Executive summary

This report makes forty four recommendations which, if adopted, the committee believes would overcome many of the challenges the construction industry faces in dealing with its unacceptably high rate of business insolvency. The recommendations seek to deal with the completely unacceptable culture of non-payment of subcontractors for work completed on construction projects.

Of these recommendations, two mark a sea change in the Commonwealth's role in regulating payment practices in the construction industry.

The first of these is the recommendation that the Commonwealth enact uniform, national legislation for a security of payment regime and rapid adjudication process in the commercial construction industry.

The second, related major recommendation is that, commencing in July 2016, the Commonwealth commence a two year trial of Project Bank Accounts on construction projects where the Commonwealth's funding contribution exceeds ten million dollars.

The committee further recommends that, following the successful completion of a trial of Project Bank Accounts on Commonwealth funded projects, the Commonwealth legislate to extend the use of a best practice form of trust account to private sector construction.

Businesses operating in the Australian building and construction industry face an unacceptably higher risk than any other stand-alone industry of either entering into insolvency themselves, or becoming the victim of insolvency further up the contracting chain.

The industry's rate of insolvencies is out of proportion to its share of national output. Over the past decade the industry has accounted for between 8 per cent and 10 per cent of annual GDP and roughly the same proportion of total employment. Over the same period, the construction industry has accounted for between one-fifth and one-quarter of all insolvencies in Australia.

This outcome isn't, as some have argued, the result of market forces. While the construction industry is highly competitive and market forces play a part, there are other powerful factors at play. The structure of the commercial construction sector, serious imbalances of power in contractual relationships, harsh, oppressive and unconscionable commercial conduct play a major role when combined with unlawful and criminal conduct and a growing culture of sharp business practices all contribute to market distortions. As a result, the industry is burdened every year by nearly $3 billion in unpaid debts, including subcontractor payments, employee entitlements and tax debts averaging around $630 million a year for the past three years

Insolvency and poor payment practices in the industry are not a new problem. This report is the latest in a long series of inquiries and reports dating back to at least 1995 that have considered the merits of changes to the law to regulate the payment of head contractors, subcontractors, workers and others in the building and construction industry. These inquiries have provided report after report, recommendation after

recommendation, to State and Commonwealth governments, providing compelling evidence that any participant in a construction project who holds or receives money on account of the contract and is under an obligation to pay another participant, should be subject to a statutory obligation to hold the money as a trustee.

Similarly, a number of inquiries and reports have recommended the introduction of uniform, national security of payments legislation in the construction industry.

Yet, little or nothing has been done. To the extent that regulatory responses have been implemented, Australia now has a fragmented and disparate legislative regime covering security of payment in the construction industry.

In the view of the committee, the relative inaction that has characterised most government responses to the completely unacceptable payment practices in the construction has to end. The continued viability of the industry in its current structure requires Commonwealth intervention to ensure that businesses, suppliers and employees that work in the industry's subcontracting chain get paid for the work they do.

The construction industry market must be supported so that it operates in as efficient a manner as possible and distortions of the kind discussed in this report should be rectified as far as possible.

Structural issues

The structure of the Australian building and construction industry, as well as the contractual relationships between people working within it has transformed in the past decade or so.

Typically, the management of major projects is assigned to a head contractor who is not a direct employer of labour on the project. These head contractors enter into agreements with the owner/developer on one side and with major specialist subcontractors who undertake packages of work, on the other. Depending on the value and scale of the project, the greater proportion of works is then sub-let to other specialist subcontractors.

This structure has distorted the construction market by concentrating market power at the top of the contracting chain and inequitably reallocating risk from the large contracting companies to those who are least able to bear it, namely subcontractors, suppliers and employees.

This significant structural change has affected the culture of the industry. A large number of subcontractors that carry the burden of risk and a concentration of market power in the hands of a relatively small number of head contractors means that head contractors can often have little regard for the competitive pressures placed on subcontractors.

One witness who gave evidence to the inquiry likened the culture to a battlefield, where subcontractors get mowed down and fresh bodies are just poured in. Evidence to the inquiry demonstrates that head contractors are often more than willing to abuse their market power to the detriment of those further down the subcontracting chain. A

consistent theme throughout the evidence provided to this inquiry by sub-contractors and industry specialists is that the dominant head contractors 'do not play nice'.

