.\textsuperscript{482}

However despite the depth of research associated with the \textit{Dugdale Report}, its
recommendations failed to provide a solution to the \textit{Wages Protection and Contractors’
Liens Act}’s continuing problems. Substantial efforts were made to implement the
recommendations but in 1969 the bill created to do this lapsed because of a lack of agreement
within the industry.\textsuperscript{483} In 1976 the well-known practitioner and authority on the act, J.N.
Wilson, described it as being: “a difficult, obscure, and technical piece of legislation, and one
that presents serious problems in its application”.\textsuperscript{484} Wilson claimed to support repeal of the
act, a view that finally found favour with the government in 1987.

2 The 1987 Repeal

New Zealand’s extensive reform and deregulation process of the 1980s has become well

\begin{footnotes}
\item[480] The \textit{Dugdale Report, supra} note 21 at 78.
\item[481] \textit{Ibid.}
\item[482] \textit{Ibid.}
\item[483] J.N. Wilson, \textit{supra} note 452 at vi.
\item[484] J.N. Wilson, \textit{supra} note 452 at vi-vii.
\end{footnotes}
publicized across many parts of the western world. It was in this context that frustration with the *Wages Protection and Contractors' Liens Act* reached its height so that, not surprisingly, it became another victim of the reforms. Debate in the House prior to the act’s repeal was aggressive and divided and took place over several days. However, on 2 December 1987 the Right Honourable Geoffrey Palmer (as he then was), Minister of Justice, gathered sufficient support to pass a bill that provided for the act’s repeal, so that New Zealand construction contractors no longer received any special statutory protection.

Sir Geoffrey led the government’s campaign for repeal on the basis that “it had been obvious for more than 20 years that the act did not work well” and that there was “history of dissension within the industry on the matter”. He saw the act as disadvantaging subcontractors (despite their opposition to its repeal) because of the sections 31 and 32 retention fund requirements. He also saw the act as often providing subcontractors with no real advantages because insolvencies frequently meant that no funds were available for

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487 Rt Hon. Sir Geoffrey Palmer held various offices during his Parliamentary career including Deputy Leader of the Opposition, Minister of Justice, Attorney General, Leader of the House, Minister for the Environment, Deputy Prime Minister and Prime Minister. He is currently a partner at Chen Palmer & Partners, Public Law Specialists (Chen Palmer & Partners Homepage <http://www.chenpalm.co.nz/> (date accessed: 30 July 2001)).


490 Ibid.
distribution. In his words: 491

I am completely satisfied that it is not possible to reach agreement with the industry on the reform of the revised liens Act, and the reason is that the interests of contractors and subcontractors are diametrically opposed to each other. Contractors prefer to hang on to retention money for as long as possible and subcontractors prefer to be paid as soon as possible. The time has arrived to let the building industry work out its own solutions... The [current] position is hopeless. The law must go, and I command the repeal of the Act to the House. It has been too many years in coming.

By contrast, the National Party opposition was critical of Labour's haste and alleged secrecy. 492 They drew attention to the fact that a majority of the select committee had recommended that the repeal bill be given further consideration, but that the committee’s chairman – a former litigation lawyer and at that time a Labour MP - overrode this recommendation. 493 They queried why the matter had not been referred to the New Zealand Law Commission, 494 and accused the government of bowing to the wishes of “treasury shock troops”. 495 According to Doug Graham, National member for Remuera: 496

It seems that what has happened is that people have said that it has taken 20 years, and they have got nowhere; the matter is too hard so the Government should repeal the Act. That is not a satisfactory approach by Parliament. It is our job to make the law work.... Parliament will make a grave mistake if it passes the Bill.

491 Ibid.

492 According to Paul East: “Most New Zealanders do not know that the Wages Protection and Contractors' Liens Act is about to be abolished. It was not a measure of its own; it was contained in a clause buried in a Law Reform (Miscellaneous Provisions) Bill” (New Zealand 1987 Hansard, supra note 486, 7 October 1987).

493 New Zealand 1987 Hansard, supra note 486, 2 December 1987 per Kathryn O'Regan.

494 New Zealand 1987 Hansard, supra note 486, 7 October 1987 per Paul East.

495 New Zealand 1987 Hansard, supra note 486, 25 November 1987 per Mr R.J.S. Munro: “it is clear that Treasury shock troops wish, and seek, to have their way. They have told the Government that the Act should be repealed, and after some discussion it is clear that that is what will be done tonight, preferably in short order, as was demonstrated by the previous two divisions”.

Certainly, there do appear to be questions that can be asked about the Labour’s justifications for the repeal. Firstly, Geoffrey Palmer’s references to there being no pool of money available upon a head contractor’s insolvency ignores the act’s main basic achievement, namely to provide security in the form of the lien and the charge. In fact, Sir Geoffrey’s references better describe the subsequent unregulated state of affairs, rather than those under the *Wages Protection and Contractors’ Liens Act*. Secondly, Sir Geoffrey later states: “there is no reason to assume that the building industry is incapable of looking after itself in the same way as its overseas counterparts.” However, there is no evidence in either this speech or any subsequent law reform research to explain which countries these overseas counterparts are. Instead, any such research points to New Zealand being the only country in which the building industry has to look after itself. Finally, Hon. David Caygill, then Minister for Health, stated that there is no legislation parallel to New Zealand’s elsewhere in the world and that no other country sees any need to protect its subcontractors in such a way. However, such a comment ignores the considerable use of builder’s liens across North America and the possibility that New Zealand could have amended its statute to accord with the law in either the United States or Canada.

Thus, Part II of the *Wages Protection and Contractors Liens’ Act* was repealed in an atmosphere of rigorous economic and legislative reform. Both the National Party opposition and the majority of the select committee opposed the repeal, as did all members of the Building Industry Advisory Council except one. The issue was arguably as far away from

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498 Ibid.

499 At that time the Building Industry Advisory Council comprised electrical contractors, painting contractors, master flooring contractors, quantity surveyors, as well as representatives from the Contractors Federation, the Employers Federation, the Master Builders Federation, the Insurance Council of New Zealand, the Plumbers Association and New Zealand’s largest construction company, Fletcher Construction Co. Ltd.. The Council
being unanimous as it could have been and it was inevitable that it would come back to haunt the government some time in the future.

3 1987 to 2001

From 1987 to 1999 New Zealand construction contractors were on their own, with little other than basic consumer protection legislation to protect them from unscrupulous or simply unsuccessful owners, developers and other contractors. However during 1999 and 2000 there were two factors that brought the protection of such contractors forward as an important issue again. The first of these issues was the increasing frequency with which construction firms were becoming insolvent, leading to losses and debts flowing down through the contractual pyramid. The second was the New Zealand Law Commission’s examination and review of the country’s insolvency laws.

The financial failings of GFF Ltd., Tauran Construction Company Ltd. and Hartner Construction Ltd. have already been discussed in Chapter I above. Other New Zealand construction related companies to have experienced recent high profile liquidations include Alotech Walls & Ceilings Ltd., International Building Systems N.Z. Ltd., Goodall A.B.L. Construction Ltd., Construction Mechanics Ltd. and Campbell Construction Company Ltd.500 Many of these liquidations have been blamed on the failings of the other companies, showing

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considered the issue in both April and August 1987. At that time the only member of the council to support repeal of the *Wages Protection and Contractors' Liens Act* was Fletcher Construction Co. Ltd. (*New Zealand 1987 Hansard, supra* note 486, 25 November 1987 per R.J.S. Munro).

how inter-related New Zealand construction companies are.\textsuperscript{501}

These failings have created both a flurry of media attention and various cries for reform. For example, The New Zealand Herald, Auckland’s main daily newspaper, has maintained frequent updates on the Hartner insolvency. These updates, as well as aggressive commentary from quantity surveyor and arbitrator Geoff Bayley, have led Hartner directors to accuse The New Zealand Herald of conducting a “trial by media”.\textsuperscript{502}

Meanwhile, opposition MPs have consistently pressured the government for action. On 12 September 2000 the Hon. Dr. Nick Smith issued a press release to announce the lodging of his Private Members Bill.\textsuperscript{503} This bill was modelled closely on the Law Commission’s Protecting Construction Contractors\textsuperscript{504} and the NSW Security of Payment Act. Since then, Dr. Smith has maintained his pleas for action, including these comments made on 12 January 2001:\textsuperscript{505}

\textsuperscript{501} In addition, the number and range of Hartner subsidiary companies – including Lifestyle Interior Ltd., Lifestyle Interiors Ltd., Hartner Joinery Ltd. and Excell Corporation Ltd. - show how widely the corporate structure is used, and arguably abused, in the New Zealand construction industry (“What is Hartner?” The New Zealand Herald, 3 February 2001, online: The New Zealand Herald Homepage <http://www.nzherald.co.nz/storyprint.cfm?storyID=170926> (dates accessed: February 2001).


\textsuperscript{504} Protecting Construction Contractors, supra note 14.

These latest collapses must spur the Government into action. Associate Commerce Minister Laila Harré has been talking about doing something for months but nothing has yet happened. Every month that passes more small business people like painters, plumbers, electricians, plasterers and glaziers are ruined.

Pressure on the government has therefore been mounting from the media, the industry and the opposition for something to be done. Every new company liquidation sparks a whole new set of demands for action.

New Zealand Law Commission insolvency research and reform proposals have also brought problems in the construction industry to light. The first relevant Law Commission publication was *Priority Debts in the Distribution of Insolvent Estates*,\(^\text{506}\) released in October 1999. This study paper addressed the issues of how preferential status ought to be accorded to certain debts upon insolvency and whether the existing categories of preferred debts could be justified. In examining these issues the Commission considered both the previous and current protection of construction contractors. It noted the difficulties that New Zealand subcontractors face and recommended that further, more detailed research be carried out to consider whether Part II of the *Wages Protection and Contractors' Liens Act* ought to be re-enacted.\(^\text{507}\) It therefore did not actively consider making construction contractors a set of preferred insolvency creditors because it saw lien legislation as the potential source of any statutory protection.

The second relevant Law Commission publication, *Protecting Construction Contractors*,\(^\text{508}\) followed up on this recommendation and was released in November 1999. As part of the

\(\text{must recognise their mistake with the misery caused to so many by Hartner's and Goodall's collapse and support this law change. Small businesses are the backbone of this country and deserve a fairer deal}^{506}\)

\(^{506}\) *NZLC Report on Insolvency, supra* note 21.

\(^{507}\) *NZLC Report on Insolvency, supra* note 21 at 53-54.

\(^{508}\) *Protecting Construction Contractors, supra* note 14.
research for this study paper the Commission consulted the Registered Master Builders Federation, the New Zealand Contractors’ Incorporated and the New Zealand Building Subcontractors’ Federation Incorporated. It cited quantitative research to show that subcontractors were far less likely to be paid on time than head contractors,\(^509\) and concluded that both subcontractors and head contractors ought to be given some form of special protection.\(^510\) However, liens were disregarded as a solution because of the previous difficulties associated with the *Wages Protection and Contractors’ Liens Act*. Other protective devices such as compulsory bonding and the licensing of building contractors were also rejected because they had received little or no support from the consultees.\(^511\) However, it is interesting to note that such devices were apparently not explained to the consultees – they were simply raised as possibilities, and rejected.

In place of liens, bonding and licensing the Commission identified three potential areas of regulation that could help to provide a solution, namely the outlawing of pay-when-paid clauses, the suspension of work by unpaid contractors, and the need for a mechanism to resolve payment disputes.\(^512\) These proposals received support from all of the consultees except the Registered Master Builders Federation, which claimed both that there was insufficient evidence to show that pay-when-paid clauses were such a problem and that it was

\(^{509}\) A 1996 survey conducted by the Business Programmes Division of the Ministry of Commerce produced results to show that head contractors were far more likely to be paid on time or within 30 days than were subcontractors (38% as opposed to 7%), they were also more likely to receive over half their payment on time or within 30 days (93% as opposed to 60%) and more likely to be paid within 90 days (72% as opposed to 29%). These results do not prove that subcontractors suffer unduly – there could be other reasons for that – but they do prove that there are blockages in the system (see *Protecting Construction Contractors*, supra note 14 at 2-3).

\(^{510}\) *Protecting Construction Contractors*, supra note 14 at 4.

\(^{511}\) *Protecting Construction Contractors*, supra note 14 at 5.

\(^{512}\) *Protecting Construction Contractors*, supra note 14 at 11.
too early to adopt the as yet unjudged *NSW Security of Payment Act* system.\(^{513}\) The Contractors Federation did however refer to the possibility that head contractors would either increase prices or pay subcontractors less in order to deal with the increased risk from the outlawing of pay-when-paid clauses.\(^{514}\) It also identified the need for consequential amendments to be made to standard form contracts, and requested that the problem of delays in courts disposing of summary judgment applications be addressed.

Finally at the end of its report in considering potential solutions, the Commission looked towards the laws applying in New South Wales and the United Kingdom. It did not consider returning the issue to the general insolvency reviews such as those contained in *Priority Debts in the Distribution of Insolvent Estates*\(^ {515}\) or *Insolvency Law Reform: Promoting Trust and Confidence*\(^ {516}\) despite the fact that the original reason for removing this issue from those general insolvency reforms was so that re-enactment of the *Wages Protection and Contractors’ Liens Act* could be considered. Instead the Commission decided to consider new Australian and British adjudication scheme solutions, and the possibility of re-enactment of the lien was thoroughly rejected.

Following the release of *Protecting Construction Contractors* the Ministry for Economic Development\(^ {517}\) established a working group to consider payment problems in the

\(^{513}\) *Protecting Construction Contractors*, supra note 14 at 13.

\(^{514}\) In response the New Zealand Law Commission stated that there was no reason to believe that its proposals would result in an increase in construction costs (*Protecting Construction Contractors*, supra note 14 at 12-13).

\(^{515}\) *NZLC Report on Insolvency*, supra note 21.

\(^{516}\) *Supra* note 485.

\(^{517}\) The Ministry of Economic Development used to be known as the Ministry of Commerce. According to its website it “facilitates, leads and implements the Coalition Government’s vision for economic development”. It has been in charge of the implementation of the recommendations contained in *Protecting Construction Contractors*, supra note 14 (see Ministry of Economic Development Homepage <http://www.med.govt.nz/about/index.html> (date accessed: 30 July 2001).
The working group was comprised of various industry members and was chaired by Geoff Bayley. In its report the group agreed that the problem was that “people in the industry are not getting paid on time” and that law reformers should focus on finding solutions that would speed up the progress of payments and discourage ineffective payment practices. The group was strongly in favour of a fast track adjudication scheme and with little or no elaboration rejected alternative options such as compulsory payment bonding, compulsory payment insurance, compulsory licensing of participants in the construction industry, a scheme of statutory trusts or charges, and covenanting. The group claimed to want to keep the focus on keeping businesses solvent rather than “dealing with priority debts on insolvency and risking distortions to the pari passu principles underlying insolvency law”.

The final relevant New Zealand Law Commission publication was Insolvency Law Reform: Promoting Trust and Confidence, released in May 2001. Although this study paper dealt primarily with issues of insolvency unrelated to the protection of construction contractors, it is interesting to examine many of the more general principles described in both this paper

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518 This is the same Geoff Bayley who has frequently been quoted in The New Zealand Herald as calling for reform of the construction industry. See above notes 4 and 502.

519 Working Group Report, supra note 39.

520 Ibid. at 2.

521 The Working Group Report did not explain what it meant by “covenanting”. It is assumed that the Group used the term to refer to (contractual) commitments that might be made for example, by a head contractor to a contractor, under which the head contractor covenanted to apply all funds received to that particular project.

522 Ibid. at 2.

523 Insolvency Law Reform: Promoting Trust and Confidence, supra note 485.

524 The report considers: (1) the role of the state in insolvency law; (2) whether additional provisions should be inserted into New Zealand law to deal with business rehabilitation or reorganization; (3) whether statutory management should be retained; and (4) whether it would be desirable for New Zealand to have a single insolvency statute (Insolvency Law Reform: Promoting Trust and Confidence, supra note 485 at vii-viii).
and in *Priority Debts in the Distribution of Insolvent Estates* because they illustrate the non-interventionalist approach that is and has been behind many recent New Zealand reforms. This approach may help to explain why law reformers are reluctant to create construction legislation to provide security or any other forms of relief from insolvencies.

For example, the authors of *Priority Debts in the Distribution of Insolvent Estates* cite the Australian *Harmer Report* to reject any wide view of insolvency law as “the guardian of values that seem appropriate in the conduct of the credit” in favour of a system where state interference occurs only where it “can be justified by reference to principles of equity and fairness which would be likely to command general public acceptance”. Similarly, the authors of *Insolvency Law Reform: Promoting Trust and Confidence* record the principles for the current insolvency review as being:

> to provide a predictable and simple regime for financial failure that can be administered quickly and efficiently, imposes the minimum necessary compliance and regulatory costs on users, and does not stifle innovation, responsible risk taking and entrepreneurism by excessively penalizing business failure.

