



## **Australian Institute of Building Submission to the**

### ***Inquiry into Construction Industry Insolvency in NSW***

#### **Introduction**

The Australian Institute of Building (AIB) welcomes the opportunity to respond to the *Inquiry into Construction Industry Insolvency in NSW*. The AIB is keen to see more efficient and thorough security of payment legislation, and welcomes this review.

#### **Vision**

The vision of the AIB in regards to this review is to ensure that:

- The building sector in NSW is improved through higher educational standards;
- The building industry is a viable and growing sector for the benefit of the state, consumers and builders; and
- Builders and sub-contractors are informed, educated and provided with adequate legislative protection and support, to reduce payment disputes.

#### **Terms of Reference**

The Terms of Reference will be answered in order.

As stated in the terms of reference: "The construction industry in NSW has a high rate of insolvency. The industry accounts for fifteen per cent of businesses in NSW, but up to thirty per cent of the companies going into administration. The government is concerned about this high rate of insolvency and the impact it is having on the community, small businesses, the NSW economy and the government's construction program. The government is establishing an independent inquiry to:"

#### **1. Assess the extent and cause of insolvency in the construction industry.**

The background to the recent activities in the construction industry in NSW is as follows:

- The state of the NSW economy has been depressed for more than 10 years, whilst the remainder of the country has thrived;
- The Global Financial Crisis struck in 2008 causing lockdown of financial institution lending;
- Construction workload retracted even further;
- Heavy price discounting starting with sub-contractor discounts then followed by deterioration of main contractor's margins; and

- Smaller unqualified contractors have attracted to larger projects by clients seeking lower construction pricing, these contractors include lower overhead and underestimated preliminaries essential for larger projects.
- The depression of the construction industry has promoted an unfair transfer of risk to main contractors, where main contractors need the work and feel forced to take on more risk on projects through inequitable contract conditions. Examples include full risk of weather at no cost or time and full risk of prior design novation with no recourse to costs for inherited prior design by others. This risk is transferred to sub-contractors by main contractors in an attempt to spread their risk. The current allocation of risk to main contractors and sub-contractors is unfair and inequitable.

The two outcomes of the above have been:

- Projects being run with inadequate systems, procedures and most importantly supervision; and
- Larger more suitable contractors cutting preliminaries and undertaking projects purely for turnover with no profitability. This practice is not only in the relationship between the principal contractor and the client but also reflected between the main contractor and its subcontractors.
- Unfair transfer of risk to main contractors and sub-contractors.

The culture of specialist sub-contracting has been fundamental in the construction industry since the 1970s, to assist in both specialist skills focus and management of human resources, and must be retained.

There has been an apparent policy by Government to allow unskilled foreign nationals to operate and to set up building/development companies in Australia. This has been highlighted in Sydney and Newcastle over recent years. These companies often do not have the same ethics or cultural practices as established local contractors and they have demonstrated that they are prepared to deliver their projects well below the allowable standards as required by the National Construction Code and Building Code of Australia. These companies are also prone to use 'sham contractors', have a track record of not paying local legitimate sub-contractors, and ultimately leave the country.

Unfortunately the established building industry is unfairly tarnished by the behaviour of these foreign companies, and the effect they have on local sub-contractors for non-payment of their invoices and their ultimate demise.

## **2. Consider payment practices affecting sub-contractors, existing protections for subcontractors and the impacts of insolvency on sub-contractors.**

The larger contractors in the industry generally operate on payment terms mirroring their head contracts. These loosely result in sub-contractors being paid within the week following the head contract payment.

Typically a sub-contractor would submit his claim on the 25<sup>th</sup> of the month, the main contractor would follow with his head contract claim on the 30<sup>th</sup>, the head contract payment would then be made around the 30<sup>th</sup> of the following month, and subsequently the sub-contractor would be paid in the first week of the following month.

In summary, the main contractor is paid on 30 day terms whilst the sub-contractor is paid on 45 day terms. In justification:

- Sub-contractors account for these payment terms in their tender;
- The sub-contractors operate commensurate payment terms with their suppliers; and
- Heavily labour bias sub-contracts are often reduced to 14 day terms.

The growing concern amongst the sub-contractor network regarding the claimed non-payment by contractors resulted in the introduction of the *Building and Construction Industry Security of Payment Act 1999*.

In the early years of introduction, this had a major impact on the contractor's ability to manage sub-contracts, as there emerged a practice of lodgement of inflated claims and a serious lean towards findings in favour of the sub-contractor. With costly avenues of recovery in late 2011, an amendment to the act saw the introduction of a mechanism for sub-contractors to approach principals directly and enforce the withholding of the main contractors payment where a claimed dispute existed between the sub-contractor and the main contractor. This had a compounding impact on the main contractor, as now a security of payment claim by the sub-contractor will likely be upheld resulting in payment, and the principal will also likely be withholding payment causing a doubling effect on the main contractors cashflow.

It is relatively simple to set up a business, but most tradespeople do not know about the Security of Payment (SOP) Act. Also, often if a tradesperson makes a claim under the SOP Act, then they are not used again by that company again, as they are perceived to be a 'trouble-maker'. Many sub-contractors unfortunately do not realise that they are in business, and do not have appropriate business practices in place. Business skills are needed to be built into the Certificate IV in Building. An important point is that businesses rely on cashflow and 'cash is king'. Given these facts it becomes very problematic if a client cannot or will not pay. It is essential that SOP legislation is put in place to protect builders, as well as sub-contractors.

Generally, current SOP legislation is designed to protect sub-contractors, except on individual dwellings. Also, there are currently no business skills built into TAFE trade courses, or experience.

### **3. Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:**

#### **a.) Options for improving the priority given to unsecured creditors where the debt results from a sub-contracting relationship**

Legislation could be considered to move wages and salaries to the top of the secured creditors ranking, ahead of lenders and administrators/liquidators.

