

## Chapter 2

### Overview and background

2.1 Businesses operating in the Australian building and construction industry face an unacceptably high risk of either entering into insolvency themselves, or becoming the victim of an insolvency further up the contracting chain. This risk is not merely the result of market forces. While market forces play a part, there are other factors at play—the structure of the commercial construction sector, serious imbalances of power in contractual relationships, harsh, oppressive and unconscionable conduct, unlawful and criminal conduct and a growing culture of sharp business practices—all contribute to the situation where every year, the industry is burdened by around \$3 billion in unpaid debts. The industry is consistently ranked as having one of the highest rates of insolvencies in Australia, with the construction industry accounting for 22 per cent to 24 per cent of all Australian company insolvencies every year.<sup>1</sup> This chapter examines the incidence and causes of insolvency in the Australian construction industry. In doing so, it will focus on the particular structure and changing culture within the industry and the unique pressure which these forces have on industry participants within it. First, this chapter clarifies what is meant by the term 'insolvency'.

#### What is insolvency?

2.2 Section 95A defines 'insolvency' generally for the purposes of the *Corporations Act 2001* ('Corporations Act'). Under s 95A, a company is insolvent if the company is not able to pay all the company's debts as and when they become due and payable. The statutory definition of insolvency suggests that a cash flow test rather than a balance sheet test is to be applied in determining insolvency although courts will usually consider both tests and the overall situation of the company.

2.3 Section 588G of the Corporations Act creates an obligation on company directors to avoid insolvent trading. Company directors must ensure, as they deal with their company's affairs, that they do not allow the company to trade while insolvent, nor incur a debt that would lead the company to insolvency. This is in addition to their general duties to act with care and diligence, in good faith in the best interests of the organisation and not to use their position or information received improperly for personal gain (ss 180–183).

#### Structure of the Australian construction industry

2.4 The structure of the Australian building and construction industry, as well as the contractual relationships of persons working within it, has transformed over a number of decades. As the Construction, Forestry, Mining and Energy Union (CFMEU) noted, this transformation is a move away 'from an industry dominated by construction companies with large, directly employed skilled workforces' towards a

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1 ETUA, *Submission 4*, pp. 5–6, [17]. Mr. Dave Noonan, National Secretary, CFMEU, *Official Committee Hansard*, 12 June 2015, p. 2.

'pyramid of contractual relationships involving a head contractor at the top and multiple layers of smaller specialised subcontractors underneath'.<sup>2</sup> The CFMEU explained further:

Typically, the management of major projects is assigned to a head contractor who is not a direct employer of any significance of the labour on the project. These head contractors contract 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.<sup>3</sup>

2.5 Mr. Michael Ravbar, Divisional Branch Secretary, CFMEU Queensland, made a similar point. Mr Ravbar explained that the change in workforce management has been accompanied by two other structural changes in the industry—a concentration of ownership among tier 1 contractors and a consequent reduction in competition at that level.<sup>4</sup>

2.6 The dramatic shift towards an industry populated by subcontractors is evidenced by figures submitted by the Subcontractors Alliance. They noted that 'in Australia subcontractors are responsible for between 80 per cent and 85 per cent of all construction work, the highest involvement of subcontracting in the world'.<sup>5</sup>

2.7 The precise layering of sub-contractual relationships and the size of sub-contracting firms does differ within the industry. The HIA explained that in commercial construction:

...whilst there is a large number of subcontracting firms, the overwhelming majority of those working in building and construction are actually employed by these subcontracting firms. Further subcontracting occurs only in specialist areas...

By contrast, in the housing industry, subcontracting predominates down to the lowest levels, so that there are significantly fewer employees on a low or medium density housing site.<sup>6</sup>

2.8 Likewise, the Air Conditioning & Mechanical Contractors' Association of Australia (AMCA) noted that the majority of construction work was performed by subcontractors, who are therefore the primary employers of workers onsite.<sup>7</sup> These,

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2 CFMEU, *Submission 15*, p. 6.

3 CFMEU, *Submission 15*, p. 6.

4 *Official Committee Hansard*, 31 August 2015, p. 2.

5 Subcontractors Alliance, *Submission 18*, p. 2. See also Mr Chris Rankin, Executive Director, Air Conditioning and Mechanical Contractors' Association of Australia, *Official Committee Hansard*, 21 September 2015, p. 11.