The result is a cut-throat industry characterised by serious problems with non-payment of subcontractors and a deeply troubling record of insolvency, many of which could be avoided.

The committee believes that the regulatory framework should do more to protect honest, hard-working subcontractors and others down the contractual chain whose principal objective of being in business is to be paid for the work they do.

Phoenixing

Phoenix company schemes have been a longstanding concern of regulatory agencies, parliamentary committees and a more than usual number of inquiries. However, despite the prevalence of inquiries and recommendations that followed, illegal phoenix activity remains a significant issue not only in the construction industry, but throughout the economy.

While the committee appreciates the increasing attention that regulators are placing on identifying and curbing phoenix activity, progress has been unacceptably slow. is time the government gave consideration to closing the legal loopholes that allow the practice to continue to flourish. This report makes some recommendations in that regard.

The majority of submissions that touched on illegal phoenix activity contended that the continuing high incidence of phoenixing in the industry demonstrates that the current legal and regulatory framework is unable to curb the practice.

The committee considers that the estimates of the incidence of illegal phoenix activity detailed in this report suggest that construction industry is being beset by a growing culture among some company directors of disregard for the corporations law. This view is reinforced by the anecdotal evidence received by the committee which indicates that phoenixing is considered by some in the industry as merely the way business is done in order to make a profit.

The committee is particularly concerned at evidence that a culture has developed in sections of the industry in which some company directors consider compliance with the corporations law to be optional, because the consequences of non-compliance are so mild and the likelihood that unlawful conduct will be detected is so low.

This culture is reflected in the number of external administrator reports indicating possible breaches of civil and criminal misconduct by company directors in the construction industry. Over three thousand possible cases of civil misconduct and nearly 250 possible criminal offences under the *Corporations Act 2001* were reported in a single year in the construction industry. This is a matter for serious concern. It suggests an industry in which company directors' contempt for the rule of law is becoming all too common.

Recent studies indicate that illegal phoenix activity (across all industries) may cost between $1.79 billion and $3.19 billion per annum.[1] Given the over-representation of construction businesses in insolvencies and phoenixing, the committee believes the construction industry is responsible for a substantial proportion of this cost.

The committee also heard evidence about an emerging business model whereby, in the period leading up to a company entering administration, companies are obtaining pre-insolvency advice on how to restructure their business prior to the company entering administration, which results in the company being able to avoid paying it creditors. ASIC noted in its evidence that this type of advice is often being provided by former insolvency practitioners who have been previously suspended from practice for misconduct. ASIC considers this practice to be a significant problem and it is unregulated. This inquiry received extensive evidence about this type of conduct in relation to the collapse of Walton Constructions, which the committee believes is a useful case study of the practice. While corporate restructuring is often a necessary and beneficial strategy to ensure the ongoing viability of a business or to provide the greatest value to creditors, it appears that unscrupulous advisors are, in some cases, facilitating illegal phoenix activity.

Insolvency affects everyone

Insolvency in the construction industry has impacts on businesses, employees, families and communities. The collapse of a business places immediate pressure on the management and employees of that business, as well as its suppliers and contractors. In regional towns, a single insolvency can affect entire communities.

Evidence from witnesses around the country drew attention to the troubling health effects and stresses placed on family life caused by the financial distress stemming from insolvencies. The committee heard evidence of people being affected by mental health issues, family breakdown, people losing their houses and becoming homeless and children facing stress and disruption to their lives. In one tragic case, the committee heard evidence from a man whose father, a highly respected and successful Perth businessman, took his own life while fighting for payment for work his company had completed for one of the biggest construction companies in the country on a major public works project in Western Australia.

The economic cost of insolvencies in the construction industry is staggering. In 2013–14 alone, ASIC figures indicate that insolvent businesses in the construction industry had, at the very least, a total shortfall of liabilities over assets accessible by their creditors of $1.625 billion. Others who have analysed the data place the amount at $2.7 billion. The construction industry consistently rates as either the highest or second highest as against all other industries when it comes to unpaid employee entitlements.