However, currently this is not possible because according to the 'Hierarchy of Liens and Charges', the Australian Tax Office (ATO) is the first to be paid, followed by secured creditors such as banks are the next to get paid, then employees, then unsecured creditors.

A compensation fund is an option to 'bail out' sub-contractors. This could change the status of sub-contractors to secured creditors, but then employees may not be paid what is owed to them in the case of business becoming insolvent 'not having done the right thing' (if not outright fraud by the employer) by its employees.

#### **b.) Opportunities to simplify debt collection processes**

As with a.), currently the hierarchy of creditors is an issue. If \$50 million is owed to creditors when a construction company goes into administration and the company has \$10 million in assets, it is the ATO and secured creditors which will receive most if not all the value of these assets before any unsecured creditor (e.g. a sub-contractor). Thus, there is usually simply no money left to be collected by a sub-contractor.

The fact that the banks are one of the 'first in line' seems completely unfair to a reasonable person, as banks are more than able to withstand the loss as opposed to a small family-run business. Banks also penalise the affected party with unrealistic interest charges and in the case of foreign banks, they

are able to recoup their losses through government backed guarantees. These options are not available to contractors who take the entire risk.

### **c.) Strategies to improve financial management skills in the industry**

Strategies to improve financial management skills in the industry are definitely worthwhile, and should be introduced at the point of licensing and in qualifications. Builders need to know more about business skills than architects. Architecture and engineering degrees simply do not focus enough on management. If they did, then they would closely resemble the construction management degrees that the AIB has been accrediting for some 50 years.

Licensing in NSW is seen as a major contributing factor in the financial administration of both contractors and sub-contractors.

Firstly, apart from the electrical and plumbing trades there is no requirement to hold a contractor's licence unless works involve residential construction. In other states, such as Queensland, there exist different licence classifications, and more rigorous criteria to obtain, including detailed business plans and declaration of financial capabilities resulting in restrictions on turnover. Furthermore, even in the case of the other trades, there is no work experience (i.e. even apprenticeship experience) required to obtain a trade contractor's licence. Both of these should be immediately rectified in order to ensure that subcontractors do not continue to go into insolvency due to technical incompetence.

As a consequence, tradesmen should also have to obtain a Cert IV in Building and Construction (as the relevant business training cannot and should not be added to detriment of ensuring technical competence) in which there is a relevant focus on financial skills and legal concepts.

### **d.) A mandatory insurance scheme to secure payments to sub-contractors**

There already exists industry-based credit insurance providers. Adoption is voluntary, and it should remain voluntary. Ultimately consumers have to pay for this, and it should not be paid for by the taxpayer.

### **e.) A discretionary mutual fund to compensate contractors from losses arising from insolvency of a lead contractor or principal**

At this point in time, AIB does not have a position on this matter. However, any possible scheme of this nature should not deter investment.

### **f.) The effectiveness of trust arrangements in protecting sub-contractor payments retained by a lead contractor or principal**

The practice of insolvent contractors relying on employees' entitlements and sub-contractors retention monies in everyday cash management of their business is known to exist in the industry.

To protect employees and sub-contractors, the inquiry should consider:

- For employee entitlements, the establishment of secure trust savings funds similar to those existing for superannuation, and long service; and
- For subcontractor retention monies, a trust fund similar to that established in the residential rental market for the security of bond monies.

**g.) Mechanisms to ensure appropriate and effective financial disclosure between contracting parties, including disclosing payment of sub-contractors**

AIB supports this initiative, and believes that transparency is always preferable.

**h.) Other relevant issues or innovations raised by the Small Business Commissioner or stakeholders.**

AIB does not have any comment on this at this point in time.

**4. In developing recommendations the inquiry should consider the impact of Commonwealth jurisdiction over insolvency.**

Currently, the Commonwealth has jurisdiction over insolvency of companies, and the bankruptcy of individuals (whether or not they are sole traders or partnerships). The Commonwealth will have to have some role over building insolvency legislation in what is thought to be several years' time. AIB does not have a view on Commonwealth jurisdiction over insolvency legislation.

**5. The inquiry will receive advice from an industry reference group including industry key associations and the Small Business Commissioner.**

AIB supports this initiative. However, the industry reference group should also include the Fair Trading Commissioner. AIB would be well qualified to nominate appropriate professions for this taskforce, and to give advice as needed.

**Further Information**

For further information, please contact the AIB Chief Executive Officer or Policy & Advocacy Manager on (02) 6247 7433 or [ceo@aib.or.au](mailto:ceo@aib.or.au) or [policy@aib.org.au](mailto:policy@aib.org.au)

## Appendix 1

### About the AIB

Founded in 1951, the AIB is the peak body for building and construction professionals, acknowledged for its ability to bring individuals together who share a common interest in improving the standing of the building profession and their career within Australia and overseas.

The AIB is incorporated by Royal Charter and is the pre-eminent professional body for building professionals in Australia and the Asia-Pacific region.

Recognised as the accrediting body for building and construction degrees at educational institutions, the AIB has a long and proud history of supporting and servicing the building profession. For more than sixty years, the Institute has worked with the building and construction industry, government, universities and allied stakeholders to promote the building profession, support the development of university courses in building and construction whilst promoting the use of innovative building techniques and a best-practice regulatory environment.

AIB is proud of its role in promoting the exchange of information amongst individuals and accomplishes this through publications including the *Construct* magazine and the Australasian Journal of Construction Economics & Building (AJCEB).

The AIB also has an extensive continuing professional development program in Australia and overseas and facilitates the annual AIB Professional Excellence in Building Awards Program.

For further information please go to [www.aib.org.au](http://www.aib.org.au)