6 HIA, *Submission 7*, p. 5.

7 AMCA, *Submission 9*, p. 2.

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and other, submissions emphasised the fact that subcontractors are 'extremely diverse small business[es]', ranging from sole practitioners to large, sophisticated operations.<sup>8</sup>

2.9 Nevertheless, despite the differences between particular subcontractors, they all share a critical characteristic—their position within the contractual structure of the business and construction industry. As a consequence of the pyramidal structure of the industry, 'there is often no direct contractual relationship between the persons performing the bulk of the work being undertaken on the project and the head contractor who is being paid by the client'.<sup>9</sup> Indeed, this new industry model was noted by Commissioner Justice Cole in the 2003 *Royal Commission into the Building and Construction Industry* (the Cole Royal Commission), which explained that 'while the large contractors subcontract most of [the] work to smaller businesses...large contractors control a substantial part of the industry's output and cash flow'.<sup>10</sup> This arrangement can have significant consequences. The CFMEU noted:

This structure has the immediate consequence that the entity being paid to deliver the project will be receiving payments which for the most part, is for work being performed or materials supplied, by someone else.<sup>11</sup>

2.10 As AMCA noted, this structure places considerable pressure on persons down the contractual chain.<sup>12</sup> As will be examined below, business failure up the chain—whether a result of general economic conditions, mismanagement or fraud—has considerable impact on subcontractors below.

### ***Cultural change in the Australian construction industry***

2.11 The structural changes occurring within the construction sector have affected the culture of the industry. As noted below at paragraph 2.31 in relation to the causes of insolvency, the surfeit of subcontractors means that head contractors often have little regard for the impact of the pressures on subcontractors.<sup>13</sup> This results in a culture in which those with the greatest amount of power and the deepest pockets dismiss payment disputes, challenge adjudication decisions or take action to prevent subcontractors being able to obtain further work if they take action under security of payment laws.

2.12 Mr John Chapman, South Australian Small Business Commissioner, informed the committee that, in his opinion, the big construction companies do not 'play nice'.<sup>14</sup> Mr Chapman explained: 'What has come across, in my area, is where people are not

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8 Subcontractors Alliance, *Submission 18*, p. 2.

9 CFMEU, *Submission 15*, p. 6.

10 *Final Report of the Royal Commission into the Building and Construction Industry: Volume 3 National Perspectives Part 1* (2003), p. 60.

11 CFMEU, *Submission 15*, p. 6.

12 AMCA, *Submission 9*, p. 1.

13 AMCA, *Submission 9*, p. 1.

14 *Official Committee Hansard*, 21 September 2015, p. 4.

being paid and for, what I have seen, no good reason...If the principal decides, "I'm not going to pay you because I don't feel like it," there is a problem'.<sup>15</sup>

2.13 Mr Christopher Rankin, Executive Director, AMCA, made a similar observation:

You are making a presumption that anyone thinks it is a bad thing for a subcontractor to go broke when you are holding retention funds and payments in excess of 90 days. Sometimes it can be a benefit. They dump one and send in another soldier. They already have the money.<sup>16</sup>

2.14 Mr Bob Gaussen, Owner, Adjudicate Today, continued the martial analogy. Mr Gaussen agreed with the characterisation that the culture of the industry approaches something like the Somme, where subcontractors 'get mowed down and fresh bodies are poured in'.<sup>17</sup>

2.15 Adjunct Professor Philip Evans, who conducted a review of the Western Australia security of payment regime, agreed that a similar culture exists in Perth. However, Adjunct Professor Evans favoured a less dramatic analogy, describing the culture towards subcontractors through the expression: 'there's another cab on the rank'.<sup>18</sup> Whichever way it is described, the changing structure of the industry has contributed to a culture which places intense pressures on subcontractors.