Insolvency hinders innovation and productivity

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1 Fair Work Ombudsman, *Phoenix Activity: Sizing the Problem and Matching Solutions* (PricewaterhouseCoopers, June 2012), pp. 2, 15; cited in ATO, *Submission 5*, p. 12.

Businesses now operate in an environment in which non-payment for work carried out is commonplace, cash flows are uncertain and businesses lower down in the subcontracting chain have little power relative to those at the top of the chain. In this environment, there is very little incentive to invest the necessary capital to adopt new and innovative construction methods, invest in new capital equipment or invest in workforce skills development.

The construction industry consistently ranks in the three least innovative industries in the country. According to latest available ABS innovation data, only a third of construction businesses could be classed as 'innovation-active' compared with more than half of businesses in the warehousing, media and telecommunications and retail sector businesses. Less than fifteen per cent of construction businesses had innovation in development, compared with over thirty percent of manufacturing businesses and 35 per cent of media and telecommunications businesses.

As innovation is a key driver of productivity, profitability and job creation, the lack of innovation in the industry must be addressed.

Early detection is critical to curbing illegal phoenix activity and preventing smaller scale insolvencies from becoming more significant

Industry participants are generally the first to become aware that a company may be entering financial distress; as such more effort needs to be expended in regularising information flows between industry participants and regulators. If industry participants are reluctant to inform the regulators as a result of intimidation and fear of commercial consequences, confidential tip-off lines, or equivalent measures, should be developed.

Failure to pay employee entitlements is often a sign of cash-flow problems that may be a precursor to insolvency. Early detection and intervention is crucial to preventing companies in financial distress from either entering insolvency, or continuing to raise debts before eventually collapsing. The committee was pleased to hear that a range of whole-of-government responses, led by the ATO and ASIC, have been established to share information between regulators. More resources should be directed to these measures and, where necessary, legislative frameworks should be amended to promote greater information sharing.

The committee also welcomes reports that the ATO and ASIC are engaged in information sharing activities with superannuation funds. The committee encourages the regulators to increase cooperation with superannuation funds aimed at early detection of non-payment.

More needs to be done to protect honest industry participants from unscrupulous individuals

The construction industry accounts for an unacceptably high proportion of total alleged criminal and civil contraventions of the *Corporations Act*. This is indicative of a culture that has developed in sections of the industry in which some company directors consider compliance with the *Corporations Act* to be optional.

This culture highlights the importance of a reform to legislative and regulatory framework so that it better protects law abiding industry participants from unscrupulous business practices.

Disqualification of directors

ASIC has the power to disqualify a person from holding a directorship under section 206F of the *Corporations Act*, where evidence indicates that insolvencies are connected to criminal or civil misconduct. Despite the considerable number of breaches within the construction industry, has been used as the exception rather than the rule, with an average of only 69 directors, across all industries, disqualified per financial year.

These low numbers have contributed to a feeling among insolvency practitioners, academics and participants within the industry—including potentially unscrupulous directors, that ASIC fails to take enforcement seriously. The committee does not agree with this view. However the committee is mindful that effective enforcement of the law requires resources, particularly in circumstances where non-compliance is the result of concerted effort on the part of those who desire to flout the law. For these reasons, the committee recommends that the government ensure ASIC is adequately resourced to enforce the law in each and every case where breaches are detected.

Director Penalty Regime

Disqualification is not the only response available. The Director Penalty Regime originally introduced as part of the *Insolvency (Tax Priorities) Legislation Amendment Act 1993* but substantially amended in 2012, aims to ensure that directors cause their companies to comply with certain taxation and superannuation obligations. The regime has been an important legislative reform in extending the ability of ATO to ensure that directors comply with their obligations to pay employee entitlements.