The *Construction Contracts Bill* already goes some way to interfere with business and to discourage risk taking – features that have led to criticism that is described in Section 6.1 below. Law reformers may therefore be extremely reluctant to include any mechanisms in the bill that are tougher such as increased forms of security, holdbacks or trust provisions. Reformers also appear to be reluctant to have the bill cross over into the insolvency regime because the two have been dealt with as separate issues. Unfortunately, such reluctance may

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mean that the bill will give rise to many of the problems that are discussed in Section 6, and a solution will be far from simple.

4 Phoenix Companies

The issue of phoenix companies has been another feature of New Zealand insolvency law reform research, and the descriptions of construction insolvencies given in Section 3 above\(^{528}\) show that it is something that is very relevant to the issue of financial protection for construction contractors. It is therefore useful to examine the questions of what phoenix companies are, and what New Zealand is doing to reduce the problems that they cause.

*Phoenix company* is a term used to describe a situation where one limited liability company incurs debts and becomes insolvent following which another limited liability company is created to assume the business of the old, whilst disclaiming any responsibility for the debts.\(^{529}\) In the construction context, at least in Australia and New Zealand the use of phoenix companies creates a problem for subcontractors, who find themselves unable to recover money for unpaid jobs from entities that are in substance the same business.\(^{530}\) New Zealand has considered this problem in relation to its more general insolvency reforms, although the issue still appears to be in need of further examination.\(^{531}\)

As part of the *NZLC Report on Insolvency*\(^{532}\) the New Zealand Law Commission was asked to consider whether problems associated with phoenix companies justified any changes in the

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528 See note 501 and accompanying text.


530 *Western Australia Report*, supra note 18 at 17-18.

531 See *NZLC Report on Insolvency*, supra note 21 at 57-59.

law relating to preferential payments upon insolvency. The Commission identified that phoenix companies do create problems that relate to both insolvency and other areas of the law, but concluded that the issues raised were much wider than the scope of that report.

Phoenix companies attract problems because of the fine line that lies between the lawful and equitable use of a limited liability vehicle, and the unlawful or at least inequitable use of that vehicle. For example, the NZLC Report on Insolvency refers to the fact that it is lawful for an insolvent company to sell its assets in good faith to someone who is prepared to pay market price for them. However, it is not lawful for an insolvent company to instigate such a sale simply in order to rid itself of assets, and consequently liability. As more and more businesses are structured as a group of companies, with each member of the group fulfilling a different aspect of the business, it becomes increasingly difficult to distinguish the former lawful behaviour from the latter unlawful behaviour.

Phoenix companies present a particular problem in the construction industry because of certain features of that industry. Firstly, there is a very high failure rate of construction companies so that insolvencies occur regularly. Secondly, such insolvencies often involve examination of the rights and obligations of owners, contractors and subcontractors, and they are therefore very complicated. Thirdly, such insolvencies may be complicated by the jurisdiction in question’s various lien, holdback, trust and bonding laws, all of which must be reconciled with the relevant insolvency laws. And finally, construction projects result in structures with a long life so that problems may arise during the building process,

533 Ibid. at 58.
534 Ibid.
536 Ibid.
immediately following completion, or at any time in the future. This greatly increases the likelihood that some of the parties involved in the purchase, development, building and sale of the project will have disappeared.

The New Zealand Law Commission did not discuss the issue of phoenix companies in Protecting Construction Contractors, nor has the matter been considered during the research and drafting of the Construction Contracts Bill. Nonetheless, such companies have the potential to create substantial problems for subcontractors, which cannot be resolved through a mere adjudication scheme. If the government intends to create a complete regime to provide proper financial protection for those in the construction industry this is another area of that industry that it needs to examine in more detail. In Canada, contractors and subcontractors have the ability to lien construction land to protect themselves against phoenix companies. In New Zealand and Australia it might be possible to impose personal liability on company directors,537 or to have liability to pass through to successors of the phoenix company,538 although such measures are likely to be extremely unpopular and a satisfactory

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537 Such as through trust provisions.

538 For example, in British Columbia section 95 of the Employment Standards Act (R.S.B.C. 1996, c.113) provides that if the Director of Employment Standards considers that “businesses, trades or undertakings are carried on by or through more than one corporation, individual, firm, syndicate or association, or any combination of them under common control or direction” the Director may treat those businesses etc as one person for the purposes of the act, and they will be jointly and severally liable for all amounts. In addition, Division 3, Part 3 of the Labour Relations Code (R.S.B.C. 1996, c.244) provides that if “a business or a part of it is sold, leased, transferred or otherwise disposed of, the purchaser, lessee or transferee is bound by all proceedings under the Code before the date of disposition and the proceedings must continue as if no change had occurred”.

However, it would require a giant step to carry such concepts from Canada to New Zealand, and from employment law to the construction industry. Given that New Zealand has little if any of a history of carrying over such liability to a successor company, and given the opposition to principles of the Construction Contracts Bill that have already come from the free market right wing (see comments made by both Gareth Morgan, and
solution will be difficult to find.

5 The Introduction of the Construction Contracts Bill

Returning to the Construction Contracts Bill, on 15 May 2001 the Hon. Laila Harré, Associate Minister of Commerce, introduced both the bill and an accompanying press release. According to the press release: “[t]he underlying aim of this Bill is to promote responsible behaviour in the construction industry... [and it] will bring about the end of more than a decade of cash flow problems and insolvency within the construction industry, brought about by the repeal of the Wages Protection and Contractors Liens Act”. On 26 June 2001 the bill received its first reading in the House and it is now with the Finance and Expenditure Select Committee for review.

The explanatory note to the bill sets out its main objective as being to reform the law relating to construction contracts. This is to be achieved through the following three more particular...
aims:

- to facilitate regular payments between the parties to a construction contract;
- to provide for the resolution of disputes arising under a construction contract; and
- to provide remedies for the recovery of payments under a construction contract.

The bill contains an introductory part with preliminary provisions, three further parts providing for each of the three particular aims and a final part containing miscellaneous provisions.

Part 1 of the bill, containing preliminary provisions, sets out both key definitions and when the act will apply. Under the definitions the bill applies to all “construction contracts”, but distinguishes between “commercial construction contracts”, to which all of the bill’s provisions apply, and “residential construction contracts”, to which the default provisions and Part 4 do not apply. A residential construction contract is “a contract for carrying out construction work in which one of the parties is the residential occupier of the premises that are the subject of the contract” and a residential occupier is “an individual who is occupying, or who intends to occupy, the premises that are the subject of a construction contract wholly or mainly as a dwellinghouse”. Thus, contracts for the construction of a residential development or other so-called “residential” premises will not fall within the definition of “residential construction contract” unless the developer/contractor plans to live in that development. Meanwhile, a commercial construction contract is “a contract for carrying out construction work in which none of the parties is a residential occupier of the premises that

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544 As that term is defined in clause 5, Construction Contracts Bill.
545 See clause 8(2).
546 See clause 5.
are the subject of the contract".\textsuperscript{547}

Under the \textit{Construction Contracts Bill}, a construction contract is a contract for the carrying out of “construction work”, a broad term that encompasses most types of work but does not specifically include the supply of materials, the provision of labour or architectural, engineering, surveying or quantity surveying services, or the provision of any of the other goods or services that fall within the definition of “related goods and services” in the \textit{NSW Security of Payment Act}.\textsuperscript{548} This presumably means that the bill will not protect material suppliers, workers, architects or engineers, although workers will retain the priority to four months’ wages that the \textit{Insolvency Act} affords them.\textsuperscript{549}

The bill applies in most situations but, like the \textit{NSW Security of Payment Act}, it does not apply where a construction contract contains or forms part of a loan agreement, guarantee or insurance contract, where consideration is calculated otherwise than by reference to the value of work, or where the person carrying out work is an “employee”.\textsuperscript{550} These exclusions,

\textsuperscript{547} \textit{Ibid}.

\textsuperscript{548} As that term is defined in section 6 of the \textit{NSW Security of Payment Act}, supra note 79.

\textsuperscript{549} See section 104(1)(d) \textit{Insolvency Act 1967}.

\textsuperscript{550} Clause 9(c) provides that the term “employee” is given the same meaning as under section 6 of the \textit{Employment Relations Act 2000}, which provides that it:

(1)(a) means any person of any age employed by an employer to do any work for hire or reward under a contract of service; and

(1)(b) includes:

(i) a homeworker; or

(ii) a person intending to work; but

(1)(c) excludes a volunteer who:

(i) does not expect to be rewarded for work to be performed as a volunteer; and

(ii) receives no reward for work performed as a volunteer.
contained in clause 9, provide for non-typical construction situations where a construction contract actually forms part of a larger loan or other arrangement, or where construction work is being done otherwise than for normal consideration. They also exclude "employees" from protection because such people will already be protected by labour legislation. However, as Section 6.4(b) discusses below, they may open loopholes to enable parties to escape the application of the legislation by fitting themselves into one of the exclusions. In general clause 10 prohibits parties from contracting out of the bill's provisions.

Part 2 of the bill governs payments. Its first subpart provides that any "conditional payment provision of a construction contract" — a definition designed to catch pay-when-paid and pay-if-paid clauses - has no legal effect so that it will not be enforceable and cannot be used as a basis for withholding periodic payments. Its second subpart provides that parties to a construction contract are free to agree on an adequate mechanism for determining the number, intervals and amounts of periodic payments under that contract. However, if they do not provide such a mechanism then the default provisions will apply, so that periodic payments will be calculated for every four weeks' work and will become due ten "working

Under subsections (2) and (3) a Court or Authority that is deciding whether a person is employed by another person must determine the "real nature of the relationship between them" and must consider all relevant matters and must not determine the matter on the basis or a statement by either party describing the relationship.


552 As that term is defined in clause 11(2). The definition uses elements of both the NSW Security of Payment Act, supra note 79 and the UK Housing Grants Act, supra note 80.

553 Clause 11(1).

554 Clause 12.

555 The default provisions are contained in sections 13 to 16.

556 Such payments will be calculated by reference to the value of the construction work carried out during that period, the contract price, other rates set out in the contract, variations agreed to by the parties and the cost of repairing any defects (clause 15).
days\textsuperscript{557} after a “payment demand” is served.\textsuperscript{558} Finally, the third subpart sets up a system to enable a “payee” to serve a “payment demand” on a “payer”\textsuperscript{559} in much the same way that a “claimant” serves a “payment claim” on a “respondent” under the \textit{NSW Security of Payment Act}.\textsuperscript{560} The payer may then respond by providing a “payment schedule” after which the payee may refer the dispute to adjudication.\textsuperscript{561}

Part 3 of the bill governs the adjudication of disputes. Any party to a construction contract is entitled to refer a “dispute” to adjudication\textsuperscript{562} and subparts 2 and 3 set out the procedure that the party, other parties to the dispute and the adjudicator are to follow.\textsuperscript{563} This procedure shares many similarities with the \textit{NSW Security of Payment Act} and again adjudicated disputes may always be appealed in court. However there are some material differences to the New South Wales system, including the fact that the adjudicator is given 20 “working days” in which to make his or her determination, as opposed to the ten “business days” that

\textsuperscript{557} As that term is defined in clause 5.

\textsuperscript{558} Clause 16.

\textsuperscript{559} The term “payee” means “the party to a construction contract who is entitled to a periodic payment” (clause 17); and “payer” means “the party to a construction contract who is liable for that payment” (clause 17). A “payment demand” is a written document identifying certain construction work for which a periodic payment or payments have not been made (clause 18); and a “payment schedule” is another written document identifying the payment demand to which it relates and setting out an amount that the payer intends to pay (clause 19).

\textsuperscript{560} As is discussed in Section 6 below, the \textit{NSW Security of Payment Act} uses language that is arguably more simple because parties are consistently referred to as the “claimant” and the “respondent”, rather than as the “claimant” and the “respondent”, “payee” and “payer”, and “party A” and “party B”.

\textsuperscript{561} Clause 23.

\textsuperscript{562} Clause 23. Clause 5 defines “dispute” to mean “a dispute that arises under a construction contract” and clause 23(2) states that “an example of a dispute is a disagreement between parties to a construction contract about whether or not an amount is payable under the contract (for example, a periodic payment) or the reasons given for non-payment of that amount”. Section 6 discusses potential problems with this definition and example.

\textsuperscript{563} See clauses 26-31 and clauses 32-37.
the *NSW Security of Payment Act* allows.\textsuperscript{564} The most problematic of the differences are discussed in Section 6 below.

Finally, Part 4 of the bill governs “other measures for securing payment under this Act”, namely the suspension of work and charges on land. A party carrying out construction work under a construction contract may suspend work if amounts become owing either because no payment schedule is provided in response to a payment demand, because the payment schedule admits that the amounts are owing, or because the debtor does not comply with an adjudication determination.\textsuperscript{565} Provided that all notice requirements are met,\textsuperscript{566} the party suspending work will not incur any liability for loss suffered as a result of the suspension.\textsuperscript{567}

In addition, if the adjudicator has determined both that money is owed to him or her and that the debtor is a “person related” to the owner then Part 4 will entitle a party carrying out construction work to a charge against the construction site.\textsuperscript{568} The requirement that the debtor be a person related to the owner means that only contractors claiming against owner/developers or subcontractors claiming against contractors that are in fact related to the

\textsuperscript{564} See section 21(3) of the *NSW Security of Payment Act* and clause 36(2) of the *Construction Contracts Bill*.

\textsuperscript{565} See clause 49(1)(a).

\textsuperscript{566} Under clause 49(1)(c) the party suspending work must give five working days’ notice. This compares with the situation under the *NSW Security of Payment Act* where he or she must give two business days’ notice (section 27(1)).

\textsuperscript{567} See clause 49(2).

\textsuperscript{568} Clause 50 provides that “person related” has the same meaning as “the words “person related to a company” in section CF 3(12) of the *Income Tax Act 1994*, except that, for the purposes of this Act, references in that provision to a specified company must be read as if they were references to an owner of a construction site”. Amongst other things section CF 3(12) of the *Income Tax Act* refers to situations in which one party owns, can directly or indirectly control or has the right to acquire 20% of either the ordinary shares in, or voting rights of, the other party. It also refers to situations in which a person is a partner or co-venturer of the company, or a trustee of a trust where the company is capable of benefiting from the trust, whether directly or indirectly. For the purposes of this section any interests held by a person’s spouse, child, spouse of a child or nominee will be attributed to that person.

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owner will be able to register such a charge, and the scope of the charge is therefore limited. This is a remedy that does not exist under the *NSW Security of Payment Act* and Laila Harré has admitted that it is the part of the bill that is most likely to cause controversy. It is one example of the various creative approaches that the bill’s drafters have taken in an attempt to make the legislation more effective than both the *NSW Security of Payment Act* and the *UK Housing Grants Act*, the acts on which the bill is otherwise based.

### 6 Potential Problems with the Construction Contracts Bill

Any legislation that is still at the first reading stage is likely to face significant problems but the *Construction Contracts Bill* appears to be particularly fraught with difficulties. Criticisms can, have, and will continue to be centred both on the bill’s underlying objectives and on specific problems with individual clauses. Such criticism has always been characteristic of the issue of protecting construction contractors and it is doubtful whether the Finance and Expenditure Select Committee will be able to find a comprehensive set of solutions now.

#### 6.1 Objections From those Who Support the Free Market

Act New Zealand generally has the reputation for holding the most strongly right wing views of all political parties. It was therefore not surprising that Stephen Franks, Act New Zealand’s spokesperson during the first reading of the *Construction Contracts Bill*,

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569 See Laila Harré’s First Reading Speech, supra note 542.

570 Act New Zealand currently holds nine out of 120 seats in the New Zealand Parliament (7.5%). All of these MPs are “list MPs”, meaning that they were elected from a predetermined list on the basis of the percentage of votes that the party obtained rather than because they won a majority in their electorates, or ridings. Therefore, Act New Zealand is currently represented in Parliament only because New Zealand has an MMP system. Information about Act New Zealand can be obtained from its website: <http://www.act.org.nz/> (dates accessed: July 2001).
spoke of concerns that the bill would interfere with the freedom of “competent adults” and “free citizens” to agree to their own contractual provisions. Mr Franks expressed doubts that the bill could solve the problems discussed, the majority of which he attributed to projects where the money simply ran out. He claimed not to be convinced of the evils of pay-when-paid and pay-if-paid clauses and pointed out that removing risk from subcontractors would not mean that that risk would disappear. Act New Zealand’s position is that the Construction Contracts Bill will lead to consolidation within the industry as contractors become increasing reluctant to subcontract out work. In turn this will lead to the need for larger and larger companies, many of which will have to come from overseas. In Mr Franks’ words: “[s]ooner or later it is recognised that there are no free lunches... There cannot be a law that is “one size fits all” without there being loss”.

Gareth Morgan, an economist who frequently comments on aspects of New Zealand law and the economy, has also criticized the potential that the Construction Contracts Bill has to interfere with individuals’ and business’ abilities to contract freely. According to Morgan, construction prices are currently kept low because risk is shared across all parties. Therefore, if the bill were to remove risks from subcontractors, prices would inevitably have to rise, both because of the increased risk on other parties and because of the decrease in competition:

Unless there was significant entry by foreign construction companies, the concomitant price escalation

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572 Ibid.
573 G. Morgan, supra note 67.
574 The theory behind this is that contractors’ consolidations and their general reluctance to subcontract out work will cause some subcontractors to go out of business. This will reduce the amount of competition between subcontractors and will consequently result in higher prices and less efficiency. The quote comes from G. Morgan, supra note 67.
would deliver a shrinkage in demand for these sized projects. So the Bill looks very much like an attempt to cure the disease by killing the patient. Why would anyone support a legislative brainwave that is going to shrink the industry?