## **Insolvency in the construction industry**

### ***Inadequate record-keeping on insolvencies***

2.16 In order to ascertain and determine appropriate responses to insolvency in the construction industry, an accurate record documenting all incidents of insolvencies is required. Unfortunately, some submissions noted that corporate insolvency statistics are inadequate at present.<sup>19</sup> This is an enduring complaint for many in the industry. ARITA noted that it 'has made many submissions to government on the inadequacy of corporate insolvency statistics in Australia',<sup>20</sup> including to this committee's 2014 *Inquiry into the Performance of the Australian Securities and Investments Commission*.<sup>21</sup>

2.17 In that report, the committee was of the view that ASIC 'should interrogate its databases and extract and publish critical information that would allow academics, professional bodies and interested members of the public to gain a greater

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15 *Official Committee Hansard*, 21 September 2015, p. 4.

16 *Official Committee Hansard*, 21 September 2015, p. 15.

17 *Official Committee Hansard*, 21 September 2015, p. 15.

18 *Proof Committee Hansard*, 26 October 2015, pp. 5–6.

19 See Melbourne Law School and Monash Business School, *Submission 1*, p. 5 and ARITA *Submission 8*, p. 2.

20 ARITA *Submission 8*, p. 2.

21 Insolvency Practitioners Association, *Submission 202*, pp. 5–6, Economics References Committee, *Inquiry into the Performance of the Australian Securities and Investments Commission*, 2014.

understanding of what is happening in the financial world'.<sup>22</sup> The committee recommended that 'ASIC promote "informed participation" in the market by making information more accessible and presented in an informative way'.<sup>23</sup> Indeed, improved data collection and dissemination might assist in overcoming some of the information asymmetries (that are discussed in chapter 12) and lead to a better functioning market in the industry.

2.18 The most common types of formal corporate insolvency are voluntary administration, liquidation and receivership. These involve an external administrator being appointed to manage the company's affairs. External administrators (be they liquidators, receivers or voluntary administrators) must lodge notice of their appointment with ASIC. These reports form the insolvency statistics that ASIC manages; however, they are accompanied by considerable qualifications.

2.19 First, external administrators are not required to lodge reports unless the preconditions of s 533, s 422 or s 438D of the Corporations Act are met, meaning that in some circumstances an external administrator may not lodge a report. Second, only reports lodged electronically in the Schedule B Report format are included in the statistics. It is not, however, mandatory for external administrators to report in this format. Third, ASIC compiles its statistics only from the initial report lodged, which merely reflect estimates and opinions of the external administrator at a point in time. The statistics do not reflect revised information from updated or subsequent reports.<sup>24</sup>

2.20 Notwithstanding these limitations, the committee considers that ASIC's statistics can be used to demonstrate the broad landscape, including the incidence and cost, of insolvencies in the construction industry.

### ***Incidence of insolvency***

2.21 Despite difficulties in data collection it is clear that the incidence of insolvency in the Australian construction industry is concerning. Initial administrator reports lodged with ASIC, and cited by the CFMEU, establish the scale of the problem, with construction businesses accounting for between one-fifth and one-quarter of all insolvencies throughout Australia (table 2.1).<sup>25</sup>

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22 Economics References Committee, *The Performance of the Australian Securities and Investments Commission*, 2014, p. 355; see generally pp. 352–356.

23 Economics References Committee, *The Performance of the Australian Securities and Investments Commission*, 2014, p. 356, Recommendation 39.

24 ASIC, *Submission 11*, p. 11.

25 CFMEU, *Submission 15*, p. 7.

**Table 2.1: Incidence of construction industry insolvencies**

Financial Year	Number of Construction Industry Insolvency Events	Construction Industry Insolvencies as a Percentage of all Industries
2004/05	935	20.1
2005/06	1,177	20.3
2006/07	1,396	20.3
2007/08	1,517	21.9
2008/09	1,760	22.8
2009/10	1,905	24.1
2010/11	1,862	23.1
2011/12	2,229	22.1

2.22 More recent data submitted by ASIC indicate that this issue is a recurrent one. Over the five-year period 2009–10 to 2013–14, the construction industry was the largest single category behind the composite category 'Other (business & personal) services' for insolvency events. Starkly, over this period 23 per cent of all external administrations related to entities in the construction industry (table 2.2):<sup>26</sup>

**Table 2.2: Initial external administrators' reports by industry type (2009–10 to 2013–14)**

Rank	Industry type	2009–2010	2010–2011	2011–2012	2012–2013	2013–2014	Total	%
1	Other (business & personal services)	1,735	1,887	2,369	2,220	2,482	10,693	24%
2	Construction	1,905	1,862	2,229	2,245	2,153	10,394	23%
3	Retail trade	818	864	1,024	904	870	4,480	10%
4	Accommodation & food services	561	611	929	817	916	3,834	9%
5	Manufacturing	511	474	574	532	463	2,554	6%
6	Transport, postal & warehousing	472	448	607	493	508	2,528	6%

2.23 These numbers are concerning and they are not atypical. Mr. John Price, Commissioner, ASIC, informed the committee that the rate of insolvencies in the Australian construction industry is consistent with the rate in Scotland, and only a little higher than in England and Wales.