Nevertheless, the committee appreciates that the regime could be utilised more broadly, and has failed to recover a significant amount of outstanding liabilities. Of more concern, however, is the fact that the regime does not cover GST liabilities, allowing unscrupulous property developers to avoid their GST obligations intentionally. The committee believes that further consideration on this point should be conducted by the Legislative and Governance Forum for Corporations, the body with oversight of corporate and financial services regulation

Transactions entered into in order to avoid employee entitlements

Section 596AB of the *Corporations Act* prohibits transactions entered into with the intention of preventing the recovery of employee entitlements or depriving employees of their entitlements and imposes a criminal sanction for breach. Yet, despite clear evidence of this occurrence, no prosecution under section 596AB has ever been initiated. The provision needs to be amended to make it fit for purpose.

Licensing arrangements

In an industry characterised by low barriers to entry, small profit margins and inequitable allocation of risk, an effective licensing regime is necessary to protect participants from both unscrupulous and hapless operators.

The committee considers that three elements of a licensing regime are critical in reducing insolvency within the construction industry: evidence of adequate capital backing; financial skills training; and a fit and proper test. The committee notes further that a critical element of any fit and proper person test is the regularity and responsiveness of the test to a change in circumstance. Random financial health spot-checks should be conducted by the relevant regulator.

Transfer of jurisdiction of insolvency matters

The Federal Circuit Court of Australia has a substantial jurisdiction in personal bankruptcy but not corporate insolvency. The committee considers that strong arguments exist for the extension of the jurisdiction of the Federal Circuit Court of Australia's to include corporate insolvency matters under the *Corporations Act 2001*. In particular, it will promote expeditious resolution of matters at a lower cost.

Valuing debt assignments fairly

The *Corporations Act* and the *Bankruptcy Act 1966* diverge over the value of debt assignments at creditors meetings. Under section 64ZB(8) of the *Bankruptcy Act* the voting power of a person who buys a debt is the amount assigned for that debt, not the original value of the debt. In contrast, under the *Corporations Act*, the value of the voting power is the original value of the debt. The committee believes that the voting value of debt assignments at creditors meetings under the *Corporations Act* should be aligned with those applicable under the *Bankruptcy Act 1966*.

This anomaly was identified in the Walton Construction's case study, where a company connected to Walton's bought $18.5 million of Walton's debt for $30,000. The committee believes that there is no cogent reason why debt assignments should be valued differently for the purposes of the *Corporations Act* and *Bankruptcy Act*.

The committee considers further those businesses that provide restructuring advice should not be permitted to buy into the companies they are advising via debt acquisitions.

Subcontractors have a right to be paid for work completed

In the view of the committee, there is one principle and one principle only that should be observed in relation to security of payment in the construction industry. It is a fundamental right of anyone who performs work in accordance with a contract to be paid without delay for the work they have done.

This is not a new or radical principle and State and Territory parliaments across Australia have introduced security of payments legislation in an attempt to ensure that money owed to subcontractors is paid. The enactment of this legislation has been a positive development. However, the committee has heard evidence that while well intentioned, the often vastly different laws operating in each jurisdiction are not working as well as they were intended and there are significant barriers to access. Indeed, the disparate nature of the various regimes and the relatively poor take up of parties enforcement rights under the State and Territory regimes, as well as other significant problems, provides a strong indication that national harmonisation is necessary.

The construction industry is a national industry. Its participants, large and small, routinely operate across state borders. It is absurd that in this day and age there are eight separate security of payments regimes which differ markedly from one other. Some of the differences are small and some are large and significant, but what they all do is present manifold difficulties for construction industry businesses that routinely operate in more than one state. This has resulted in a great deal of wasteful litigation in which parallel points of law are raised in the different jurisdictions.

Witnesses and submitters to the inquiry expressed almost universal support for a single set of rules applying around the country for security of payment and related matters in the construction industry. The most effective way of achieving this would be for the Commonwealth to legislate based on the Commonwealth's various heads of legislative power, especially the corporations' power. This approach was adopted by both the Cole Royal Commission and the more recent Society of Construction Law Report on Security of Payment and Adjudication in the Australian Construction Industry.

As both these reports pointed out, there may not be completely universal coverage achieved by Commonwealth legislation. However it would be near enough to universal provided at least one party to a contract is incorporated, such that any marginal loss of coverage relative to State legislation would be an acceptable price to pay for this long-overdue reform. For these reasons, the committee recommends that the Commonwealth enact uniform, national legislation for a security of payment regime and rapid adjudication process in the commercial construction industry.