One final criticism of the bill has come from the National Party opposition, which does not generally advocate the free market to the same extent that Act New Zealand does but which has nonetheless always been New Zealand’s leading centre-right political party. The National Party’s criticism centres on the fact that Laila Harre and those Labour MPs involved with the Construction Contracts Bill have little or no practical experience in, or knowledge of, the construction industry. During debate prior to the bill’s first reading Phil Heatley, National’s member for Whangarei, remarked that Laila Harre and those from the Labour Party have probably never worked on a building site, and had certainly never paid provisional tax. In comparison, he referred to the fact that both he and Nick Smith were engineers and would therefore have “a lot to offer”.

575 The National Party currently holds 39 out of 120 seats in the New Zealand Parliament (32.5%). Information about the National Party can be obtained from its website: <http://www.national.org.nz/> (dates accessed: July 2001).

576 See above note 539.

577 The Labour Party currently holds 49 out of 120 seats in the New Zealand Parliament (40.8%). The Labour Party and the Alliance Party hold the majority under a formal coalition agreement. They also frequently obtain the support of the Green Party (who hold 7 seats (5.8%)) and this arrangement probably represents New Zealand’s most stable government since the first application of MMP in 1996. Information about the Labour Party can be obtained from its website: <http://www.labour.org.nz/> (dates accessed: July 2001).

578 New Zealand 2001 Hansard, supra note 70, 27 June 2001. Provisional tax is deducted in three annual instalments from income that is not otherwise taxed and is therefore usually collected from people who are self employed (see Provisional Tax, online: New Zealand Inland Revenue Homepage: <http://www.ird.govt.nz/resource/publicat/ir289.pdf> (date accessed: 31 July 2001). Mr Heatly was alluding to the fact that Ms Harré is a salary or wage earner, so that she does not need to concern herself with the financial aspects of running a (small) business.

579 Who attempted to introduce a Private Members Bill to protect construction contractors in 1999. See above notes 503 and 505 and accompanying text.
that both the National Party and Act New Zealand intend to monitor the bill’s progress with interest.

6.2 Objections From Canada

Examining the Construction Contracts Bill from a Canadian perspective allows an objective viewpoint, which compares the proposed legislation with the substantial protections provided by the builder’s lien, the holdback and the statutory construction trust. In contrast with the free market theories that see the bill as being over-interventionalist, a Canadian examination makes it appear that the bill does not go far enough.

As was alluded to in the discussion relating to New Zealand’s insolvency reviews, one primary problem with the bill is that it provides virtually no protection for a contractor who is owed money by an insolvent debtor. The adjudication and suspension of work devices may allow the creditor to identify the debtor’s failure to pay earlier than might otherwise happen and to stop work at that point. The statutory land charge will also provide security for a creditor who has been engaged by an owner-contractor. However, because some debts will have to be outstanding before the creditor will ever initiate adjudication and subsequently suspend work, and because the statutory land charge may only be imposed in limited circumstances and therefore not by a typical subcontractor, a creditor runs the substantial risk that he or she will be left with unsecured debts. By contrast in Canada such a creditor will have recourse through the lien, against holdback funds and through use of the trust provisions actionable against individual directors if a breach of trust has occurred.

581 See Section 5 above.
An additional problem is that a “quick and dirty” adjudication process will be unsuitable for large-scale complicated commercial or industrial construction projects. Any project involving numerous parties, large sums of money and/or detailed contractual provisions is likely to be too complicated for an adjudicator to resolve with both the limited evidence that the bill allows and within 20 days.\footnote{Although it appears that drafters have recognised some aspects of this problem because of their decision to change the 10 (business) day period, to 20 (working) days.} Although the bill’s timeframes may be extended, there are problems associated with doing this, as are discussed in Section 5.3 below. Such disputes will almost inevitably end in court anyway, so that the adjudication process may have the potential to serve as a delaying tactic.\footnote{The parties could agree to skip the process altogether since clause 24 provides that nothing in that part of the bill “prevents parties to a construction contract from agreeing (whether before or after a dispute arises) to submit a dispute between them to another dispute resolution procedure (for example, to mediation, arbitration, or to the courts)”. This would mean that the \textit{Construction Contracts Bill} would serve no useful, but also no detrimental, purpose. However, if one party thought that there was a good chance that it would be successful in adjudication it would be likely to use that process. If the adjudicator then determined that that other party owed money, the party would be required to pay the money up-front even if the matter were to be appealed. This problem is discussed in Section 6 below.}

One Canadian lawyer has also expressed doubts about the reliability of using arbitration\footnote{For the purposes of this argument adjudication can be associated with arbitration} in this context. According to Marina Pratchett,\footnote{Interview with Marina Pratchett, \textit{supra} note 52.} arbitration decisions have a reputation for going “50/50” even if there is substantial evidence in favour of one party. She therefore claims that she will recommend arbitration more frequently to a client who has a weaker case, and litigation to a client who has a stronger case.\footnote{\textit{Ibid.}} However, another Canadian lawyer has suggested that there may be sufficient construction and legal...
professionals available in the industry to enable proper decisions to be made. Canadians therefore appear to view the proposed New Zealand system with some suspicion, seeing their builder's and construction lien legislation as providing more comprehensive and reliable protection.

6.3 General Problems With the Bill

In addition to both the free market and Canadian criticisms, there are also several other general potential problems with the Construction Contracts Bill. The first of these is that New Zealand has adopted and modified the NSW Security of Payment Act in isolation from the other reforms that have been planned and are being effected in New South Wales. Chapter III sets out the ten actions that comprise the New South Wales reforms, of which the NSW Security of Payment Act is but one part of one action. While New South Wales carried out three years of comprehensive consultation across the construction industry, New Zealand could be accused of trying to "plug the gaps" with this one lone bill.

A further problem stems from the fact that the NSW Security of Payment Act is being followed by New Zealand before it has had a chance to be tested in Australia. Already there is evidence to indicate that both industry registration and compulsory insurance may not go ahead as initially planned and because the NSW Security of Payment Act was drafted with the view that these things would occur it consequently may now not have the same effect as was intended. In addition, teething problems with specific provisions have not yet had the chance to come to light in Australia and therefore New Zealand cannot have the benefit of removing these from the legislation in advance.

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587 Interview with Derek Brindle, supra note 326.

588 See Section 6.1 above.
The Construction Contracts Bill can also be criticized for certain provisions that have been created because of the drafters’ attempts to “go further” than both the NSW Security of Payment Act and the UK Housing Grants Act do. For example, clause 12 provides that the parties to a construction contract are free to agree between themselves on an adequate mechanism for determining periodic payments. This clause has the admirable aim of attempting to maintain contractual freedom, but leaves scope for considerable problems in determining whether “adequate” means that all the details of a mechanism must be set out or whether it must be fair and equitable as well. A mechanism could foreseeably be “adequate” in providing for periodic payments at say, eight week intervals that are due a further eight weeks after they are claimed, in circumstances where a subcontractor has only agreed to the provisions out of financial and competitive necessity.

Another example of the bill’s intended broad scope arises from provisions that allow parties to a construction contract to modify the bill’s timeframes by agreement. Parties may agree to change the statutory time frames that provide for when a payment becomes due so that a payment demand may be served, when a payment schedule must be provided by, when a respondent must provide his or her adjudication response by,

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589 Laila Harré made this claim that the bill would take New Zealand further than either the New South Wales or the United Kingdom legislation in her speech prior to the first reading (Laila Harré’s First Reading Speech, supra note 542).

590 Most parties appear to agree that one of the inherent problems in the (New Zealand) construction industry is the inequality of bargaining power between subcontractors and others. Allowing parties to change essential aspects of the Construction Contracts Bill is not going to provide a solution. By contrast the NSW Security of Payment Act provides that periodic payments must be due at least every four weeks (see section 8).

591 Clause 18(1).

592 Clause 20(2).

593 Clause 31(1).
and how long the adjudicator has to produce his or her determination. They may also expand the adjudicator’s jurisdiction in any way so that disputes of all types may be heard. Such provisions make it possible for adjudications to stretch out indefinitely and for them to take on litigation style characteristics that the bill presumably did not intend them to have. The only restriction on such time and jurisdictional expansions will be the adjudicator’s duties to act in a timely manner, to avoid incurring unnecessary expense and to comply with the principles of natural justice. Given the inequalities of bargaining power that exist in the construction industry, there will be potential for contractors and subcontractors to “agree” to expansions that significantly disadvantage the subcontractors.

A final example of the drafters’ attempts to go further than both the NSW Security of Payment Act and the UK Housing Grants Act arises from clause 23 and the right of any party to a construction contract to refer a “dispute” to adjudication. Under the NSW Security of Payment Act a claimant may (only) make an adjudication application when an amount in a payment schedule is less than the amount claimed in the payment claim, so that adjudication proceedings will therefore only arise where there is a dispute relating to periodic payments. However, the Construction Contracts Bill goes further than this so that while an example of a dispute is “a disagreement between the parties to a construction contract about whether or not an amount is payable”, a dispute may still be any “dispute that arises under a construction contract”. This definition means that there is the potential for confusion and for unpredictable results because at this stage the bill is not

594 Clause 36(2)(b).
595 Under clause 32.
596 These duties are contained in clause 33.
597 Clause 23(2).
598 Clause 5.
designed or set for any disputes other than those relating to periodic payments. If the adjudication scheme turns out to be effective in resolving payment disputes, lawyers will inevitably attempt to use it for broader purposes and adjudicators may then not be able to cope.

Another substantial problem with the Construction Contracts Bill arises from the fact that it requires amounts determined to be owing to be paid out straight away and does not allow for them to be posted as security until appeals are heard. By contrast, section 23 of the NSW Security of Payment Act allows a respondent to give security for determined amounts by obtaining an unconditional promise from a recognised financial institution, by paying the amount into a designated trust account or by any other method agreed between the parties. This means that even if a court subsequently overturns the determination any loss suffered will be minimal and there will no risk of the claimant absconding with the money. In Chapter III P. Davenport was cited to explain that this is why commentators do not believe that New South Wales adjudicators face much risk of liability and they are therefore unlikely to need professional indemnity insurance.

599 For example, clause 37 sets out the following things that the adjudicator must determine, which noticeably do not include anything other than things relating to periodic payments. They are:

(a) whether or not any of the parties to the adjudication are liable to make a payment under the contract; and

(b) if so, the amount payable; and

(c) the date on which that amount became or becomes payable.

And, as another example, clause 25 provides that if an issue relevant to a dispute is the subject of other civil proceedings, then the court or tribunal must take the adjudication into account. However, rather than providing for this in a general way the section states that the tribunal “must allow for any amount paid to a party to the contract, or for the purposes of, this Part”. The clause therefore only anticipates a dispute resulting in an amount being paid, and does not contemplate any wider form of dispute.

600 Section 23(2)(a) – (c) NSW Security of Payment Act, supra note 79.

601 See above note 383.
However, New Zealand respondents will face a much greater risk of losing their money between the time that they pay it and later appeals. Accordingly, New Zealand adjudicators will also face a greater threat from actions for negligent determinations.

The *Construction Contracts Bill* also introduces two further provisions that are not contained within the *NSW Security of Payment Act*. Clause 45 provides that parties to an adjudication may be represented, whether legally or otherwise. Clause 46 provides that the adjudicator and all parties to a dispute must not disclose any information about the dispute without consent unless it is strictly necessary or unless the information is already in the public domain. The Finance and Expenditure Select Committee will need to decide whether allowing legal representation will defeat the purposes of making the bill’s procedures simple, cheap and accessible to all. They will also need to consider the confidentiality requirements because in its current state clause 46 has the potential for conflict with other clauses.

Finally, one remaining general problem relating to the *Construction Contracts Bill* relates to the statutory land charge provisions. As has already been discussed, Laila Harré freely acknowledges that this part of the bill is the one most likely to cause controversy.

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602 Clause 45(2) states that section 45(1) is subject to the adjudicator’s power to limit such representation “to allow for the efficient conduct of proceedings”. It is uncertain whether this would enable an adjudicator to disallow (legal) representation altogether.

603 Clause 46(2)(c) provides that disclosure is permitted “to the extent that it is necessary for the purposes of, or in conjunction with, the adjudication or the enforcement of the adjudicator’s decision”.

604 Clause 46(2)(b).

605 For example, clause 25 requires the court or tribunal in any other civil proceedings that relate to a *Construction Contracts Bill* dispute to allow for any awards that have been made under the bill. However, if information relating to an award may not be disclosed for confidentiality reasons then that award cannot be allowed for. Clause 46 could also even potentially come into conflict with future appeals.

606 Laila Harré’s First Reading Speech, supra note 542.
Already complaints have been made that the Statutory Land Charges Registration Act is designed to apply in the local government setting and that consequently it may not be appropriate for use in the general construction context. The scope for imposing such a charge will also be very narrow because of the requirement that the respondent be “a person related to the owner”. As Nick Smith put it: “[t]he provisions in this Government bill concerning the provision of a certificate against the title of a building are so narrow that any lawyer with half a brain will drive a bus through them”. While Canadians would argue that such a charge is essential to provide security and should be expanded, it appears likely that the charge’s future in final legislation may be in jeopardy.

6.4 Specific Problems With the Bill

There are also numerous specific problems and questions associated with the bill, the majority of which it is hoped will be ironed out prior to enactment so as to avoid subsequent litigation. The following is a list of some of the issues that the Finance and Expenditure Select Committee needs to address, and there will undoubtedly be many others as well:

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607 New Zealand 2001 Hansard, supra note 70, 27 June 2001 per Richard Worth. Various New Zealand statutes provide that unpaid debts will constitute a charge on property of the debtor, which may be registered under the Statutory Land Charges Registration Act 1928. For example, sections 40 and 42 of the Legal Services Act 1991 provides that where a person is required to make contributions towards legal aid that they receive, unpaid contributions will constitute a registerable charge on that person’s property. Similarly, section 315 of the Resource Management Act 1991 provides that where an enforcement order is made, such as in circumstances where a building permit is not complied with (see New Plymouth District Council v. Wharehoka, [1994] B.C.L. 1391, B.R.M. Gazette 82), and the person against whom the order is made fails to comply with it, any other person who has the consent of the Planning Tribunal may enter on to the land to comply with the order. Then, that other person may recover the costs and expenses of complying with the order as a debt due, and may register a charge if the debt is not paid.

608 See above note 568.

(a) it is uncertain why "related goods and services" have been omitted from the bill, so that material suppliers, labourers, engineers, architects, landscapers and decorators are excluded from the new protections;

(b) section 9 may provide a loophole allowing parties to contract out of the bill's provisions. Amongst other things section 9 provides that the act will not apply to any construction contract that forms part of a loan agreement, guarantee or insurance or that contains provisions relating to a loan, guarantee or indemnity. Although section 9 has been taken directly from the *NSW Security of Payment Act* it may nonetheless still require review to examine any potential abuses. For example, it would appear not to be difficult for an unscrupulous contractor to include loan, guarantee or indemnity provisions in a contract in an attempt to use section 9 to escape application of the statute. The clause 9 exclusions are presumably designed to exempt construction contracts that do not need, or cannot easily be reconciled with, the protections of the *Construction Contracts Bill*. They should not be able to be used as a means for parties to an ordinary construction contract to contract out of the bill's provisions;

(c) there are several terms used in the bill that may have the potential to invoke definitional problems. The problems associated with "adequate" in clause 12 have already been discussed.\(^{610}\) Problems may also arise in determining how quickly actions that must be performed "as soon as practicable" in clause 27 and "at the same time" as each other in clause 30 must be completed. In these clauses it may be useful to moderate the requirements with the insertion of the words "reasonably" or "approximately" as appropriate. Finally, it may also be difficult to determine when

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\(^{610}\) See Section 6.3 above.
a person has an “interest (whether financial or otherwise)” in a construction contract or a “direct or indirect relationship” with a party to such a contract so that they may not act as an adjudicator under clause 28;

(d) the drafters of the *Construction Contracts Bill* have also chosen to alter the definitions of the parties to a construction contract, and the names of some of the documents they must serve. Under the *NSW Security of Payment Act* the parties are referred to as the “claimant” and the “respondent” throughout all proceedings. However, under the bill the parties commence life as the “payee” and “payer”, become the “claimant” and the “respondent” when adjudication proceedings commence and at other times are referred to as “party A” and “party B”.611 These definitions are not only confusing, they are also somewhat inaccurate,612 and it is submitted that the *NSW Security of Payment Act* definitions are preferable. Drafters have also chosen to rename the New South Wales “payment claim” as the “payment demand” and again it is submitted that it would be better to maintain consistency between the two statutes;

(e) clauses 22 and 39 of the *Construction Contracts Bill* allow a payee/claimant to recover amounts agreed or determined to be owing in any court of competent jurisdiction. However, the Select Committee should note that the Contractors Federation’s requests, which were reported in *Protecting Construction*

611 These terms are used in clauses 39 and 49 to describe the consequences of one party failing to comply with an adjudicator’s determination and the consequent suspension of work procedures.