...the Scottish construction industry had 23 per cent of reported compulsory liquidations. ...It is exactly the same as us. In England and Wales it was less—it was around 15 per cent of compulsory liquidations. My experience is that those figures are relatively typical. Construction is a very challenging

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and competitive environment to work in and there do tend to be high levels of failure in those sectors consistently over many years.<sup>27</sup>

2.24 Nevertheless, this should not be used as an excuse to do nothing. The rate of insolvencies in the Australian construction industry and their cost is unacceptably high.

2.25 It is true that construction is a challenging and competitive environment. While the initial external administrator reports lodged with ASIC demonstrate that the majority of companies entering into external administration are small to medium size enterprises,<sup>28</sup> the pyramidal structure of the industry means that even a small enterprise suffering financial distress is likely to create ripple effects throughout the industry and affect multiple businesses. The significant economic and social cost of these insolvencies will be addressed in more detail in chapters 3 and 4. The substantial cost borne by individuals and the public purse is reason enough alone to examine the legal, policy and administrative measures which can be taken to reduce the incidence of insolvencies in the Australian building and construction industry.

### **Causes of insolvency**

2.26 Initial external administrators' reports lodged with ASIC between 2009–10 and 2013–14 illustrated that the causes of insolvencies in the construction industry are myriad (table 2.3). Inadequate cash flow or high cash use, poor strategic management of the business and poor financial control, including a lack of record-keeping, accounted for the highest number of business failures. These were not the only causes, however, as poor economic conditions and trading losses accounted for a considerable number of insolvencies.<sup>29</sup>

2.27 The evidence received by the committee indicates that in addition to the usual market factors referred to above, non-market factors, including highly unequal power relations in contractual relationships, non-payment of contractual obligations and a range of civil and criminal non-compliance with the corporations law are contributing factors.

2.28 Although fraud was rarely considered a factor, two points should be remembered. First, these statistics are only compiled from initial reports and external administrators may not have had enough time or information to ascertain whether fraud was a contributing factor when required to lodge their report. Second, the pyramidal structure of the industry means that one collapse can cascade throughout the industry. Importantly, while the failure of one business may have been a result of inadequate cash flow, the business may have lacked cash flow as a result of the fraud of a contractor further up the chain.

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27 *Proof Committee Hansard*, 28 September 2015, pp. 37–38. See also *Proof Committee Hansard*, 28 September 2015, p. 28.

28 ASIC, *Submission 11*, pp. 3–4.

29 ASIC *Submission 11*, p. 20.

**Table 2.3: Nominated causes of failure—Construction industry (2013–14)**

Causes of failure	2013/14	2012/13	2011/12	2010/11	2009/10	Total
Under capitalisation	435	473	508	426	428	2270
Poor financial control including lack of records	660	679	676	582	672	3269
Poor management of accounts receivable	336	385	358	318	323	1720
Poor strategic management of business	892	959	914	775	839	4379
Inadequate cash flow or high cash use	1000	964	900	783	736	4383
Poor economic conditions	558	722	724	559	503	3066
Natural disaster	17	25	26	4	10	82
Fraud	30	19	31	23	24	127
DOCA failed	35	18	16	11	7	87
Dispute among directors	52	42	58	44	61	257
Trading losses	698	704	675	525	510	3112
Industry restructuring	50	34	23	21	10	138
Other	611	664	588	482	466	2811
<b>Total</b>	<b>5374</b>	<b>5688</b>	<b>5497</b>	<b>4553</b>	<b>4589</b>	<b>25701</b>
<b>Number of reports lodged</b>	<b>2153</b>	<b>2245</b>	<b>2229</b>	<b>1862</b>	<b>1904</b>	<b>10394</b>

