HOUSING INDUSTRY ASSOCIATION

Submission to
Senate Economics Legislation Committee

Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017

12 July 2017

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contents

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ABOUT THE HOUSING INDUSTRY ASSOCIATION

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

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

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

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

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

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

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

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

The Association operates offices in 23 centres around the nation providing a wide range of advocacy and business support.

1. EXECUTIVE SUMMARY

HIA welcome the opportunity to comment on the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017*.

HIA notes that the intent of the legislation is to encourage and facilitate company restructuring and to reduce the stigma attached to business financial distress and failure.

Part 1 of the amendments proposes to provide a safe harbour from civil liability for insolvent trading for directors who take reasonable and appropriate steps to attempt to restructure a company during times of financial distress.

Part 2 restricts the ability to enforce "ipso facto clauses" that trigger an automatic right under the contract (such as to terminate, suspend) where a scheme is proposed to avoid winding up or an administrator is appointed.

Although the broad intent of the Bill is supported, HIA has concerns with aspects of the legislation, most particularly the potential impact the proposed restriction on enforcing ipso facto clauses will have on contracting and warranty insurance arrangements that already operate in the residential building industry.

HIA understands the motivation behind Part 2 of the Bill is that the exercise of a contractual right of termination that is exclusively based on the appointment of a voluntary administrator can present a serious challenge to restructuring opportunities. This is particularly the case, when there has otherwise been no performance breach and the contract remains in good standing.

At the same time, it is imperative for a correct balance to be struck between the policy objectives of contract law which favour freedom of contract and enforcement of the bargain agreed between the parties and those of insolvency law which are focused on protecting the rights of creditors.

It is common for building contracts to include clauses which enable either party to terminate the contract upon insolvency. Such clauses represent a fair and pragmatic response to the disruptive and ripple effects insolvency may cause across building projects.

From the builder's point of view, the insolvency of the client significantly increases their financial exposure, as they are essentially unsecured lenders throughout the life of the project. Whilst they remain committed to a project with a client that is likely to be impecunious, they will potentially be foregoing other work with financially sound clients.

Further it would be entirely unreasonable if the laws prevented the builder securing its plant, equipment and materials or exercising retention of title rights. This is particularly important for plant and equipment that is 'on hire' or may be needed for other projects.

Concurrently, from the owner's point of view there are various considerations including their right to remove the insolvent party from the project and replace them with a party that is capable of performing and completing the relevant works.

HIA is also concerned that aspects of the drafting of the Bill could interfere with and undermine the operation of home owners warranty insurance (HWI). These policies are established features of the consumer protection landscape in Australia, providing home owners with coverage for defects in building work (arising from a failure to comply with the statutory warranties under the building contract) and non-completion claims in the event that a builder becomes "insolvent, dies or disappears".

In the vast majority of cases, an owner's rights to access the policy of insurance is triggered upon the builder's insolvency, which is defined to include the appointment of a voluntary administrator.

To address these issues, HIA recommends that the legislation expressly carve out contracts for domestic building and warranty insurance policies from the operation of Part 2 of the Bill.

HIA elaborates on these matters below.

2. GENERAL COMMENTS ON THE BILL

2.1 INSOLVENCY IN THE CONSTRUCTION INDUSTRY

A number of government inquiries and initiatives have been targeted at insolvencies in the building and construction industry, including most recently a 2015 report of the Senate Standing Committee on Economics.

According to ASIC, the construction industry represents approximately 21% of lodgements for external administration.

To some extent this is a natural reflection of the size and number of construction industry firms operating in the economy. Australian Bureau of Statistics (ABS) data also indicates that as of June 2016, the construction industry had the highest number of businesses operating in Australia with a count of 346,499 units.

It must also be acknowledged financial failure for some firms will be an unavoidable consequence of the competitive forces of Australia's market economy. As some businesses fail, others will thrive and new opportunities will emerge for newer entrants.

Builder insolvency rates are highly correlated to underlying building and economic cycles.

Nonetheless, high rates of insolvency are a concern for productivity in any industry.

By its very nature, insolvency means that some financiers of activity in the industry are left out of pocket upon the liquidation of the insolvent entity. This has unfavourable impacts on the financing costs for all businesses in the same sector, regardless of how strong their own solvency is. The higher costs of financing may have a flow on adverse impact on the productivity of all firms in the industry. In terms of economic signalling, insolvency is the system's way of saying that the resources consumed in creating the firm's output exceeds the benefit of that output.

As long as insolvent companies remain trading, they are diverting resources and productivity away from other areas of the economy. A firm's customers and suppliers are often materially impacted by insolvency, and in some cases this could damage the reputation of other firms in the same industry and cause its customers, suppliers and other stakeholders to engage with them in a more cautious and less favourable manner.