612 In particular, under clause 17 the definition of “payee” refers to a party “who is entitled to a periodic payment” and the definition of “payer” refers to a party “who is liable for that payment”. However, a payee and payer are first termed as such when a dispute initially arises. And, at the time that the dispute initially arises nobody knows who is entitled to what, and who is liable for what. The definitions are therefore based around supposed answers to the very questions that are in issue.
Contractors\textsuperscript{613} and discussed above, that any reforms that were to be carried out would need to address the delays in some parts of the country that occur in disposing of summary judgment applications;

(f) in New South Wales a claimant commences adjudication proceedings by serving an "adjudication application".\textsuperscript{614} However, under the Construction Contracts Bill the claimant must initially serve a "notice of adjudication", and then must later serve an "adjudication claim". In addition, the bill provides for an adjudicator to be selected through a "nominating body" or through an "authorised nominating authority",\textsuperscript{615} whereas the NSW Security of Payment Act only allows for appointments by an "authorised nominating authority". In both cases it is submitted that New Zealand should disregard these modifications and follow the NSW Security of Payment Act unless there are very strong reasons not to;

(g) finally, some of the means of serving notice may not be appropriate given the short times contained within the bill. For example, in clause 53 permits the posting of notices but because a payment schedule will normally have to be served within 10 working days of the payment demand being served this may not be a suitable means of service. The bill also provides for notices to be served by fax and by email and the Select Committee should anticipate that these provisions might give rise to teething problems, particularly with service by email.

In conclusion, the Construction Contracts Bill appears to be subject to a large number of

\textsuperscript{613} Supra note 14 at 12.

\textsuperscript{614} Section 17 NSW Security of Payment Act, supra note 79.

\textsuperscript{615} Under clause 5 a "nominating body" is defined as "a person (whether incorporated or not) who nominates adjudicators for the purposes of this Act" and an "authorised nominating authority" is defined as "a person authorised by the Minister under section 43 to nominate an adjudicator".
potential problems. These problems centre on the philosophical basis behind the bill, on
general problems associated with it and on specific problems with many individual clauses.
In addition, the New Zealand construction industry faces substantial problems from phoenix
companies, an issue that the Construction Contracts Bill does not even attempt to address.
The Finance and Expenditure Select Committee has a difficult and time-consuming task
ahead of it and it is likely both that there may be substantial modifications made before the
bill becomes law and that further law reform measures will need to be taken after the bill
becomes law. The Select Committee indicated that submissions were to be made by 8
August 2001 and that a report will be released on 26 December 2001.\footnote{\textsuperscript{616}}
V AN ANALYSIS OF THE SYSTEMS

1 Introduction

The previous chapters' descriptions of the Canadian, United States, New South Wales, United Kingdom and New Zealand systems have identified two main methods that these countries use to protect construction subcontractors.

- The lien method: some jurisdictions allow builders' liens in order to provide security to subcontractors. In practice there are inevitably additional devices that balance subcontractors' interests against those of owners, lenders, contractors and others.

- The alternative dispute resolution method: the alternative dispute resolution, or “ADR”, method provides “quick and dirty” adjudications so that disputes are heard quickly, before parties with an obligation to pay or be paid become insolvent.

The two methods differ quite substantially from each other, both philosophically and practically. The lien method centres on construction land, and involves the registration of encumbrances on land titles to secure the interests of subcontractors (and contractors). The ADR method follows the growing trend towards the use of alternative dispute resolution in the construction industry. It involves the service of notices, and brief hearings before an adjudicator with the aim of resolving issues before there are irreversible changes, particularly in the viability of firms. The two systems can be expected to have quite different results and it is useful to contrast them in an effort to determine issues that New Zealand law reformers need to consider.

At present, there appears to have been little empirical research undertaken to compare the lien method, the ADR method and any other systems that are used around the world to protect construction contractors and subcontractors. That research that has been undertaken
was described in Chapter I above, but otherwise general concepts and models must be used. Economic analysis provides one means of contrasting the systems, particularly the concepts of *efficiency* and the *perfect contract*. While it is not the aim of this thesis to provide a complete economic analysis of the construction industry, these economic concepts provide a way to understand the strengths and weaknesses of the lien and ADR methods.

In economics, *efficiency* is described in different ways that each focus on the use and sharing of resources in the best way possible. For example, a producer's processes are said to be *productively efficient* if they yield an output with the least cost combination of inputs, or they maximize output for a given set of inputs.\(^{617}\) Similarly, a distribution of goods amongst consumers is said to be *allocatively efficient* if it is impossible to redistribute the goods to make one consumer better off without making another consumer worse off.\(^{618}\) Efficiency is said to be achieved when parties have a *perfect contract* – a contract involving “a promise that, if enforceable, is ideally suited to achieving the ends of the promisor and promisee”.\(^{619}\)

The parties will strive to achieve such a result.

However, the parties may find that *market failure* precludes them from achieving a perfect contract. Such market failure is said to occur when a contract is less than perfect to the extent that performance of the market in question is impaired. It can arise in a number of different ways and in certain circumstances it can justify government intervention.

\(^{617}\) R. Cooter & T. Ulen, *Law and Economics* (Glenview, Illinois: Scott, Forseman and Company, 1988) [hereinafter “Cooter & Ulen 2\(^{nd}\) ed”]. This text, and the subsequent edition cited in note * above, provide a practical explanation of law and economics, and the book is therefore a useful tool in a practical subject area such as construction. Concepts and explanations contained in the book have been used extensively in this thesis because of their potential for direct application to the issue of financial protection for construction contractors. Other more theoretical law and economics texts such as *Economic Analysis of Law*, 5\(^{th}\) ed. (New York: Aspen Law & Business, 1998) by R.A. Posner do not have such direct application and have not been cited.

\(^{618}\) Cooter & Ulen 2\(^{nd}\) ed, supra note 617 at 17-18.

\(^{619}\) Cooter & Ulen 2\(^{nd}\) ed, supra note 617 at 230.
Firstly, and possibly most importantly in this context, market failure can arise when one or both parties lacks important and relevant information. For example, when a subcontractor tenders for a job, he or she is likely to hold substantially less information than the contractor holds about the project as a whole, the financial stability of the contractor, the head contractor and the owner, as well as the quantity and calibre of other tenderers. This may lead that subcontractor to make a bid that is lower than he or she would prefer in an attempt to secure the job. Alternatively, it may lead the subcontractor to forego making the bid at all. Ultimately this renders the market less efficient because tenders will either be artificially deflated because of bidders’ attempts to secure jobs, or will not made at all so that there is decreased competition.

Secondly, market failure can arise when there are *externalities*, i.e. circumstances where the behaviour of third parties affects a contract, or the contract affects third parties. In any construction project a head contractor’s relations (contractual and otherwise) with the owner or developer will inevitably affect subcontractors. For example, the subcontractor is likely to have to satisfy quality requirements that accord with standards set out in the head contract, and may even become bound by the terms of the head contract. Similarly, the activities of one subcontractor on a project may well impinge on other subcontractors in ways not understood at the time that their respective contracts with the head contractor were agreed. For example, if a subcontracting drywaller fails to finish his or her work by the specified deadline this may prevent a subsequent subcontracting painter from starting his or her subcontract on time.

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621 For example, if a subcontracting drywaller fails to finish his or her work by the specified deadline this may prevent a subsequent subcontracting painter from starting his or her subcontract on time.
subcontracts. \(^622\)

Thirdly, market failure can arise when one party has disproportionate market power. In an extreme situation such power will result from a *monopoly*, such that there is a single seller with complete freedom to dictate the price of goods or services sold. \(^623\) However in construction, some disproportionate market power is more likely to result from a subcontractor (or contractor) being at a disadvantage in terms of levels of information, bargaining power and financial resources, but not from a complete monopoly.

### 2 Seven Assumptions About the Perfect Contract

#### 2.1 Introduction

If the *perfect contract* is to be the goal of parties to a construction project, then those parties need to identify and agree on terms which enable them to meet their objectives. To the extent that a contract is less than perfect it can often be restructured, either by the courts after a dispute has arisen, or by regulation in advance of a dispute arising. Cooter and Ulen have identified seven assumptions or features of a perfect contract, all of which these writers believe must be fulfilled in order for efficiency to be achieved. Three of the seven assumptions relate to what is termed “individual rationality”, while the remaining four relate to the “market environment”. \(^624\) In the context of construction subcontractors, it appears that at least five of the seven assumptions have the potential for non-fulfillment.

#### 2.2 The First Assumption: decision makers have stable preferences

The first assumption relating to “individual rationality” is that the decision makers have

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\(^622\) See *Cooter & Ulen 2nd ed, supra* note 617 at 45.

\(^623\) S. Dobson, G.S. Maddala & E. Miller, *supra* note 620 at 170.

\(^624\) *Cooter & Ulen 2nd ed, supra* note 617 at 233-241.
stable preferences.\textsuperscript{625} A rational decision maker must have the ability to rank potential outcomes in order of preference – the decision maker must know what he or she wants. The majority of construction owners, contractors, subcontractors, workers and material suppliers would appear to satisfy this requirement.

2.3 The Second Assumption: the decision maker’s opportunities are properly constrained

The second assumption is that the decision maker’s opportunities are constrained so that he or she can achieve some, but not all, of his or her objectives. Without constraints the parties can both meet all their objectives and there is no resource allocation problem. If, on the other hand, the constraints are too tight agreement cannot be reached. There is also a need to consider the propriety of constraints facing the parties. For example, a construction subcontractor may be constrained by a need to earn a certain income from each contract, or by a shortage of workers, but public policy considerations suggest he or she should not be constrained by threats of violence or a life threatening illness.\textsuperscript{626}

At least in New Zealand, there appears to be evidence that construction subcontractors are constrained by extreme competition within the industry to under-tender on jobs.\textsuperscript{627} In addition, bid shopping, or even just the fear of bid shopping, might also push prices to levels that are not viable. The pressure on subcontractors to make risky decisions to bid on potentially financially dangerous projects so that they can maintain a more or less continuous income appears to have become quite extreme. In such instances subcontractors may just cover their marginal costs but their inability to cover fixed costs

\textsuperscript{625} Cooter & Ulen 2\textsuperscript{nd} ed, supra note 617 at 234.

\textsuperscript{626} Ibid.

\textsuperscript{627} Working Group Report, supra note 39 at 2.
and to meet contingencies may undermine their longer term financial viability. Therefore it is arguable that this second assumption has the potential to not be fulfilled in the construction context.

2.4 The Third Assumption: the decision maker will choose the best feasible outcome

The third and final assumption about individual rationality is that a decision maker who has ranked his or her preferences and who has constrained opportunities will choose the best feasible outcome. Only if the decision maker can be relied on to choose the most favourable options can that decision maker be said to maximize his or her utility or profits (or minimize utility). It seems likely that in most situations construction owners, contractors, subcontractors, workers and material suppliers will satisfy this requirement.

2.5 The Fourth Assumption: there are no third party effects

The first of the market environment assumptions is that the contract in question has no adverse third party effects. Because contracts in the construction pyramid are usually closely interlinked this makes it very likely that this assumption would often not be fulfilled. These third party effects are often referred to as externalities and have been discussed as one of the causes of market failure in Section 1 above. The danger associated with such externalities is that the subcontractor will bargain in good faith but not understand the obligations that might arise from other relevant contracts and be imposed on him or her.

2.6 The Fifth Assumption: each decision maker has full information

The second market environment assumption is that each decision-maker has full

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628 Cooter & Ulen 2nd ed, supra note 617 at 234.
information about the nature and consequences of his or her choice.\footnote{Cooter & Ulen 2\textsuperscript{nd} ed, supra note 617 at 235.} The reasoning behind this assumption is that a decision that appears to be rational may prove irrational if the decision maker is misinformed in some respect.\footnote{Ibid.} Some economists see imperfect information as a market failure in and of itself. It is thought to lead people to miscalculate costs and benefits; and it gives those with full information the incentive to waste resources trying to take advantage of the other party’s ignorance.\footnote{A.W. Katz, ed., \textit{Foundations of the Economic Approach to Law} (New York: Oxford University Press Inc., 1998) at 231.} It seems that in practice construction subcontractors will frequently have few details about the contents of other relevant contracts, and even of contractual terms by which they are bound.\footnote{See above Chapter I, Section 4 and Hinze & Tracey, supra note 6 at 281.} In addition, they may know little about the project as a whole, about financing arrangements or about the owner’s, developer’s and contractors’ financial positions. Consequently, it appears that this assumption is also likely to not be fulfilled.

### 2.7 The Sixth Assumption: each party has alternative trading partners

The third market environment assumption is that there are enough buyers and sellers so that each party to the contract has alternative trading partners.\footnote{Cooter & Ulen 2\textsuperscript{nd} ed, supra note 617 at 235.} Construction subcontractors tend to operate in a relatively limited geographic area in which the number of head contractors will usually be limited. Many subcontracting firms are small\footnote{See Chapter I, Section 2, note 7 and accompanying text.} so that they can undertake only one or two projects at a time and so that gaps between projects result in irrecoverable losses. The consequent bargaining weakness of construction
subcontractors suffer is reflected in their often being forced to make very low bids and to be subjected to unfavourable contractual terms. Gareth Morgan, a New Zealand economist, recently referred to the barriers to entry being too low in the construction industry, meaning that it is too easy for too many parties to enter the market at the bottom end of a construction project. Were there fewer subcontracting firms their size would inevitably be larger and their activities diversified over more projects; the loss of one job would be relatively much less important. It would therefore seem clear that the sixth assumption is also typically not fulfilled.

2.8 The Seventh Assumption: there are no transaction costs

Finally, the seventh assumption is that carrying out a transaction has no cost. Transaction costs is a term used to describe things such as a lack of information, barriers to communication and strategic costs, which hinder a party’s ability to bargain fully. In construction other costs might also relate to locating potential business, negotiating and drafting contracts, settling disputes, engaging lawyers and accountants, or foregoing income when potential jobs are declined. Although such costs are never zero, economic analyses sometimes assume them to be because they are so small in relation to the overall contract price. However, because subcontractors frequently do not negotiate and draft contractual terms adequately, do not engage lawyers or accountants, and suffer losses from foregone income, it appears that in this context they may not be sufficiently close to zero. Therefore, like many of the others, this final assumption seems likely to not be fulfilled.

635 G. Morgan, supra note 67.

636 Cooter & Ulen 2nd ed, supra note 617 at 236.
2.9 Three Remaining Factors

There are three remaining factors that should be mentioned before the seven assumptions are discussed in the context of the lien and ADR methods. The first factor relates to transaction costs and Coase theory, which attributes everything relevant to a market in terms of transaction costs. Thus, negotiating and drafting contracts, settling disputes and engaging lawyers will be transaction costs, but so will the costs of establishing and maintaining any statutory regime for either builder's liens or for adjudication. This means that state intervention will not always necessarily be justified just because there are imperfect contracts or market failures. According to Coase, such intervention should only be permitted where the transaction costs of establishing and maintaining the intervention are less than the transaction costs of the perceived market failures. Arguably, if Coase theory is taken into account, the seventh assumption should be accorded particular importance, over and above the remaining six. If the transaction costs of a particular set of institutional arrangements are too high then it cannot be justified.

The second factor relates to the difficult and unpredictable role that extras play in construction contracts. Because a typical construction contract will take place over a certain period of time, and will require the contractor or subcontractor to tie his or her work in with the work of others, work will sometimes arise and materials will sometimes be required in excess of those anticipated at the outset. This additional work and these materials are termed extras, and are usually billed to the owner or contractor (as applicable) in addition to the contracted progress payments. Such additional bills often cause disputes, and add a degree of uncertainty to almost any construction contract.


638 A.W. Katz, supra note 631 at 41 and 148.
Finally, the third factor relates to the effect that the long-term nature of relationships in the construction industry has on the relevant economic principles and more generally illustrates the limits of a purely economic analysis. According to Cooter: 639

Any long-term human relationship, whether in business or in personal life, is unlikely to be tightly controlled by rules. Rules just do not allow sufficient flexibility for the parties to respond to changing conditions as they pursue their own interests through the relationship. Instead of looking to rules, parties are likely to rely upon informal devices to control their relationship.

It needs to be kept in mind that most parties in a particular construction industry will work with each other on a number of different projects, over long periods of time. While such parties’ lawyers may encourage them to draw up strict contractual terms to govern their relationships, the parties will disregard such terms when the practicalities of a situation demand it. The ideal solution to any construction problem will balance the need for strict legal obligations with the flexibility that the parties require. If a system is too rigid in terms of the rules it imposes it will not be able to operate effectively. Likewise, if an analysis is too rigid in applying economic principles it will not provide a complete solution.