2.29 The Final Report of the 2012 *Independent Inquiry into Construction Industry Insolvency in New South Wales* (the Collins Inquiry) mirrored ASIC's statistics. The Collins Inquiry found that the most commonly cited causes of insolvency in the NSW construction industry were:

- insufficient capital together with excessive debt;
- poor financial management skills;
- an inability to manage the scope of projects;
- lack of requisite expertise for a particular project;
- low margins;
- payments withheld or not paid;
- fraud; and
- poor economic conditions.<sup>30</sup>

2.30 A number of submissions and witnesses informed the committee that these causes have an underlying contributing factor. AMCA argued that the very structure of the construction industry inequitably allocates risk to those least able to bear it.

30 *Final Report of the Independent Inquiry into Construction Industry Insolvency in NSW* (2012), p. 40; cited in CFMEU, *Submission 15*, p. 8.



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This consequential power-relationship that is developed between contractors and subcontractors, and which evidence before the committee shows has been exploited by certain principals and head contractors, contributes to insolvency:

It is the AMCA's belief that the structure of the commercial building and construction sector, typically characterised by a top-down chain of contractual relationships, propagates an environment whereby risk is disproportionately allocated to subcontractors.<sup>31</sup>

2.31 AMCA listed four factors that, in its view, contribute to the structural power imbalance between contractors and subcontractors:

- vast differences in financial, legal and human resources, particularly as it relates to contractual negotiations;
- access to legal advice to review contract conditions;
- fierce competition between subcontractors, which leads to a 'lose a soldier, send in another one' mentality among head contractors; and
- a reticence among subcontractors to push back against onerous contract conditions through fear of being excluded from future tenders.<sup>32</sup>

2.32 Mr Chapman agreed that participants higher up the contractual chain, particularly principals, can—and sometimes do—misuse their power to damage the position of subcontractors:

Major construction companies have subcontractors and then subs of subs down the tree and some of the behaviours by the principals are quite abhorrent—you can take us to court but we have got a room of lawyers out the back and we will keep going. I have seen evidence of that with some subcontractors in some big projects. One South Australian subcontractor working interstate suffered tremendous financial harm through a legal case that was brought just to try and get paid and it may force him to the wall.<sup>33</sup>

2.33 Mr Rankin explained that the power imbalance itself is not necessarily 'some sort of conspiracy towards subcontractors' but is 'simply an outcome' or consequence of the structure of the industry. In Mr Rankin's view, 'it may not be exclusively market drive, but a lot of it is'.<sup>34</sup> In any case, it is clear that the structural power imbalances present an opportunity for unscrupulous participants to pressure subcontractors.

2.34 The committee examined in detail three causes for failure in the construction industry that were repeatedly cited in written submissions and in public hearings before the committee:

- broader economic conditions and the cyclical nature of the industry;

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31 AMCA, *Submission 9*, p. 1.

32 AMCA, *Submission 9*, p. 1.

33 *Official Committee Hansard*, 21 September 2015, p. 2.

34 *Official Committee Hansard*, 21 September 2015, p. 12.

- inadequate cash flow and poor industry payment practices (as a consequence of the structure of the construction industry); and,
- the level of business acumen in the construction industry.

2.35 The incidence of illegal phoenix activity, and other criminal and civil misconduct, will be examined in chapter 5.

### ***Broader economic conditions and cyclical nature of the industry***

2.36 A number of witnesses and submissions referred to broader economic conditions and the cyclical nature of construction industry work as a cause of insolvencies. Many witnesses explained to the committee that the building and construction industry goes through cycles.<sup>35</sup> In a competitive industry, a down cycle naturally leads to companies entering financial distress. The Electrical Trades Union of Australia (ETUA) observed that the relationship between economic growth and insolvencies was inversely proportional:

There is a steady inverse relationship between insolvencies and economic growth and productivity. When economic and productivity growth has been higher, growth in insolvency activity has trended lower and vice versa. The global financial crisis is good example of illustrating this relationship...In 2008–09, company insolvency administrations grew by a record 26.5%, the highest rate in a decade.<sup>36</sup>