In the building industry the fallout from an insolvency can be significant, impacting not only directors and their employees, subcontractors and suppliers but other people in the industry. A shutdown of one project can impact on other projects and cause further shutdowns.

Accordingly, an effective, efficient and balanced statutory framework is required to help business and creditors deal with the impact of insolvency.

In looking to law reform, HIA considers the goal should be to maintain proper director conduct and duties whilst providing appropriate incentives for directors to genuinely attempt to find a solution to the company's financial difficulties. HIA acknowledge that this is not a simple task.

2.2 Part 1 - The Safe Harbour

The aim of Australia's insolvent trading laws is to stop directors continuing to trade while insolvent, thereby reducing the potential loss suffered by creditors.

Under Section 588G of the current law, company directors who allow the company to trade while it is insolvent can be personally liable to pay for the loss or damage caused by the company's insolvent trading.

Once a director concludes that the company is insolvent, the only course of action to avoid liability is to cause the company to cease trading (where trading involves the incurring of debts) or appoint a voluntary administrator.

It is arguable that, at times, this strict approach actually damages the interests of creditors, as there is little opportunity for a company to trade out of its predicament.

According to the Explanatory Memorandum, the Bill intends to enable directors to take reasonable risks to facilitate the company's recovery instead of simply placing the company prematurely into voluntary administration or liquidation.

HIA supports the amendment, in principle, but notes the drafting is largely in technical terms.

The provisions enable a debt to be incurred in an attempt to the save the company provided that the directors develop a comprehensive plan to achieve solvency within a reasonable period of time.

Significantly under draft section 588GA(3), the company director bears the evidential burden of proving that they took "a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors", as required by draft section 588GA(1).

'Better outcome' is 'an outcome that is better for both:

- the company; and
- the company's creditors as a whole than they would otherwise have if the company entered some form of external administration under Chapter 5 of the Act.

The Explanatory Memorandum explains this as a 'low evidential burden', which makes it clear that the director need only identify relevant action taken that could be said to be 'reasonably likely to lead to a better outcome for the company and the company's creditors' (s 588GA(1)(a)).

Nonetheless one of the potential issues in the new laws being practically applied is that 588GA(1)(a) directs attention to the specific time that the director 'starts to suspect that a company may become insolvent'. Director liability under section 588G(2) is triggered when a debt is incurred at a time when, relevantly, there are reasonable grounds for suspecting that the company is insolvent or would become.

Under the current drafting, there is a risk that the focus will be identifying the precise moment from when the directors suspected insolvency rather than the reasonable action taken by the directors to restructure the business to limit the risk of insolvency occurring.

Given the goal of the reform is to give Directors certainty so that they can have confidence to focus on reasonable restructuring efforts, in HIA's submission, the Bill should be amended to remove nexus with the moment that there is a suspicion that the company is in dire financial circumstances.

In addition, for the amendments to have a practical impact the company must be allowed to trade on whilst restructuring is taking place.

However in practice, HIA anticipates that there is likely to be some confusion and debate over those debts that continue to be incurred as part of the ordinary trading activities of the company, in contrast to those debts incurred as part of the restructuring activity.

In the residential building industry cashflow, or lack of it, is a key factor in many building company collapses.

Whilst attempting a restructure most residential builders will naturally wish to continue with their contractual obligations under their existing construction contracts.

Residential builders are reliant on receiving milestone progress payments to pay their employees and ordinary trade creditors, such as subcontractors and suppliers. They are also liable to their clients under liquidated damages provisions for project delays.

In such circumstances, it is highly unlikely that ordinary trade payments will attract the benefit of the safe harbour and for these reasons HIA suspects that the new provisions are going to be difficult to be relied upon by many builders and contractors in the residential building industry.

HIA otherwise supports the protections in the Bill that deny the safe harbour to directors who fail to maintain proper books and records or pay employee entitlements.

2.3 PART 2 – LIMITING THE RIGHT TO ENFORCE IPSO FACTO CLAUSES

Part 2 of the Bill addresses ipso facto clauses in contracts that allow rights to be exercised purely on the basis of an insolvency event (such as the appointment of an administrator or deed administrator).

Under the Bill there will be a delay in enforcing “rights” that arise by express provision of a contract, agreement or arrangement because a company:

- applies for or enters into a scheme of arrangement (but only where the company's application to commence the scheme states that it is being made to avoid being wound up in insolvency); or
- enters into voluntary administration.

These amendments broadly reflect arrangements in the United States, where companies in Chapter 11 proceedings (or certain other proceedings) under the US Bankruptcy Code have the benefit, subject to certain exceptions, of a general prohibition on the enforcement of ipso facto clauses in certain contracts.

The new provisions will apply to all contracts except those to be carved out via regulation or ministerial declaration.