3 Analysing the Lien and ADR Systems

The following sections analyse the lien method, and the New South Wales and New Zealand ADR methods, in terms of the seven assumptions. The aim is to examine each method’s success in meeting these assumptions from the perspective of the three parties discussed in Chapter I, Section 3, namely the owner, the contractor and the subcontractor. These successes are then summarised at the end of each section in a chart that lists the assumptions, and provides scores from zero to two. A score of zero is given if the method appears to give

639 Cooter & Ulen 2nd ed, supra note 617 at 243.
rise to no particular problem; a score of one is given if there appears to be some problem; and a score of two is given if there appears to be a significant problem. The scoring was impressionistic rather than being based on any systematic empirical evidence as might be obtained from a well-designed survey. It is, therefore, indicative rather than definitive. In addition the rating scale chosen is arbitrary, so that while there is an implication that "a significant problem" is twice as bad as "some problem", this need not necessarily be the case. The scoring does, however, provide some comparison of the alternative systems and a way to clarify the factors that New Zealand law reformers might take into account when considering the options. Any better method would require considerable resources and an empirical study, and is beyond the scope of this thesis.

3.1 Applying the Seven Assumptions to the Lien Method

Decision makers who work under the various Canadian and United States lien systems appear to have stable preferences, regardless of whether they are owners, contractors or subcontractors. Each of these parties has the ability to decide what they want and the score attributed to the first assumption under this method is therefore zero. These decision makers' opportunities also appear to generally be properly constrained, although it is arguable that the threat of lien claims limits an owner's absolute freedom. The owner is therefore attributed a score of one for this assumption.

North American decision makers also appear likely to choose the best feasible outcome so that this assumption is not violated. However, this method does appear to give rise to some third party effects. A subcontractor's filing of a lien claim will have a significant effect on the owner while a contractor's failure to pay will have an effect on the subcontractor, and then on the owner if that subcontractor files a claim. The holdback provisions will limit the owner's liability so that this latter event will have less of a third
party effect. It is therefore attributed a score of one, while the potential for effects arising from a subcontractor's actions is attributed a score of two.

With regard to the fifth assumption, North American parties appear to be comparatively well informed. However, while the various statutes enable contractors and subcontractors to request specified information,\textsuperscript{640} owners and contractors still have little or no way of predicting when a lien claim might be filed and this gives rise to another form of information not being available, so that these parties are therefore attributed a score of one for this section. Parties also seem to have better access to alternative trading partners than their equivalents under the New Zealand system do, although at times subcontractors still suffer from the low barriers to entry that typify the construction industry. They are therefore attributed a score of one for this assumption.

Finally, it is important to note that the major failing of the lien method appears to lie with the seventh assumption. Legislative research and drafting procedures associated with the various builder's and construction lien acts have been complicated and time consuming. It also appears from the interviews described in Chapter II that contractors and subcontractors in Canada at least, frequently do not understand how the legislation works. Meanwhile, owners suffer significant transaction costs in removing, or passing on the responsibility to remove, liens from their titles. While the system appears to receive general support, its workings do not appear to be particularly efficient.\textsuperscript{641}

\textsuperscript{640} See for example, section 41 of the Builders Lien Act, which allows a lien holder to seek certain information from the owner or the construction lender, an owner to seek certain information from a contractor or subcontractor, and any other interested party to seek certain information through an application to court.

\textsuperscript{641} However, as Section I described above, there has been little or no empirical research undertaken in Canada or elsewhere to measure and compare the successes and failings of the various systems. This is particularly the case in Canada where law reform commissions appear to have consistently dealt only with potential reforms of the lien systems, and have rarely if ever considered alternative systems (see Chapter II, Section 1.2).
3.2 Applying the Seven Assumptions to the New South Wales ADR Method

For the purposes of this analysis it is most useful to examine the complete proposed New South Wales system, which will be in place when (or if) all reforms are carried out. While Chapter III has made it clear that some of these reforms may never eventuate, it is nonetheless useful to analyse them as a whole. This is because the New South Wales measures aim to create an entire system of reforms and can therefore be contrasted with the proposed New Zealand bill, which consists of the security of payment measures alone. The analysis therefore assumes that all compulsory insurance, builder registration, occupational safety health and rehabilitation, environmental, information technology and other reforms are put in place.
Under the complete proposed New South Wales system it would appear that all parties will have stable preferences, their opportunities will be properly constrained, they will be able to choose their best feasible outcomes and there will be no material third party effects. Subcontractors will suffer the same potential problems as their North American counterparts in obtaining alternative trading partners so that they are attributed a score of one for the sixth assumption. However, otherwise the only problems facing the New South Wales system relate to transaction costs. Unfortunately though, these costs are likely to be significant.

The reforms that Construct NSW sets out are considerable and ambitious. Already the compulsory insurance and builder registration reforms have been put on hold, arguably because they will be too complicated and expensive to be truly feasible. The financial costs, delays, work and education that will need to be put in place to make these reforms work will be considerable so that all sections are attributed a score of two for this assumption, and Coase theory’s questions about whether a system with significant transactions costs should be enacted at all appears particularly pertinent.
3.3 Applying the Seven Assumptions to the New Zealand ADR Method

Under the *Construction Contracts Bill* parties are likely to have stable preferences. However in relation to the second assumption, the Bill is unlikely to remove subcontractors’ problems relating to excess competition, which give rise to improper bidding practices and other unethical behaviour. Optimistically subcontractors are attributed a score of one for this assumption, although if the problems show no sign of improvement a score of two may be more appropriate.

The new system does not seem likely to present any obstacles to prevent the parties choosing their best feasible outcomes so all parties are attributed a score of zero for the third assumption. However, the system will do little to remove a subcontractor from his
or her current position of disadvantage, or to reduce the likelihood that he or she will be forced to commit him or herself to possibly unknown terms in the relevant head contract. Owners therefore have the potential to cause significant third party effects and are attributed a score of two for this fourth assumption, while contractors will likely cause a lesser problem and are attributed a score of one.

Similarly, the *Construction Contracts Bill* will do little to provide subcontractors with more information. Although a contractor or subcontractor will be able to file a payment claim and subsequently instigate adjudication proceedings he or she is likely to still be subject to significant competition and will therefore remain in an inherently disadvantaged position. These parties are therefore attributed a score of one for the fifth assumption. This competition will also limit the availability of alternative trading partners so that contractors and subcontractors are attributed scores of one and two respectively for the sixth assumption.

However finally, the *Construction Contracts Bill* does present some advantages in that it will involve significantly lower transaction costs than either the lien method or the New South Wales system. Research associated with the reforms has been relatively quick and inexpensive, the Bill should not require large amounts of education and it should be relatively easy for contractors and subcontractors to use. Therefore, in this respect the New Zealand model shows considerable advantages over other, more complicated systems.
3.4 A Comparison of the Methods

At first glance the perfect contract analysis makes it appear that the New South Wales ADR method has substantial advantages over both the lien method and the New Zealand ADR method. The New South Wales system seems set to remove almost all significant problems relating to lack of information, improper practices arising from competition and third party effects. By comparison, the lien method renders owners vulnerable to lien claims and does not remove all of the problems relating to competition. Meanwhile, the New Zealand system leaves subcontractors exposed and does not cure the current informational problems.

However, in light of the three factors discussed at the end of Section 2 above, it appears
that the perfect contract analysis may not be entirely accurate. Firstly, given that Coase theory puts primary emphasis on transaction costs, the New Zealand Construction Contracts Bill may be more satisfactory than it first appears. Both the lien method and the New South Wales ADR method involve considerable transaction costs because of the complexities of their systems. In the case of the New South Wales ADR method these complexities are so significant that they may prevent parts of the system being implemented at all. New Zealand may therefore not be better off by attempting to adopt these complex additional devices at this stage, but should nonetheless monitor their progress and effectiveness as they are adopted in Australia.

Secondly, it is important to recognise the limits of a purely economic analysis. As Section 2 identified, the perfect contract analysis does not take into account the uncertainties that arise in construction contracts because of extras. In addition, it does not recognise the effect that construction parties' long-term relationships have on both their behaviour and the extent to which they will follow rules and procedures. Finally, economic analysis arguably has a tendency to favour measures that benefit the system, or the majority, over those that benefit particular individuals.

These limits of economic analysis further support the argument that the proposed New Zealand reforms could potentially be more successful than the perfect contract analysis would have us believe. However, they also indicate the benefits of the New South Wales system. Any ADR adjudication scheme seems likely to aid parties dealing with extras, because such a scheme will enable them to have disputes heard quickly and inexpensively. Similarly, a flexible scheme will allow parties to pay proper account of their relationships, and to adjust the measures that they take to the particular relationship that is in question at each time. The United Kingdom, New South Wales and proposed New Zealand
adjudication systems all provide this flexibility, although arguably, New South Wales' additional measures may impose undesirable regulation on parties' long-term relationships.

Finally, it seems likely that the adjudication systems will advance the rights of the individual and not just those of the system, or the majority. However, the lien system also helps the individual, and in this respect it appears that all of the systems analysed are of greater benefit than the economic analysis makes it appear. The crucial lesson for New Zealand should therefore be to take what it can from the perfect contract analysis, but to consider the transaction costs of any system that it proposes to adopt, and to keep in mind the need to provide a system that is flexible and appropriate to the construction industry.

4 Using Trade Associations as a Solution

Some of New Zealand economist Gareth Morgan's criticisms of the Construction Contracts Bill were described in Chapter IV and his observations about barriers to entry were discussed in Section 2.7 above. Dr Morgan sees the Bill as having the potential to stifle competition and overly penalize owners, developers and construction companies. He cites the construction industry's low barriers to entry as being the cause of its problems because these low barriers allow too many subcontractors who cannot take on what he sees as a necessary share of risk to enter the industry to enter the market.

Morgan has proposed solutions to the problems faced by the New Zealand construction industry that arise from neither the lien method, nor the New South Wales ADR method. In his view these systems impose too much regulation and too many costs on the industry – along the same lines as the argument above relating to transaction costs and Coase theory. He sees the solution as lying not in the implementation of a new statutory regime but with
current trade associations. He believes that organisations like the New Zealand Master Builders Federation have the ability to solve the majority of contractors' and subcontractors' financial problems.\footnote{G. Morgan, supra note 67.}

In Morgan's opinion the solution lies in requiring New Zealand trade associations to move beyond the forms of technical accreditation that they currently provide, so that they will also accredit the "business acumen" of their members. He describes a system of classifying members' balance sheets as "A", "B" or "C", so that those contracting with such parties could anticipate an "A" contractor to have a much better ability to carry financial risk than a "C" contractor. In his words: "[t]hose bodies may have done well at accrediting builders insofar as their ability to wield a hammer effectively and sink a nail plumb, but they haven't even scratched the surface of accrediting the 'business acumen' of their members. This is a huge opportunity".\footnote{Ibid.}

While this solution might be seen as an attractive one because it would require no legislation and only minor set-up costs, it is submitted that it would be more difficult to establish than Morgan implies. The first obstacle facing the solution would be the lack of funding and expertise that such trade associations currently have to carry out this role. Organisations such as the Master Plumbers Association, the Master Builders Federation and the New Zealand Contractors' Association are currently designed to provide technical advice and certification \textit{from trades-people, to trades-people} (and their customers). Requiring the organisations to provide accounting and other financial advice and certification would create the need for substantial educational and other resources. Arguably, it would ask the associations to do something that they were not established to do and simply could not do.
without substantial financial and technical assistance.

The second obstacle facing the solution would arise from the fact that insufficient numbers of contractors and subcontractors actually belong to these associations. For example, Don Fraser the executive director of the Master Painters Association reports that while there are currently around 6,000 people in New Zealand who describe their occupation as “painter”, there are only 600 members of the Association.\textsuperscript{644} Similarly, the estimated 1768 members of the Master Builders Federation make up only 33.3\% of builders in New Zealand, although they are estimated to carry out 75\% of all construction work by value.\textsuperscript{645} However, it is possible that these numbers could increase if there was a significant incentive for contractors and subcontractors to join the associations, and obtain their corresponding accreditations.

Like so many other potential solutions proposed in New Zealand, it appears that Morgan’s ideas would not create as simple and complete an answer to the problems that are faced as he would have us believe. However, the concept of contractor registration would be compatible with the \textit{Construction Contracts Bill}, and ideas about more complete technical and financial accreditation could be considered alongside consideration of the New South Wales plans for registration.

At present, the Master Builders Federation provides guarantees for all deficiencies, including any latent or hidden deficiencies, on residential construction.\textsuperscript{646} It may be possible to build on such concepts, adapting them to apply to commercial and industrial construction, and extending them to apply in the event of insolvency. It might also be possible for bonding

\textsuperscript{644} Email from Don Fraser, Executive Director of the New Zealand Master Painters Association, received on 29 August 2001.

\textsuperscript{645} Email from Jim Hagarty, member of the New Zealand Master Builders Federation, received on 18 July 2001.

companies to provide tools that would complement the associations' services and that could be developed as the market demanded them. However, if any such measures are to be implemented in New Zealand they will require substantial research and resources. Law reformers should consider Morgan's comments, and the possibility of bonding, but will need to invest sufficient time and money into the matter, and be careful to carry out all of the appropriate consultations.
VI SUMMARY AND CONCLUSIONS

1 Introduction

When Hartner Construction went into voluntary liquidation in February 2001 those New Zealand contractors and subcontractors working for the company faced the sad realisation that the majority of Hartner’s debts might now become their own. The New Zealand Herald reported that:647

Around 200 contractors left millions of dollars out of pocket through the demise of Hartner Construction have no guarantees they will ever get paid. Bitter workers met with receivers Pricewaterhouse Coopers on Friday afternoon but were left with many unanswered questions as receiver John Waller prepares to negotiate with moneylenders over unpaid wages. Mr Waller wants to give contractors a guarantee that they will be paid if they continue to work on the Hartner Construction sites around Auckland city. He says he is anxious to get the sites operating again. But workers are sceptical. “You have got us by the neck and we are always going to be swinging in that noose if we go back onto the sites. We want an honest day’s work for an honest day’s pay that’s all we ask for”, says William Schick of B and L Contractors – one of the workers turned away from Hartner’s Princes Wharf $50m Hilton site.

Hartner’s insolvency came hot on the heels of the financial collapse of two other high profile construction companies, GFF Ltd. and Tauran Construction Company Ltd. It created a scurry of media attention and gave rise to a series of angry calls for the government to do something.

Across New Zealand, Australia, Canada, the United States and the United Kingdom there appears to be a fairly consistent belief that the construction industry possesses certain features that makes it unique to other industries, and that give rise to a need for its contractors

and subcontractors to receive special financial protection. In Canada and the United States this belief has led to the maintenance of a well-established builder’s lien system that dates back to 1791. In New South Wales, Australia and the United Kingdom the belief has led to the creation of processes that allow for the adjudication of construction disputes. And in New Zealand the belief initially gave rise to adoption of the builder’s lien, and more recently has led to the creation of the Construction Contracts Bill, based on the New South Wales and United Kingdom adjudication measures.

At the heart of what makes the construction industry unique is its contractual pyramid structure. At the top of a typical construction project an owner employs a developer, who employs a head contractor, who employs contractors, who employ subcontractors, who employ workers and material suppliers. Clearly, this structure gives rise to multiple contracts that create privity of contract problems and that make it difficult for parties at the bottom of the pyramid to enforce payment against parties two or more levels higher up.

However, while parties at the bottom of a project are typically subcontractors, workers and material suppliers, subcontractors bear the brunt of the payment burden. Material suppliers are often comparatively large companies that have sufficient bargaining strength to demand payment up-front and workers will be protected by labour laws. By contrast subcontractors often work individually, or as part of small or medium sized businesses, and lack the legal and financial resources to protect their financial interests adequately.

In addition, there are other obstacles that make it difficult for construction contractors and subcontractors to obtain payment for their work, including the nature of construction work. Such work usually involves the provision of services, or the installation of items that subsequently become fixtures, both of which are irreversible in the event of non-payment. In addition, construction work typically relates to one-off projects that are individually tailored
to the owner's requirements. Consequently, a contractor or subcontractor will not have the ability to refine processes or payment enforcement mechanisms over time.

The use of limited liability corporate structures and "phoenix companies" also presents an obstacle to construction contractors and subcontractors. In a typical scenario a contractor will find himself or herself claiming payment from an insolvent company, while the directors of that company remain free to create a new corporate vehicle for their next venture. Given the substantial increase in the quantity of work subcontracted out that has occurred over the past twenty years, this creates a substantial risk to many people.

Chapter I has described some of the evidence that is available worldwide to illustrate the problems that construction contractors and subcontractors face. This evidence is contained in a wide variety of sources including newspaper articles, journal articles, law reform commission reports, articles from technical magazines and Parliamentary debates. In New Zealand it has been sufficient to convince many of those in the industry, as well as the media and the Parliamentary opposition, that something needs to be done. The pressure is now on the New Zealand government to find a solution to the problems, and to find it fast. This pressure appears to have led to inadequate consideration of both the various systems applying around the world, and the consequences of the proposed New Zealand reforms. It has therefore been the purpose of this thesis to consider those systems and those consequences in more detail.

2 The Canadian Solution

The Canadian common law provinces protect construction contractors by using a builder's lien system, which was originally based on the early United States equivalent. Today these Canadian lien systems remain more unified than their United States counterparts and
therefore provide a better model for analysis. In particular this thesis has examined the British Columbia system both because of its proximity to the author and because it was reformed comparatively recently in 1987.

The builder's lien itself is a device that strongly favours contractors and subcontractors. It is a statutory lien that arises automatically whenever a party performs work or supplies materials on or at an "improvement", as that term is defined. In the event that the party is not paid the lien may be "preserved" through a simple registration process, which will thereafter ensure that the land in question may not be sold or otherwise dealt with unless the payment dispute is addressed.