2.37 The cyclical nature of the industry presents additional significant challenges to participants. AMCA indicated that management of a businesses' workforce is particularly difficult and, if not managed appropriately, can contribute to insolvencies.<sup>37</sup> AMCA provided the example of a subcontracting firm with a large project approaching completion. Without a new project of comparable size, or several smaller jobs, the firm will face the prospect of having an idle workforce. AMCA suggested:

One option available to the firm is to reduce their workforce through redundancies. However this is a costly exercise with several negative implications, including:

- the wellbeing of those made redundant;
- uncertainty for remaining staff;
- the attrition of skills and knowledge; and
- costs for firms to rehire staff when new projects are won.<sup>38</sup>

2.38 AMCA explained that 'to avoid having to employ such strategies, subcontractors seek to keep staff employed by having a consistent pipeline of work'. However, in practice:

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35 See for example: Mr John Chapman, South Australian Small Business Commissioner, *Official Committee Hansard*, 21 September 2015, p. 1.

36 ETUA, *Submission 4*, p. 11.

37 AMCA, *Submission 9*, p. 2.

38 AMCA, *Submission 9*, p. 3.

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...this often means accepting jobs with onerous contract conditions and razor thin profit margins, perpetuating an environment of financial and personal stress, and clearly increasing the risk of insolvencies.<sup>39</sup>

2.39 Indeed, the construction industry is one of the most competitive sectors in Australia. Mr Jade Ingham, Assistant Secretary CFMEU Queensland, noted that this competitiveness means that 'margins are tight, and it flows downhill'.<sup>40</sup> Mr Ingham continued, explaining how the tender process increases both competition and pressure on participants in the industry:

When a developer wants to build a project, they call for tenders with a builder. A number of builders will price the job and they will price it based on different design methodologies, different safety mechanisms they can build into the job, and of course the labour cost component. Then that flows downhill. So they are competing at very tight margins and they take risks and they take gambles.<sup>41</sup>

2.40 As Mr Ingham explained, 'you only need a few unforeseen events—weather, for example, or supply issues or even one of their own subcontractors tipping over and going bust during the life of the project' to destroy the profitability of the project.<sup>42</sup> Mr Christopher Rankin informed the committee that some businesses tender 'at zero margin or a negative margin...in the hope that they can drag it back through the process of the project'.<sup>43</sup> As later chapters will demonstrate, dragging a profit margin back during the life of a project often means subcontractors, tax liabilities and employee entitlements are left unpaid.

2.41 AMCA informed the committee of the range of strategies its members employ to avoid laying-off valued staff and the pressure to accept onerous contract conditions. Unfortunately, these measures rely on positive economic conditions more broadly.

For example, AMCA members in Victoria have devised a loose scheme whereby workers may be provisionally loaned to other firms to avoid redundancies. This option has proved to [be] reasonably effective, but relies upon demand from other firms and is subject to cyclical fluctuations in the market. AMCA members also seek to avoid redundancies by having staff take annual leave entitlements during slow periods; however this is a limited and short term solution.<sup>44</sup>

### ***Inadequate cash flow and poor industry payment practices***

2.42 Submissions referred to below and witnesses appearing before the committee identified cash flow problems as a principal cause of financial stress in the industry. While cash flow problems can be the result of broader economic conditions, or poor

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39 AMCA, *Submission 9*, p. 3.

40 *Official Committee Hansard*, 31 August 2015, p. 3.

41 *Official Committee Hansard*, 31 August 2015, p. 3.

42 *Official Committee Hansard*, 31 August 2015, p. 3.

43 *Official Committee Hansard*, 21 September 2015, p. 15.

44 AMCA, *Submission 9*, p. 3.

(although bona fide) decisions of company directors, many submissions argued that a primary cause of inadequate cash flow was poor industry payment practices.