HIA acknowledges that it can be very difficult, and somewhat impractical, for a company to be salvaged if all of its key suppliers, contractors and customers are free to terminate their contracts with the company solely on the basis of the appointment of an administrator.

Further the specific restructuring procedures that have been nominated by the government as attracting the benefit of the stay are commonly used to attempt to resuscitate the company, require the approval of creditors and are limited in duration.

In theory, these amendments have the capacity to reduce the rate of some unnecessary exits from the building industry.

In practice however, the blanket application of the new rules staying enforcement of ipso facto clauses to all home building contracts will be problematic.

As outlined earlier, it is very common for building contracts, including home building or residential building contracts, to allow termination by either party due to insolvency. This ability to terminate upon insolvency can be an important lever for either party.

From the principal contractor/ builder's point of view, even if a client under external administration is not in arrears, continuing to undertake further works for that client without security or evidence that they have capacity to pay presents an unacceptable risk for most builders.

Notably, under section 415D "rights" are not specific to the contract or agreement that the corporate body is a party to. Further the term "right" is not defined or specifically limited to the right to terminate or vary the contract. In a building contract, such a right could also extend to a suspension of works.

From the client's point of view, the appointment of voluntary administrator will ordinarily bring physical works to a stop.

In many cases a builder under external administration (even if it does not end up in liquidation) can trigger an immediate suspension of the builder's licence, which impacts on their capacity to continue with and complete works under construction.

For some owners, the sooner they are able terminate the contract and appoint an alternate builder, the less the insolvency will impact upon the overall project.

In addition, Part 2 as drafted, could potentially interfere with the operation of builder's indemnity/ home warranty insurance schemes.

Home warranty insurance (HWI)[1] schemes are integral and compulsory components of the legislated consumer protection package for homeowners in all states and territories, except Tasmania.

Under the various schemes, policies of insurance provide cover for home owners if the builder who they contracted with produces defective work (in breach of the builder's statutory warranties) or fails to complete the work under certain circumstances.

The builder's client, the home owner, has the benefit of the insurance, as does the owner's successor in title, whilst the policy is in force. The insurance cover is purchased and obtained by the builder on the home owner's behalf before works are commenced and monies are paid under the contract.

The insurance cover specifically comes into effect and is triggered where a builder is unable to complete a building contract or return and rectify defective work because they have become "insolvent, died or disappeared"2.

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[1] This is its description in New South Wales and Queensland. It is also known by other names in other jurisdictions, including "builders warranty insurance" and "domestic building insurance". Apart from the Fidelity fund schemes offered in the ACT and NT and QBCC insurance in Queensland where the regulator directly issues and underwrites the insurance, the insurance is a form of general insurance and is regulated as a "financial product" under Chapter 7 of the *Corporations Act 2001*.

2 In New South Wales and Victoria there are additional triggers when a builder's licence is cancelled and there has been non-compliance with a judgment of a competent court or tribunal.

The insurer may pay the owner damages and losses on the project up to a cap and/or appoint an alternate builder to finalise their project.

In HIA's experience, the vast majority of claims are triggered by the insolvency of a builder with claim payments made being for a builder's failure to complete work.

The insolvency trigger for homeowners can be activated on the builder going into external (voluntary) administration for the purposes of the Corporation's Act. It does not require a full liquidation or winding up.

As part of this process the contract with the builder may be terminated either directly by the home owner or by the insurer exercising rights of subrogation.

The scheme in operation in Queensland is unique to that state. Home warranty insurance in Queensland specifically cannot provide assistance to a consumer for loss suffered as a result of a building contractor failing to complete work unless the contract has ended. If the consumer has terminated the contract, the termination must occur within 2 years of the date of payment of the insurance premium or the date of entering into the contract, whichever is the earlier. Also, the Scheme cannot assist a consumer to remedy defects in partially completed work where the building contract has not come to an end. In many instances, this can only occur if the consumer lawfully terminates the contract.

HIA recommendation: Carve out residential building contracts and home warranty insurance policies from the operation of these provisions via the Regulations

For the above reasons HIA submits to the Committee that residential building contracts and "financial products" that manage the risk of insolvency (such as policies of HWI) be carved out via an exclusion in the legislation (or failing that, specifically listed in the regulations) and exempt from the application of the Bill.

3. CONCLUSION

In principle, HIA supports the reform package but considers modifications are necessary with respect to Part 2 of the Bill, which deals with the ipso facto clauses to prevent unintended consequences for residential building contracts.

The proposed automatic stay that will prevent a contractual party taking action when the other party has gone into voluntary administration will cause uncertainty for parties to residential construction contracts and potentially cause confusion for home owners wishing to access their policies of home owners warranty insurance.

In HIA's submission, this automatic stay should not apply to residential construction contracts or polices of home owners warranty insurance.