At various times following its creation, owners, developers, head contractors and lenders all expressed dissatisfaction with the extent to which the builder's lien favoured contractors and subcontractors. In turn this dissatisfaction led to the creation of supplementary devices that aimed to balance the rights of those other parties. One of those devices was the mandatory holdback that, for example, in British Columbia now requires 10% of all contracted amounts to be withheld until certain time limits have expired. This holdback serves two purposes in that it provides a source of funds to satisfy unpaid lien claims and, more importantly, limits the liability of the party withholding it as against claims from parties lower down in the pyramid. British Columbia introduced a major reform when it specified that this holdback was to be retained at all levels of a construction project in almost every contract, a measure that has been termed the "multiple holdback".

The statutory construction trust is another device that supplements the lien, this time by attempting to ensure that all funds intended for a particular project remain within that project. As is the case in the other common law provinces, the British Columbia trust provisions specify that all amounts received by a contractor or subcontractor constitute a trust fund.

193
This means that if the amounts are used for any improper purpose the use will constitute a breach of trust and may result in personal liability.

Across Canada the builder's lien, the holdback and the construction trust have all given rise to problems. Firstly, the lien has strict procedural requirements and it can also be slow and unwieldy. Secondly, the holdback also creates delays and parties sometimes find its increasingly complicated requirements difficult. Finally, the trust is an area of the law that while heavily litigated, can often be uncertain and slow. Problems commonly occur with the trust's privity requirements, with issues relating to co-mingling of trust funds, with the imposition of personal liability on trustees and with confusion relating to whether the trust applies upon bankruptcy. Law reforms such as those implemented in British Columbia in 1987 attempt to resolve these problems but new issues often appear to arise, while reforms often seem to make the systems more confusing to the people that they are intended to benefit.

There are also various other devices that parties in the Canadian construction industry use to protect their financial interests. The bonding and insurance market has adapted itself well to construction, and provides a wide variety of specifically targeted services to owners, contractors and subcontractors. Bonds appear to be particularly useful because they are flexible and adapt to market needs, they serve as a form of screening process and they can often be provided for quite low premiums. The provinces' various Personal Property Security Acts can also provide useful protection, but only where a contractor or subcontractor installs goods that do not constitute "building materials", and where he or she ensures that all necessary registration procedures are carried out.

Finally, there are numerous ways in which alternative dispute resolution, or "ADR", techniques have made their way into the Canadian construction industry, and some of these
techniques can be used to protect the financial interests of contractors and subcontractors. However, the moves towards ADR have arisen from a variety of sources including lawyers and those in the industry, as well as standard form contracts, provincial statutes and court decisions. Therefore perhaps not surprisingly, the moves have not been unified and the extent to which the techniques can be, and are, used appears to be somewhat haphazard.

In preparation for Chapter II interviews were carried out with the head of the British Columbia Law Institute, two construction lawyers, the vice president and legal counsel of the British Columbia Construction Association, a surety broker and a painting contractor. It became apparent from these interviews that despite the number of problems with the Canadian builder’s lien systems that were described both above and in earlier chapters, those involved with the systems appear to have relatively few complaints. Except for the head of the British Columbia Law Institute, all of the people interviewed expressed general satisfaction with the concept of the builder’s lien, the holdback and the construction trust and they identified only minor complaints with aspects of the British Columbia system. These parties supported retention of the lien and, by contrast, appeared to see any adjudication scheme as being lacking in “teeth” because it would provide no real property security and no trust protection to an unpaid contractor or subcontractor.

3 The New South Wales and the United Kingdom Systems

While the Australian construction industry appears to suffer from many of the same problems that the North American industries do, Australian states have never shown the same support for the builder’s lien system that the Canadian provinces and American states have. At times some Australian states have used the builder’s lien to protect contractors and subcontractors but substantial efforts have generally not been made to improve that lien, or to develop the supplementary holdback and trust devices. Instead, in recent times those Australian states
have moved towards greater use of ADR to resolve payment disputes and have attempted to reform and improve aspects of the industry in other ways.

Because New Zealand has chosen the *NSW Security of Payment Act* as a potential model for its proposed legislation, this thesis has examined the progress of the New South Wales construction industry reforms in some detail. During the 1980s and 1990s both the Australian states and the federal government carried out substantial research into a broad range of problems that were seen to arise in the construction industry. New South Wales participated in these moves, and in particular established the Construction Industry Steering Committee, or "CPSC", which was charged with implementing all necessary measures. More recently the CPSC has produced *Construct New South Wales*, a continually updated web-based document that sets out the framework for reform of the New South Wales industry.

The central feature of *Construct New South Wales* is ten actions that have been termed "security of payment", "industrial relations", "occupational safety, health and rehabilitation", "towards an ecologically sustainable industry", "information technology", "strategic information", "business ethics and practice", "management and workforce development", "continuous improvement" and "encouragement and recognition". Each of these actions describes a broad range of measures and reforms that are being developed with a view to improving the industry as a whole. The *NSW Security of Payment Act* represents one part of the first action, namely "security of payment".

As Chapters III and IV have identified, New Zealand reformers have shown considerable interest in the *NSW Security of Payment Act* and have carried over many of its provisions into the *Construction Contracts Bill*. In general terms that act's aim is to ensure that construction industry progress payments are made, and that they are made on time. In order to do this it
sets up a procedure under which an unpaid contractor or subcontractor may alert his or her debtor to the fact that payment has not been made and thereby force that debtor to respond. Then, if this process of alerting and responding does not settle the dispute, the unpaid contractor or subcontractor may take the dispute to “adjudication”. Under this adjudication process an appointed adjudicator will use certain information to make a determination and that determination will have to be produced within a limited time period.

Chapter III has also discussed both the remaining features of the security of payment action and the nine remaining actions. When the New South Wales reforms are considered in totality it becomes clear that by choosing to implement legislation based solely on the *NSW Security of Payment Act*, New Zealand has isolated only one small part of the Australian measures. In particular, it has omitted questions relating to compulsory insurance and mandatory contractor registration, which were always intended to complement the *NSW Security of Payment Act*. These are important issues to consider, and are something that appears to have become problematic in New South Wales. It has also ignored the important features of the remaining actions that have been created, and has thereby lost the opportunity to improve its construction industry as a whole.

In addition to using the *NSW Security of Payment Act*, New Zealand has also modelled parts of its *Construction Contracts Bill* on the *UK Housing Grants Act*. In particular, the *Construction Contracts Bill* has been drafted to apply to any “dispute”, as that term is defined, and therefore will go beyond the narrow range of payment disputes that the *NSW Security of Payment Act* deals with. These attempts to have the bill “go further” than the New South Wales act perhaps represent an effort to address the broader range of issues that the remaining Australian reforms aim to deal with. However, Chapter III has identified that issues relating to the similarly broad scope of the *UK Housing Grants Act* have been very
contentious in that country. Chapter III has also identified that the United Kingdom judicial system and construction industry are both much better set up to facilitate operation of the adjudication legislation than their New Zealand counterparts are. New Zealand may therefore be making a mistake in borrowing from the *UK Housing Grants Act* in this way, and may be better advised to “keep it simple” – at least initially.

### 4 New Zealand Reforms

Prior to 1987 New Zealand contractors and subcontractors were protected by lien and charge provisions that were contained in Part II of the *Wages Protection and Contractors' Liens Act 1939*. These provisions had their origins in Canadian lien legislation and anticipated a similar process under which an unpaid contractor or subcontractor would complete a simple registration process to obtain security over construction land. Then, once the security had been obtained, the construction land would be thereafter prevented from being sold or otherwise dealt with until the payment dispute was addressed.

However, despite the fact that Part II of the *Wages Protection and Contractors' Liens Act 1939* had its origins in Canadian legislation, it lifespan differed from that legislation because it gave rise to a series of problems that became impossible to resolve. Over time despite the government’s considerable efforts to find solutions to these problems, reforms became more and more difficult to implement because the different industry groups were unable to agree on what they should be. Eventually, the government became frustrated with its lack of success in implementing reforms and Part II of the *Wages Protection and Contractors' Liens Act 1939* became another victim to New Zealand’s substantial deregulation process of the 1980s and was repealed.

Chapters I and IV have discussed some of the frequent and high profile construction
insolvencies that have occurred in New Zealand in recent years. It appears that while the majority of contractors and subcontractors were dissatisfied with the provisions of Part II of the *Wages Protection and Contractors’ Liens Act 1939* prior to its repeal, few if any of them would have supported the complete absence of special protection that has applied since then. These contractors and subcontractors have been particularly vulnerable to insolvencies like those of Hartner Construction, GFF Ltd. and Tauran Construction Company Ltd. Many of them have suffered considerable losses and some have been put out of business.

In 1999 the New Zealand Law Commission recognised that there might be a problem in this area and commissioned a special report to investigate whether the builder’s lien should be reinstated. The resulting special report, *Protecting Construction Contractors*,[^648] did not support such reinstatement and instead recommended that New Zealand model new laws on the *NSW Security of Payment Act*. The media and members of the parliamentary opposition both seized upon this report as being a potential solution to the construction industry’s problems and thereafter put considerable pressure on the government to act on it. As a result of this pressure the government prepared the *Construction Contracts Bill*, which had its first reading on 26 June 2001 and is currently before the Finance and Expenditure Select Committee.

The *Construction Contracts Bill* is said to have three aims, namely to facilitate regular payments between the parties to a construction contract; to provide for the resolution of disputes arising under a construction contract; and to provide remedies for the recovery of payments under a construction contract. The bill outlaws pay-when-paid and pay-if-paid clauses and also follows many other provisions of the *NSW Security of Payment Act*. However as was discussed in Section 3 above, it attempts to provide for a wider range of

[^648]: Supra note 14.
disputes than the *NSW Security of Payment Act* does, and it borrows from the *UK Housing Grants Act* to do this. It also introduces an entirely new concept of allowing for registration of a statutory land charge in certain circumstances. Thus, while the *Construction Contracts Bill* is based on New South Wales and United Kingdom precedents it also makes brave attempts to do new things.

Chapter IV has discussed some of the problems that may potentially arise under the *Construction Contracts Bill*, as well as some of the criticisms that have already been made. Those who favour free market policies criticize the bill for inhibiting parties’ freedom of contract. There have also been predictions that the bill’s regulation will necessitate costs, most likely caused by construction companies consolidating and shifting overseas, a decrease in subcontracting out and a consequent increase in industry prices. In addition, it would appear that those with experience in the Canadian construction industry would criticize the bill for not going far enough. The statutory land charge provisions apply only in limited circumstances and in all other situations an unpaid contractor or subcontractor will have no means of obtaining (real property) security with which to protect him or herself.

One of the most major of the potential problems with the bill is that it provides little or no protection for a contractor or subcontractor in the event of insolvency of his or her debtor. While the New Zealand Law Commission first discussed the need for legislation in the insolvency context, *Protecting Construction Contractors* removed it from that context and researchers, drafters and politicians appear to be continuing to try to keep it separate. Arguably by doing so, they are ignoring one of contractors and subcontractors’ biggest problems – how to recover from insolvent debtors.

Other major issues relate to whether the bill and its “quick and dirty” adjudication system will be capable of dealing with large scale and complicated disputes. The bill also fails to
allow parties to post security for debts that have been determined to be owing, which will increase the risk of irreversible loss being suffered when incorrect determinations are made and some time elapses before the matter is brought before the court. Finally, the bill appears to create potential loopholes that will enable parties to contract out of remaining provisions in circumstances where they would not otherwise be entitled to do so.

All of the problems discussed in this Section, in addition to those raised in both Chapter III and Section 3 above relating to New Zealand's failure to consider other News South Wales reforms, mean that the Construction Contracts Bill has a lot of outstanding issues. Despite its admirable purpose, the bill is unlikely to provide any immediate closure to the issue of the financial protection of construction contractors, or to the construction industry in general. If New Zealand is to continue with its attempts to enact an adjudication system, researchers and politicians need to take proper account of New South Wales reforms, and United Kingdom commentary. It is submitted that New Zealand's best solution would be to enact basic security of payment provisions now, and to monitor future New South Wales events carefully, with a view to adopting those measures that can be proven to have been successful. Although this would extend the time and resources needed for reforms, it would provide a more satisfactory solution than the current attempts to broaden the NSW Security of Payment Act by adding United Kingdom provisions.

5 The Perfect Contract Analysis

Although many of the problems that arise in the Canadian, United States, United Kingdom, Australian and New Zealand construction industries are similar, these countries' methods of dealing with them are different. For the purposes of analysis this thesis has termed the type of system in place across North America the "lien method", and the system that is currently in place in the United Kingdom and New South Wales, and is likely to be adopted in New
Zealand, the “ADR method”.

Other than the evidence given in Chapter I, there appears to have been little or no empirical research undertaken to compare the strengths and weaknesses of the lien and ADR methods. Chapter V has therefore borrowed concepts and tools from economics to carry out this comparison, and in particular has adapted Cooter and Ulen’s *perfect contract* analysis to the construction industry. This perfect contract analysis examines seven assumptions about the perfect contract, three of which relate to “individual rationality”, and four of which relate to the “market environment”. The theory behind the analysis is that to the extent that a contract does not satisfy one or more of the seven assumptions, it will be considered to be less than perfect. Furthermore, if the contract is less than perfect to the point that performance of the market in question is impaired, this will cause *market failure*. In certain circumstances economists use market failure as a justification for government intervention.

The Canadian lien method scored well under the perfect contract analysis in the three assumptions relating to individual rationality, although arguably the method presented some risk that lien claims might constrain owners’ freedom. However, it did not score as well in the four assumptions relating to the market environment. In particular, the method appeared to present risks in relation to its effects on third parties, parties’ lack of information and the method’s high transaction costs.

By comparison, the New South Wales ADR method scored very well in relation to most assumptions, and achieved a much better overall score than did the lien method. The ADR method appeared to raise virtually no problems in relation to the first six assumptions although it did receive the maximum (and therefore worst) score in relation to transaction costs. It should be noted that the New South Wales ADR method was assessed on the basis that all of the reforms that the CPSC is currently proposing had already been implemented.
Therefore, the New South Wales construction reforms were assessed in totality despite the fact that at this point the NSW Security of Payment Act is the only measure that has actually been completed. The breadth and quantity of these reforms explains why the method received such a high score in relation to transaction costs. While it may not be realistic to assume that all of the New South Wales reforms will be enacted in this way, it is nonetheless useful to contrast this complete system that those reforms aim to create with the single measure that New Zealand reforms will achieve.

Finally, the New Zealand ADR method also scored well in the assumptions relating to individual rationality, although there did appear to be the potential for constraints on subcontractors’ opportunities. However like the lien method, the New Zealand ADR method did not score as well in the assumptions relating to the market environment. There appeared to be potential problems relating to third party effects, a lack of certain information and the availability of alternative trading partners. There also appeared to be some transaction costs associated with the method, although these were anticipated to be considerably lower than those in both Canada and New South Wales.

In conclusion, Chapter V’s analysis indicated that the New South Wales ADR method would give rise to arrangements that were much closer to the perfect contract than the two other methods would. The New Zealand ADR method obtained a marginally better score than did the Canadian lien method but it appears that the method of scoring was not precise enough for this small difference to be considered indicative. What does appear to be significant is that New South Wales’ carefully researched and planned proposals have the potential to create a system that will be very effective in protecting construction contractors. Furthermore, given that the proposals have such a broad scope, they are likely to be just as effective in the many other areas of construction that they relate to.
However, Chapter V has also indicated that it is important to recognise the weaknesses of an economic analysis, and to examine these weaknesses in order to ascertain what additional things can be learnt about the construction industry. The Cooter and Ulen perfect contract analysis appears to have three weaknesses, namely its failure to acknowledge the significance of transaction costs and to recognise that the costs of a system itself are transaction costs; its failure to recognise the role that extras play in construction contracts; and finally its failure to recognise the effect that the long-term relationships that are common to the construction industry may have on parties’ willingness to follow strict statutory rules and procedures.

By examining these three weaknesses it is submitted that New Zealand should take note of certain things. New Zealand should realise that the New South Wales reforms are likely to provide an effective and broad solution to problems in the construction industry. However, it should also note that the reforms will be expensive to establish and they may be too rigid to allow the flexibility that both extras and the construction industry’s long-term relationships require. New Zealand may therefore prefer to leave itself open to adopting any or all of the reforms, but to wait sometime before it does so. In the meantime it is submitted that it should not attempt to close the matter by adopting the broad approach of the UK Housing Grants Act, or by creating its own system of statutory land charges. These measures have no guarantee of success and will merely prevent New Zealand from adopting other aspects of the New South Wales system.

One further measure that New Zealand may wish to consider, perhaps in the future, and in conjunction with New South Wales reforms, is the additional roles that both trade associations and surety companies could play in the construction industry. Chapter V has discussed Gareth Morgan’s proposals for trade associations to provide financial accreditation for their members. Chapter II has discussed both the way that surety companies operate in
Canada and the fact that these companies appear to be keen to extend their operations in Australia and New Zealand. If trade associations were to provide this financial accreditation and surety companies were to provide specialist bonds as and when they were required, owners, contractor and subcontractors would have means of obtaining security for their work and investments. It is submitted that these means of obtaining security would be preferable to the current proposed system of statutory land charges.