Retention trusts and project bank accounts

Again, submissions and evidence to this inquiry expressed almost universal support for the implementation of a retention trust model or similar mechanism to facilitate the prompt payment of contract payments to subcontractors. Such a mechanism would be in addition to security of payment legislation that provides for rapid adjudication processes in relation to payment disputes.

The committee agrees with the evidence and submissions of the many witnesses and submitters who have supported the concept of a trust account model for securing payments to subcontractors and reducing the incidence of insolvency in the industry.

The committee believes that Project Bank Accounts (PBAs) have the very strong potential to resolve the payment problems that have beset the industry and help minimise the great harm that the high level of insolvencies in the industry is inflicting on thousands of businesses and the people who run them and work in them every year.

PBAs would complement a harmonised national security of payments act. Any disputes in relation to payments or the head contractor's payment instructions to the bank could be resolved through access to the security of payment and rapid adjudication legislation.

The Commonwealth, as a major funder of construction projects, has a responsibility to ensure that it is a best practice participant in the industry. The overwhelming body of the evidence received by the committee in the course of this inquiry indicates that payment practices in the industry are a long way from best practice. The committee

accepts the evidence that the introduction of a form of statutory trust account for construction projects which puts payment of subcontractors at arm's length from head contractors would mark a significant step towards best practice payment system.

For this reason, the committee recommends that, commencing in July 2016, the Commonwealth commence a two year trial of Project Bank Accounts on major construction projects where the Commonwealth's funding contribution exceeds ten million dollars.

The committee further recommends that, following the successful completion of a trial of Project Bank Accounts on Commonwealth funded projects, the Commonwealth legislate to extend best practice payment systems that protect subcontractors from harsh, unconscionable and unlawful conduct in the construction industry.

Information asymmetries

Economists recognise the importance of overcoming information asymmetries to ensure the proper functioning of markets. This understanding underpins the requirement that public companies lodge their financial reports with ASIC each year. Asymmetries of information naturally create power imbalances. During the course of this inquiry the committee's attention was drawn to a number of information asymmetries that negatively affect subcontractors. Proposals to rectify these asymmetries are discussed in the report.

A legal obligation to warn of impending insolvency

Information is critical in inhibiting illegal phoenix activity and preventing small-scale insolvencies turning into larger collapses. Financial institutions are privy to more information about the financial status of companies they are involved with than subcontractors engaged in specified projects. This came to a head in the case of Walton Construction's, which collapsed on 3 October 2013.

The committee notes that in this case, an information asymmetry existed between the National Australia Bank (NAB) and subcontractors engaged with Walton's, which allowed NAB time to protect their interests. Removing the asymmetry by imposing a duty on those with more information to inform other participants in the market will reduce power imbalances and lead to a more effective market overall.

The committee is supportive in principle of requiring financial institutions to warn respective regulators if they have reasonable grounds to suspect that a business is in financial distress and may be, or may be about to, trade insolvent.

However, the committee accepts that imposing a legal obligation on financial institutions to do so could in many circumstances be counterproductive and may force companies into administration that could otherwise survive. The committee suggests that in order to protect their own interests, participants in the industry who provide goods or services on credit should seek as much information about the financial situation of their trading partners as possible.

A beneficial owners' register and a Director Identification Number

To register a company a person must lodge an application with ASIC. Under section 117(2) of the *Corporations Act*, the application must include the name and address of

each director of the company. However, little is done to verify that information and consequently there is a lack of transparency surrounding the identity of company directors.

The inability of regulators and participants in the building and construction industry to identify and track individuals suspected of illegal activity is a significant cause of the incidence of illegal phoenix activity.

A lack of transparency around company directors means that regulators are slower in clamping down on illegal phoenix operators and therefore more innocent participants are caught up in schemes, suffering significant economic and social effects. A comprehensive and verified beneficial owners' register would save regulators time in drawing links between suspected companies.

The committee believes that the recommendations in this report must be implemented as soon as practicable to ensure a productive, properly functioning construction market in which people are paid for the work they do.