2.43 AMCA supported this position, arguing that cash flow difficulties resulting from poor industry payment practices were 'a key driver of financial distress and risk of insolvency'.<sup>45</sup> In AMCA's view, both onerous payment terms enforced by head contractors, as well as poor invoicing and record keeping practices of subcontractors, contributed to this problem.<sup>46</sup> AMCA listed some of the issues attendant with poor industry payment practices, including:

- head contractors holding funds paid by the principal, despite having unpaid progress claims owing to subcontractors;
- the lack of legislation identifying the permitted uses of monies paid by the project principal to the head contractor, which increases risks for subcontractors waiting to be paid;
- head contractors can employ tactics to strong-arm subcontractors into accepting long claim periods, ranging anywhere between 30 and 90 days;
- delays in the payment of monies owed to subcontractors, regardless of the payment terms;
- the often onerous process for submitting variations, which can lead to disputes, further delays in payment, and increase the risk of cash flow trouble; and
- clients have little or no accountability for the payment of subcontractors, and are often unaware of the contract conditions affecting subcontractors.<sup>47</sup>

2.44 The Subcontractors Alliance supported AMCA's position regarding delayed payments to subcontractors. The Alliance explained how ordinary industry practice relating to payment terms place significant pressure on subcontractors. In their experience, it takes 'generally 30 days, sometimes longer' for invoices to be paid.<sup>48</sup> Under the typical arrangement a subcontractor works and supplies for Month 1, invoices for that work, and is then paid thirty days later at the end of Month 2. This means that subcontractors carry 60 days debt.

2.45 The ATO informed the committee that independent analysis shows that average payment in the construction industry is lengthening beyond 30 days. Ms Cheryl-Lea Field, Deputy Commissioner, ATO, explained that it 'is now up to 50 days on average that payments are made to subsequent contractors'. Ms Field noted that the ATO is working to support some businesses that experience difficulty paying their tax on time as a result of delayed payments from contractors.<sup>49</sup>

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45 AMCA, *Submission 9*, p. 1.

46 AMCA, *Submission 9*, pp. 1–2.

47 AMCA, *Submission 9*, p. 2.

48 Subcontractors Alliance, *Submission 18*, p. 3.

49 *Proof Committee Hansard*, 28 September 2015, p. 20.

2.46 Indeed, the committee heard from a number of witnesses who had been pressured into accepting excessively lengthy payment terms. Mrs Nikki Lo Re, manager of Capital Hydraulics & Drains, a Canberra-based business, explained why subcontractors sign contracts with such onerous terms and the consequences of doing so:

We sign these contracts out of fear of our employees being unemployed. We do not agree with the contracts but we do not have a choice when we are trying to keep everyone employed.

This contract was for payment 60 days from the end of the month, so it was 90 days ago that I had actually done the work and I still had not got my payment. I was the lucky one. There are a lot more people out there who really cannot afford that type of hit.<sup>50</sup>

2.47 Poor payment practices compound difficulties arising from the pyramidal structure of the industry, for it is not merely delay in receiving progress payments that threaten subcontractors. The committee heard that in some cases, subcontractors' invoices are reduced by the head contractor on various grounds, not all fair and equitable. Mr Dave Noonan, CFMEU, explained that the union hears 'many, many stories from subcontractors who tell us that there are spurious or false reasons given for deducting payments or not paying progress payments'.<sup>51</sup>

2.48 In these cases, poor industry payment practices merely 'heightened pressures already built into the hierarchical system of contracting in which the major contractors hold most of the important cards'.<sup>52</sup> Mr Noonan explained further:

As most subcontractors in the industry are relatively capital poor and rely on cash flow for their business survival, they are put into a very uneven bargaining situation with the head contractor and, in many cases, their only recourse is to go to the courts, which is a long and difficult process and one in which subcontractors are often ill equipped to match the might of the larger companies.<sup>53</sup>

2.49 All states and territories have sought to rectify poor payment practices through security of payment legislation. Chapter 8 will detail these legislative regimes and chapter 9 will examine the effectiveness of these responses in detail.

### ***Level of business acumen in the construction industry***

2.50 Poor payment practices are not the only cause of insolvency. A recurrent issue cited in many submissions and highlighted by witnesses concerned the level of business acumen in the construction industry. The combination of low barriers to entry and a shift within the industry away from large construction companies with directly employed workforces towards smaller subcontractors has opened up the

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50 *Official Committee Hansard*, 12 June 2015, p. 43. See also Miss Rachel Prater, Prater Kitchens, *Official Committee Hansard*, 21 September 2015, pp. 36–37.

51 *Official Committee Hansard*, 12 June 2015, p. 4.

52 CFMEU, *Submission 15*, p. 7.

53 *Official Committee Hansard*, 12 June 2015, p. 4.

industry to individuals that may not have appropriate or adequate skills. Unfortunately, when these businesses fail they do not only harm themselves but inexorably affect other businesses.