6 Final Words

The New Zealand government seems determined to introduce legislation to protect construction contractors' financial interests and evidence from both New Zealand and overseas appears to support the need for it. Systems based around the builder’s lien work comparatively well in the United States and Canada but have fallen out of favour in New Zealand and Australia. Instead, New Zealand is in the process of preparing and enacting the Construction Contracts Bill, which is modelled on a New South Wales statute but which also incorporates aspects of United Kingdom legislation, as well as other additional features.

This thesis has examined the United States and Canadian lien systems, the New South Wales and United Kingdom adjudication systems and the history and current state of New Zealand law in this area. It has also used tools and concepts from economics to analyse and compare the lien and adjudication systems, both with each other and with the Construction Contracts Bill. As a result of this analysis and comparison certain things have become evident.

The lien systems in place across Canada are relatively similar, and new reforms such as the British Columbia Builders Lien Act have been designed to improve these systems, rather than to alter them substantially. Nonetheless, there are still some problems remaining particularly because lien, holdback and construction trust provisions appear to have become increasingly
complicated, so that those whom they are intended to benefit do not always understand them. Although people in and involved with the British Columbia construction industry show support for the lien method, New Zealand is unlikely, and would not be advised, to adopt this method in totality. However, New Zealand could benefit from examining what the most successful aspects of the lien, the holdback and the trust are.

Since the early 1990s New South Wales has been undertaking reforms that have addressed the construction industry and its problems as a whole. The CPSC has laid out ten actions that aim to improve the entire nature of construction in that state. These actions are ambitious and some of them have already proved to be difficult, if not impossible, to reach consensus on and to implement. However, Chapter V’s adaptation of Cooter and Ulen’s perfect contract analysis has shown them to be likely to lead to fairer contractual arrangements than either the lien method or the New Zealand ADR method have the potential to do.

The United Kingdom construction industry also applies an adjudication method and has done so for some time, although in different forms. This method applies more broadly than the _NSW Security of Payment Act_ provisions do, and can be invoked in relation to any “dispute”, rather than just to matters relating to payment. However, United Kingdom commentators have criticized this broad scope and it appears to give rise to some problems. It may therefore be unwise for New Zealand to adopt similar provisions, particularly given that neither that country’s judiciary nor its construction industry are as well established to facilitate such provisions as the United Kingdom equivalents are.

The best position for New Zealand to take may be to implement reforms in stages, so that they can be as effective as possible. Although the New South Wales lien method received the best score in the perfect contract analysis, it is likely to be expensive and may provide a system that is somewhat rigid and inflexible. New Zealand may therefore be advised to
implement basic security of payment provisions modelled on the *NSW Security of Payment Act* and to thereafter wait and see which of New South Wales's other reforms are successful. Trade associations and surety companies may also be able to provide useful information and security. However, New Zealand should not attempt to provide a complete solution now simply by adopting isolated features of the *UK Housing Grants Act* and additional statutory land charge provisions.

The New Zealand construction industry appears to have faced problems in protecting contractors and subcontractors ever since the precursor to Part II of the *Wages Protection and Contractors Liens Act 1939* was enacted in 1892. It cannot expect that those problems can be solved now simply with the swift enactment of one sole act.
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Definitions and interpretation

1 (1) In this Act:

"certificate of completion" means a certificate under section 7 stating that work under a contract or subcontract has been completed and includes an order made under section 7 (5);

"claim of lien" means a claim of lien in the prescribed form;

"class of lien claimants" means all lien claimants engaged by the same person in connection with an improvement;

"completed", if used with reference to a contract or subcontract in respect of an improvement, means substantially completed or performed, not necessarily totally completed or performed;

"contractor" means a person engaged by an owner to do one or more of the following in relation to an improvement:

(a) perform or provide work;

(b) supply material;

but does not include a worker;

"court" means the Supreme Court;

"head contractor" means a contractor who is engaged to do substantially all of the work respecting an improvement, whether or not others are engaged as subcontractors, material suppliers or workers;

"holdback period" means the period of time calculated under section 8;

"improvement" includes anything made, constructed, erected, built, altered, repaired or added to, in, on or under land, and attached to it or intended to become a part of it, and also includes any clearing, excavating, digging, drilling, tunnelling, filling, grading or ditching of, in, on or under land;

"land title office" means the land title office for the land title district or districts in which the land or any part of it is located and on which the improvement is made or is being made;

"lien claimant" means a person who files a claim of lien under this Act;

"lien holder" means a person entitled to a lien under this Act;

"material" means movable property that is delivered to the land on which the improvement is located and is intended to become part of the improvement, either directly or in a transformed state, or is consumed or used in the making of the improvement, including equipment rented without an operator;

"material supplier" means a contractor or subcontractor who supplies only material in relation to an improvement;

"notice of certification of completion" means a notice in the prescribed form stating that a certificate of completion or a court order to the same effect has been issued;
"notice of interest" means a notice in the prescribed form warning other persons that the owner's interest in the land described in the notice is not bound by a lien claimed under this Act in respect of an improvement on the land unless that improvement is undertaken at the express request of the owner;

"notice to commence an action" means a notice in the prescribed form requiring a claim holder to commence an action to enforce a claim of lien;

"operator" means an individual who operates equipment at an improvement site but does not include an individual who temporarily or periodically is present at the improvement site to install, inspect, service, empty or remove equipment;

"owner" includes a person who has, at the time a claim of lien is filed under this Act, an estate or interest, whether legal or equitable, in the land on which the improvement is located, at whose request and

(a) on whose credit,

(b) on whose behalf,

(c) with whose knowledge or consent, or

(d) for whose direct benefit

work is done or material is supplied, and includes all persons claiming under the owner, but does not include a mortgagee unless the mortgagee is in possession of the land;

"registrar" means the registrar of a land title office;

"required holdback" means, in relation to a contract or subcontract, the amount required under section 4 to be retained from payments under that contract or subcontract, less any payments made under an entitlement to payment arising under section 9;

"services" includes

(a) services as an architect or engineer whether provided before or after the construction of an improvement has begun, and

(b) the rental of equipment, with an operator, for use in making an improvement;

"subcontractor" means a person engaged by a contractor or another subcontractor to do one or more of the following in relation to an improvement:

(a) perform or provide work;

(b) supply material;

but does not include a worker or a person engaged by an architect, an engineer or a material supplier;
"wages" means money earned by a worker for work and includes

(a) salaries, commissions or money, paid or payable by an employer to an employee for work,

(b) money that is paid or payable by an employer as an incentive and that relates to hours of work, production or efficiency,

(c) money, including the amount of any liability under section 63 of the Employment Standards Act, required to be paid by an employer to an employee under that Act,

(d) money required to be paid in accordance with a determination or an order of the tribunal under the Employment Standards Act,

(e) money required under a contract of employment to be paid, for an employee's benefit, to a fund, insurer or other person and includes money payable under Parts 10 and 11 of the Employment Standards Act, and

(f) money required to be paid under a collective agreement;

"work" means work, labour or services, skilled or unskilled, on an improvement;

"worker" means an individual engaged by an owner, contractor or subcontractor for wages in any kind of work, whether engaged under a contract of service or not, but does not include an architect or engineer or a person engaged by an architect or engineer.

(2) For the purposes of this Act, a head contract, contract or subcontract is substantially performed if the work to be done under that contract is capable of completion or correction at a cost of not more than

(a) 3% of the first $500,000 of the contract price,

(b) 2% of the next $500,000 of the contract price, and

(c) 1% of the balance of the contract price.

(3) For the purposes of this Act, an improvement is completed if the improvement or a substantial part of it is ready for use or is being used for the purpose intended.

(4) For the purposes of this Act, the construction of a strata lot, as defined by the Strata Property Act, is completed, or a contract for its construction is substantially performed, not later than the date the strata lot is first occupied.

(4.1) With respect to common property or common assets held by a strata corporation under the Strata Property Act, for the purposes of sections 7 and 41 of this Act, and any other provision of this Act specified in the regulations, the strata corporation is deemed to be the owner.

(4.2) With respect to common property or common assets held by a strata corporation under the Strata Property Act, for the purposes of section 25 of this Act and any other provision of this Act specified in the regulations, a reference to an owner includes the strata corporation.
(5) For the purposes of this Act, a contract or improvement is deemed to be abandoned on the expiry of a period of 30 days during which no work has been done in connection with the contract or improvement, unless the cause for the cessation of work was and continued to be a strike, lockout, sickness, weather conditions, holidays, a court order, shortage of material or other similar cause.

(6) Anything that may be done under this Act by or with reference to an owner, contractor, subcontractor, worker or mortgagee is valid if done by or with reference to an agent of that person.

Exemptions

1.1 Nothing in this Act extends to any of the following:

(a) a highway, as defined by the Highway Act, or to any improvement done or caused to be done on it by a municipality, the Minister of Transportation and Highways, the BC Transportation Financing Authority or its subsidiaries or any other public body designated by regulation;

(b) a forest service road, as defined in the Forest Act, or any improvement done or caused to be done by or for the Minister of Forests.

Lien for work and material

2 (1) Subject to this Act, a contractor, subcontractor or worker who, in relation to an improvement,

(a) performs or provides work,

(b) supplies material, or

(c) does any combination of those things referred to in paragraphs (a) and (b)

has a lien for the price of the work and material, to the extent that the price remains unpaid, on all of the following:

(d) the interest of the owner in the improvement;

(e) the improvement itself;

(f) the land in, on or under which the improvement is located;

(g) the material delivered to or placed on the land.

(2) Subsection (1) does not create a lien in favour of a person who performs or provides work or supplies material to an architect, engineer or material supplier.

Deemed authorization

3 (1) An improvement done with the prior knowledge, but not at the request, of an owner is deemed to have been done at the request of the owner.
(2) Subsection (1) does not apply to an improvement made after the owner has filed a notice of interest in the land title office.

(3) Subsection (1) does not apply to an improvement on land owned by the government.

**Holdback**

4 (1) The person primarily liable on each contract, and the person primarily liable on each subcontract, under which a lien may arise under this Act must retain a holdback equal to 10% of the greater of

(a) the value of the work or material as they are actually provided under the contract or subcontract, and

(b) the amount of any payment made on account of the contract or subcontract price.

(2) The obligation to retain the holdback under subsection (1) applies whether or not the contract or subcontract provides for periodic payments or payment on completion.

(3) For the purposes of subsection (1), value must be calculated on the basis of the contract or subcontract price or, if there is no specific price, on the basis of the actual value of the work or material.

(4) Subject to section 5 (4), if a mortgagee is a savings institution and is authorized by the owner to disburse the money secured by a mortgage, the mortgagee may retain as a holdback the amount required to be retained by the owner as the payor on the contract and the retention by the mortgagee of that amount is deemed to be compliance with this section by the owner.

(5) Subject to section 5 (4), a mortgagee who retains or agrees to retain a holdback under subsection (4) of this section

(a) has the same rights and obligations in relation to the holdback as if it had been retained by the owner, and

(b) is liable to the owner or any lien holder who suffers loss or damage as a result of the failure of the mortgagee

(i) to retain the holdback as agreed, or

(ii) to fulfill the mortgagee's obligations in relation to the holdback.

(6) Despite subsection (1) (a), a holdback must not be retained from a worker, material supplier, architect or engineer.

(9) Subject to section 34, a holdback required to be retained under this section is subject to a lien under this Act, and each holdback is charged with payment of all persons engaged, in connection with the improvement, by or under the person from whom the holdback is retained.

**Holdback account**

5 (1) Subject to subsection (8), an owner must
(a) establish at a savings institution a holdback account for each contract under which a lien may arise,

(b) pay into the holdback account the amount the owner is required to retain under section 4, and

(c) administer the holdback account together with the contractor from whom the holdback was retained.

(2) Subject to sections 9 and 34, all amounts deposited into a holdback account

(a) are charged with payment of all liens arising under the contractor from whom the holdback was retained,

(b) subject to paragraph (a), are held in trust for the contractor referred to in paragraph (a), and

(c) must not be paid out of the account without the agreement of all the persons who administer the account.

(3) An administrator of a holdback account may apply to the court for directions respecting administration of the account, and the court may make any order it considers appropriate, including one or more of the following orders:

(a) that the owner establish and maintain a holdback account as sole administrator;

(b) that some or all of the money in the holdback account be paid into court under section 23 for the removal of claims of lien;

(c) that an administrator be removed or replaced;

(d) that a lien holder be paid.

(4) If the mortgagee retains a holdback under section 4 (4), this section other than this subsection does not apply.

(5) If there is more than one owner, only one of the owners is required to establish and administer the holdback account.

(6) Unless otherwise agreed, interest on the holdback account accrues to the owner during the holdback period and after that accrues to the credit of the contractor from whom the holdback was retained.

(7) Failure by the owner to comply with subsection (1) (b) constitutes an act of default under the contract and the contractor, on 10 days' notice, may suspend operations for as long as the default continues.

(8) This section does not apply to
(a) if it is an owner, the government, a government corporation as defined in the Financial Administration Act or any other public body designated, by name or by class, by regulation, or

(b) a contract in respect of an improvement, if the aggregate value of work and material provided is less than $100 000.

Prohibited application of holdback

6 (1) If a contractor or subcontractor defaults under a contract or subcontract, the required holdback must not be applied to the completion of the contract or subcontract, or for the payment of damages, or for any other purpose until the possibility of any lien arising under the person in default is exhausted.

(2) A payment applied contrary to this section does not reduce the liability under this Act of the person making the payment.

(3) This section does not apply to money held in excess of the required holdback.

Certificate of completion

7 (1) In this section, "payment certifier" means

(a) an architect, engineer or other person identified in the contract or subcontract as the person responsible for payment certification, or

(b) if there is no person as described in paragraph (a),

(i) the owner acting alone in respect of amounts due to the contractor, or

(ii) the owner and the contractor acting together in respect of amounts due to any subcontractor.

(2) A lien holder in respect of an improvement may, by making a written request, require that the payment certifier for the improvement deliver to the lien holder

(a) particulars of any certificate of completion issued under this section before and after the request, or

(b) particulars of certificates of completion issued, before and after the request, with respect to stipulated contracts or subcontracts.

(3) On the request of a contractor or subcontractor, the payment certifier must, within 10 days after the date of the request, determine whether the contract or subcontract has been completed and, if the payment certifier determines that it has been completed, the payment certifier must issue a certificate of completion.

(4) If a certificate of completion is issued, the payment certifier must, within 7 days,

(a) deliver a copy of the certificate to the owner, the head contractor, if any, and the person at whose request the certificate was issued,
(b) deliver a notice of certification of completion to all persons who submitted a request under subsection (2) in relation to the contract or subcontract, and

c) post, in a prominent place on the improvement, a notice of certification of completion.

(5) If the payment certifier fails or refuses to issue a certificate of completion as provided in subsection (3), the court may, on application by the person who requested the certificate and on being satisfied that the contract or subcontract has been completed, make an order declaring that the contract or subcontract has been completed.

(6) An order under subsection (5)

(a) may be made on terms and conditions as to costs or otherwise that the court considers just, and

(b) has the same effect as a certificate of completion issued by a payment certifier.

(7) If an order is made under subsection (5) declaring that a contract or subcontract has been completed, the payment certifier must comply with subsection (4) as if the order were a certificate of completion.

(8) A payment certifier who receives a request under subsection (3) and who fails or refuses, without reasonable excuse and within the time specified in that subsection, to issue a certificate of completion respecting the contract or subcontract is liable to anyone who suffers loss or damage as a result.

(9) A payment certifier who fails or refuses to comply with subsection (4) or (7) is liable to anyone who suffers loss or damage as a result.

(10) A certificate of completion may be in the prescribed form and, if it is in the prescribed form, it is sufficient to comply with this Act.

Holdback period

8 (1) If a certificate of completion is issued with respect to a contract or subcontract, the holdback period in relation to

(a) the contract or subcontract, and

(b) any subcontract under the contract or subcontract

expires at the end of 55 days after the certificate of completion is issued.

(2) The holdback period for a contract or subcontract that is not governed by subsection (1) expires at the end of 55 days after

(a) the head contract is completed, abandoned or terminated, if the owner engaged a head contractor, or
(b) the improvement is completed or abandoned, if paragraph (a) does not apply.

[section 8(3) not yet in force]

(4) Payment of a holdback required to be retained under section 4 may be made after expiry of the holdback period, and all liens of the person to whom the holdback is paid, and of any person engaged by or under the person to whom the holdback is paid, are then discharged unless in the meantime a claim of lien is filed by one of those persons or proceedings are commenced to enforce a lien against the holdback.

Rights on payment of holdback

9 (1) A contractor is entitled to receive, from the holdback retained by the owner from the contractor, an amount equal to the holdback amount applicable to a subcontract if

(a) a certificate of completion has been issued in respect of the subcontract to which the contractor was a party, and

(b) the holdback period established under section 8 (1) has expired without any claims of lien being filed that arose under the subcontract.

(2) An owner is deemed to have complied with the requirements of section 4 even if the amount retained has been reduced to a lesser percentage than is required by that section if

(a) an amount is paid to a contractor in accordance with subsection (1) of this section, and

(b) the amount retained by the owner would have complied with the requirements of section 4 had no payments been made under this section.

(3) Subsections (1) and (2) apply if a certificate of completion is given in relation to a subcontract to which a contractor is not a party.

(4) If a contractor is entitled to an amount under subsection (1), payment may be made from the holdback account established under section 5.

Contract money received constitutes trust fund

10 (1) Money received by a contractor or subcontractor on account of the price of the contract or subcontract constitutes a trust fund for the benefit of persons engaged in connection with the improvement by that contractor or subcontractor and the contractor or subcontractor is the trustee of the fund.

(2) Until all of the beneficiaries of the fund referred to in subsection (1) are paid, a contractor or subcontractor must not appropriate any part of the fund to that person's own use or to a use not authorized by the trust.

(3) If the liens of a class of lien claimants are discharged under this Act by the payment of an amount that is less than the amount owing to the person who engaged the class, the members of the class are subrogated to the rights under subsections (1) and (2) of the person who engaged the class.
(4) Subsections (1) and (2) do not apply to money received by an architect, engineer or material supplier.

Certain applications of trust fund deemed not to be appropriation or conversion

11 (1) A contractor or subcontractor commits an offence if that person

(a) appropriates or converts any part of a fund in contravention of section 10, or

(b) contravenes section 13 (2).

(2) A person who commits an offence under subsection (1) (a) is liable to a fine of not more than $10 000 or to imprisonment for a term of not more than 2 years, or both.

(3) If a contractor or subcontractor is a corporation, a director or officer of the corporation who knowingly assents to or acquiesces in an offence under subsection (1) (a) by the corporation commits the offence in addition to the corporation.

(4) Despite subsections (1) to (3),

(a) to the extent that a contractor or subcontractor has paid for work or material supplied under a contract or subcontract, the retention by the contractor or subcontractor of trust money in an amount equal to the amount paid is not an appropriation or conversion that contravenes section 10, and

(b) if money is loaned to a person on whom a trust is imposed by section 10 and is used to pay for all or part of work or material supplied, trust money may be applied to discharge the loan to the extent that the lender's money was so used by the trustee, and money so applied is not an appropriation or conversion that contravenes section 10.

(5) An information must not be laid in respect of an alleged offence under subsection (1) or (3) more than 3 years after the alleged offence occurred.

(6) Subsection (4) (b) does not limit the rights of a lender who, in the ordinary course of business, receives money in good faith from a person on whom a trust is imposed under section 10.

(7) If a contractor or subcontractor commingles, with other money, any part of the fund referred to in section 10, that, of itself, does not constitute a breach of the trust created under section 10 (1) or a contravention of section 10 (2).

Crediting of money earmarked for particular improvement

12 If a person makes a payment from money in a trust fund constituted in respect of a particular improvement, a person who receives the money must credit it against the debt in respect of the improvement.

Garnishment and money in court

13 (1) In the case of money owing to a contractor or subcontractor that would, if paid to the contractor or subcontractor, be subject to a trust under section 10, the money, if it is paid into
court under an attachment under the Court Order Enforcement Act, is subject to a trust as if it had been paid to the contractor or subcontractor, and the interest of the garnishor is subordinate to the interest of the beneficiaries of the trust.

(2) A garnishee under an attachment referred to in subsection (1) must, at the time of payment into court, file in the court registry a notice in the prescribed form and deliver a copy of the notice to the garnishor.

(3) If a notice is filed under subsection (2), the registrar of the court must not pay out of court without an order of the court any money paid into court under subsection (1).

(4) Money held in a holdback account established under section 5 is not subject to garnishment.

(5) If money is paid into court under this Act by a contractor, subcontractor or owner, the money becomes or remains subject to the trust imposed by section 10.

**Limitation period**

14 An action by a beneficiary or against a trustee of a trust created under section 10 must not be commenced later than one year after

(a) the head contract is completed, abandoned or terminated, or

(b) if the owner did not engage a head contractor, the completion or abandonment of the improvement in respect of which the money over which a trust is claimed became available.

**Claim of lien to be in prescribed form**

15 (1) Except as provided in section 18, a claim of lien is made by filing in the land title office a claim of lien in the prescribed form.

(2) An agent who represents more than one lien claimant may, with respect to a particular improvement, make a single claim of lien on behalf of all of the lien claimants represented, and the prescribed form may be altered accordingly for that purpose.

(3) The registrar must not allow a claim of lien to be filed unless satisfied that the land is adequately described.

(4) On the filing of the claim of lien in the land title office, the registrar must endorse a memorandum of the filing on the register of title to the land or against the estate or interest in the land described in the claim of lien.

**No claim under $200**

17 A claim of lien must not be filed if the amount of the claim or aggregate of joined claims is less than $200.

**Liability for wrongful filing**

19 A person who files a claim of lien against an estate or interest in land to which the lien claimed does not attach is liable for costs and damages incurred by an owner of any estate or interest in the land as a result of the wrongful filing of the claim of lien.

**Time for filing claim of lien**

234
20 (1) If a certificate of completion has been issued with respect to a contract or subcontract, the claims of lien of

(a) the contractor or subcontractor, and

(b) any persons engaged by or under the contractor or subcontractor

may be filed no later than 45 days after the date on which the certificate of completion was issued.

(2) A claim of lien that is not governed by subsection (1) may be filed no later than 45 days after

(a) the head contract has been completed, abandoned or terminated, if the owner engaged a head contractor, or

(b) the improvement has been completed or abandoned, if paragraph (a) does not apply.

(3) Subsection (1) does not operate to extend or renew the time for filing of a claim of lien if

(a) that time would otherwise be determined with reference to the time an earlier certificate of completion was issued, or

(b) time had started to run under subsection (2).

(4) On the filing of a claim of lien under this Act, the registrar or gold commissioner has no duty to inquire as to whether or not the lien claimant has complied with the time limit for filing the claim of lien.

When claim of lien takes effect

21 A claim of lien filed under this Act takes effect from the time work began or the time the first material was supplied for which the lien is claimed, and it has priority over all judgments, executions, attachments and receiving orders recovered, issued or made after that date.

Lien extinguished if not filed as required by Act

22 A lien in respect of which a claim of lien is not filed in the manner and within the time provided in this Act is extinguished.

Removal of claims of lien by payment of total amount recoverable

23 (1) If a claim of lien is filed by one or more members of a class of lien claimants, other than a class of lien claimants engaged by an owner, the owner, contractor, subcontractor or mortgagee authorized by the owner to disburse money secured by a mortgage may, on application, pay into court the lesser of

(a) the total amount of the claim or claims filed, and

(b) the amount owing by the payor to the person engaged by the payor through whom the liens are claimed provided the amount is at least equal
to the required holdback in relation to the contract or subcontract between
the payor and that person or, if the payment is made by a purchaser to
whom section 35 applies, 10% of the purchase price of the improvement.

(2) Payment into court under an order made under subsection (1) discharges the owner from
liability in respect of the claims of lien filed and

(a) the money paid into court stands in place of the improvement and the land
or mineral title, and

(b) the order must provide that the claims of lien be removed from the title to
the land or mineral title.

(3) If an application has been made under subsection (1) and the claims of lien have been
removed under subsection (2), and if additional claims of lien are filed by persons claiming
through the same person engaged by the payor with respect to the lien claimants whose
claims of lien were removed under subsection (2), application may be made under subsection
(1) to have the additional claims of lien removed under subsection (2) on payment into court
of whatever additional sum is necessary to bring the amount in court up to the amount that
would have been paid into court if the additional claims of lien had been filed at the time of
the prior application.

(4) An application under subsection (1) or (3) may be brought by interlocutory application in
proceedings that have been commenced to enforce a claims of lien, or by an originating
application, and the court may

(a) hear and receive evidence, by affidavit or orally or otherwise, that it
considers necessary in order to determine the proper amount to be paid
into court,

(b) direct the trial of an issue to determine the amount to be paid into court,
and

(c) refuse the application if it is of the opinion that the determination of the
total amount that may be recovered by lien claimants should be made at
the trial of the action.

(5) If the amount held back by the payor from the person engaged by the payor through
whom the liens are claimed exceeds the required holdback in relation to the contract or
subcontract between the payor and that person, and that person has defaulted in completing
or carrying out the contract or subcontract with the payor, for the purposes of subsections (1)
and (3) the amount owing by the payor to that person does not include any amount that the
payor is entitled to apply to remedy the default or complete the contract or subcontract.

Cancellation of claim of lien by giving security

24 (1) A person against whose land a claim of lien has been filed, and a contractor,
subcontractor or any other person liable on a contract or subcontract in connection with an
improvement on the land, may apply to a court to have the claim of lien cancelled on giving
sufficient security for the payment of the claim.
(2) The court hearing the application under subsection (1) may, after considering all relevant circumstances, order the cancellation of the claim of lien on the giving of security satisfactory to the court.

(3) The value of the security required under an order under subsection (2) may be less than the amount of the claim of lien.

(4) The registrar or gold commissioner in whose office a claim of lien is filed must, on receiving an order or certified copy of the order made under subsection (2), file it and cancel the claim of lien as to the property affected by the order.

(5) The giving of security for the payment of a claim of lien under subsection (1) does not make the owner liable for a greater sum than provided for in section 34.

Powers of court, registrar or gold commissioner to remove claim of lien

25 (1) An owner, contractor, subcontractor, lien claimant or agent of any of them may at any time apply to the court, registrar or gold commissioner and the court, registrar or gold commissioner may cancel a claim of lien if satisfied that

(a) a lien is extinguished under section 22 or 33,

(b) an action to enforce the claim of lien has been dismissed and no appeal from the dismissal has been taken within the time limited for the appeal,

(c) an action to enforce the claim of lien has been discontinued, or

(d) the claim of lien has been satisfied.

(2) An owner, contractor, subcontractor, lien claimant or agent of any of them may at any time apply to the court and the court may cancel a claim of lien if satisfied that

(a) the claim of lien does not relate to the land against which it is filed, or

(b) the claim of lien is vexatious, frivolous or an abuse of process.

(3) An application under subsection (1) or (2) may be made without notice to any other person.

Enforcement of claim

26 A claim of lien may be enforced by an action according to the Rules of Court.

Priority of secured lender

32 (1) Subject to subsection (2), the amount secured in good faith by a registered mortgage as either a direct or contingent liability of the mortgagor has priority over the amount secured by a claim of lien.

(2) Despite subsection (1), an advance by a mortgagee that results in an increase in the direct or contingent liability of a mortgagor, or both, under a registered mortgage occurring after the time a claim of lien is filed ranks in priority after the amount secured by that claim of lien.
(3) In a proceeding for the enforcement of a claim of lien,

(a) the court may order the sale of mortgaged land at an upset price of at least the amount secured by all registered mortgages that have priority over the claim of lien, court ordered costs and the costs of the sale, and

(b) the amount secured by any registered mortgages must be satisfied out of the proceeds of the sale in the order of their priorities and in priority over the claim of lien to the extent provided under this section.

(4) A mortgagee who applies mortgage money in payment of a claim of lien that has been filed is subrogated to the rights and priority of the lien claimant to the extent of the money applied.

(5) Despite subsections (1) and (2) or any other enactment, if one or more claims of lien are filed in a land title office in relation to an improvement, a mortgagee may apply to the court for an order that one or more further advances under the mortgage are to have priority over the claims of lien.

(6) On an application by a mortgagee under subsection (5), the court must make the order if it is satisfied that

(a) the advances will be applied to complete the improvement, and

(b) the advances will result in an increased value of the land and the improvement at least equal to the amount of the proposed advances.

(7) An amount secured in good faith by a registered right to purchase land has the same priority over the amount secured by a claim of lien as has the amount secured by a registered mortgage under subsections (1) and (2).

(8) For the purposes of this Act, the vendor under a registered right to purchase is deemed to be a mortgagee under a registered mortgage, and the amount secured in good faith by the registered right to purchase is subject to this section as though the amount had been secured in good faith under a registered mortgage.

Limitation and notice to commence an action

33 (1) If a claim of lien has been filed, an action to enforce the claim of lien must be commenced and, unless the claim of lien has been removed or cancelled under section 23 or 24, a certificate of pending litigation in respect of the action must be registered, not later than one year from the date of its filing, in the land title office or gold commissioner's office in which the claim has been filed.

(2) Despite subsection (1),

(a) an owner, or

(b) a lien claimant who has commenced an action
may serve on a lien claimant, or other lien claimants, as the case may be, a notice to commence an action to enforce the claim of lien and to register in the land title office or in the gold commissioner's office, as the case may be, a certificate of pending litigation within 21 days after service of the notice.

(3) The notice served under subsection (2) must be in the prescribed form, and service is validly effected if the notice is

(a) served personally on the lien claimant, or

(b) mailed or delivered to the address for service given in the claim of lien.

(4) If service is by mail the notice is conclusively deemed to have been served on the eighth day after deposit of the notice in the Canada Post Office at any place in Canada.

(5) Unless an action to enforce a claim of lien is commenced and a certificate of pending litigation is registered within the time provided in this section, the lien is extinguished.

Limit of claims

34 (1) The maximum aggregate amount that may be recovered under this Act by all lien holders who claim under the same contractor or subcontractor is equal to the greater of

(a) the amount owing to the contractor or subcontractor by the person who engaged the contractor or subcontractor, and

(b) the amount of the required holdback in relation to the contract between the contractor or subcontractor and the person who engaged the contractor or subcontractor.

(2) For the purposes of subsection (1) (a),

(a) an amount claimed by way of counterclaim against a contractor or subcontractor by the person who engaged the contractor or subcontractor does not reduce the amount owing to the contractor or subcontractor by that person,

(b) a payment that is made in bad faith to a contractor or subcontractor by the person who engaged the contractor or subcontractor does not reduce the amount owing to the contractor or subcontractor by that person, and

(c) a payment to a contractor or subcontractor by the person who engaged the contractor or subcontractor that is made

(i) after a claim of lien has been filed by a lien holder claiming under the contractor or subcontractor,

(ii) if the person has actual notice of the claim of lien, and

(iii) if the claim of lien has not been removed or cancelled from the title to the land, under section 23 or 24 or otherwise, at the time the payment
was made,

does not, to the extent of the lien, reduce the amount owing to the contractor or subcontractor by that person.

(3) Despite subsection (2), a person may, on the default of another person that the first person engaged, apply money held by the first person in excess of the required holdback in order to remedy that default or compensate for damage caused by the default.

Right to information

41 (1) A lien holder or a beneficiary of a trust under this Act may, at any time, by delivering a written request, require

(a) from the owner

(i) the terms of the head contract or contract under which the lien holder of beneficiary claims, including the names of the parties to the contract, the contract price and the state of accounts between the owner and the head contractor,

(ii) the name and address of the savings institution in which a holdback account has been opened, and the account number,

(iii) particulars of credits to and payments from the holdback account, including the dates of credits and payments, and the balance at the time the information is given, and

(iv) particulars of any labour and material payment bond posted by the contractor with the owner in respect of the head contract or contract under which the lien holder or beneficiary claims, and

(b) from a mortgagee or an unpaid vendor

(i) the terms of the mortgage or agreement for sale,

(ii) in the case of a mortgage, particulars of the amount advanced under the mortgage, including the dates of advances, and of any arrears in payment, and

(iii) in the case of an agreement for sale, particulars of the amount secured under the agreement for sale and any arrears in payment.

(2) The owner may request in writing from

(a) a subcontractor when a claim of lien has been filed or a written notice of a claim of lien has been received by the owner, and

(b) the contractor, at any time,
the following information:

(c) the terms of any subcontract, including the names of the parties to the subcontract, the subcontract price and the state of accounts between the contractor and a subcontractor or between a subcontractor and another subcontractor, or any other person providing work or material;

(d) particulars of any labour and material payment bond posted by a subcontractor with the contractor or by a subcontractor with another subcontractor.

(3) The person to whom a request is made under subsection (1) or (2) must comply within 10 days after the day the request is delivered.

(4) A person who fails to comply in writing with a request within the time provided in subsection (3), or who knowingly or negligently misstates the information requested, is liable to the person requesting the information for any resulting loss or damage.

(5) On the failure of a person to comply with a request made under subsection (2) within the time provided, the owner may also, if the request is made of

(a) a contractor, withhold further payments to the contractor, or

(b) a subcontractor, instruct the contractor or another subcontractor to withhold further payments to the subcontractor

until the contractor or subcontractor, as the case may be, has complied with the request.

(6) The court may, on application by an interested person at any time before or after an action is commenced for the enforcement of a claim of lien,

(a) order that the owner, mortgagee, vendor, contractor or subcontractor produce for inspection all contracts, subcontracts, documents, books or records relating to the contract or subcontract or to the payment of the contract or subcontract price,

(b) order that any person referred to in paragraph (a) deliver to the applicant copies of any documents referred to in that paragraph, and

(c) make an order as to the costs of the application.

Offence

45 (1) A person who knowingly files or causes an agent to file a claim of lien containing a false statement commits an offence.

(2) A person who commits an offence under subsection (1) is liable to a fine not exceeding the greater of $2 000 and the amount by which the stated claim exceeds the actual claim.