2.51 Mr Wayne Squire, CFMEU, described how the decline of manufacturing in Australia has led to a rise in numbers of people entering the construction sector with limited knowledge or experience of the industry:

As our manufacturing is leaving these shores, I am finding more and more of those jobs are now moving to construction. They are inexperienced, they are looking for work and they are trying to think of new ways, which has created a new wave of inexperience in the industry. I have seen some people from completely non-related jobs all of a sudden running a construction company. You just wonder how that is so easy to do, and then they run projects worth millions of dollars in some cases, playing with millions of dollars of our money.<sup>54</sup>

2.52 According to the ATO, although contractors in the building and construction sector 'have high levels of industry specific technical skills, they mostly have limited business support and are often time poor'. In its view, these circumstances may lead 'to poor record keeping and challenges understanding the financial aspects of their business'.<sup>55</sup> This position was supported by many witnesses.

2.53 Mr Graham Cohen, Manager, TC Plastering, explained that smaller participants simply do 'not have the training, the experience or the inclination in accounting matters'. In Mr Cohen's view, 'most often, the invoicing is done by the wife or a bookkeeper and they go to the accountant once a year'.<sup>56</sup>

2.54 Mr John Chapman, South Australia Small Business Commissioner, made a similar point. The low barriers to entry allow individuals who 'have been very good tradies [to] set up as subbies and become very good subcontractors'. However, 'their administrative systems behind have not necessarily supported the expansion of the businesses they are going into, and that includes both accounting and legal advice'.<sup>57</sup>

2.55 The question is whether the training courses offered are both mandatory and effective.<sup>58</sup> This is a critical point for the low level of business acumen throughout the industry is linked to licensing arrangements. The Collins Inquiry found that the then-current licensing regime for builders was both limited and piecemeal. The Collins Inquiry observed that while essentially limited to licensing in the context of the *Home Builders Act 1999* (NSW), licensing and other regulatory functions were shared across a number of different agencies. These included:

- NSW Fair Trading;
- NSW Building Professionals Board;

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54 *Official Committee Hansard*, 12 June 2015, p. 5.

55 ATO, *Submission 5*, p. 6.

56 *Official Committee Hansard*, 31 August 2015, p. 21.

57 *Official Committee Hansard*, 21 September 2015, p. 2.

58 Mr Edward Sain, *Official Committee Hansard*, 21 September 2015, p. 46.

- NSW Planning Self Insurance Corporation;
- Long Service Corporation;
- NSW Public Works;
- NSW Government Procurement;
- Home Building Advisory Council; and
- WorkCover Building Industry Co-ordination Committee.<sup>59</sup>

2.56 That inquiry recommended consolidating the licensing functions in a new statutory body and introducing a licensing system requiring all builders and construction contractors operating in the sector to hold a graduated licence category according to the net financial backing they are able to demonstrate.<sup>60</sup>

2.57 This position was supported by a number of submissions to the committee, in particular, the Australian Institute of Building, the Electrical Trades Union of Australia and Cbus Super.<sup>61</sup> They all indicated their support for measures designed to 'ensure that contractors or subcontractors were able to demonstrate a financial capacity and wherewithal to meet the level of contract they are seeking through an appropriate licensing regime'<sup>62</sup> with the aim of reducing insolvency in the building and construction industry. These proposals, and others, will be addressed in detail chapter 11.

2.58 It is not only low levels of business acumen and financial skills, but also the lack of legal understanding and the inability to afford legal advice, which negatively affects the ability of industry participants to exercise their legal rights. Adjunct Professor Philip Evans of Notre Dame Law School noted that his review of the Western Australian security of payment act found a surprisingly low level of understanding among industry participants of their rights and obligations under ordinary contract law.<sup>63</sup>

### ***Committee's views***

2.59 The committee considers that the structure of the Australian construction industry inequitably allocates risk to those who are least able to bear it, namely subcontractors, suppliers and employees. It concentrates market power in the hands of a relatively small number of head contractors who, the evidence to the inquiry demonstrates, are often willing to abuse their market power to the detriment of those further down the subcontracting chain. At present, this allocation of risk and power means that head contractors, or contractors further up the contractual chain, are in a

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59 *Final Report of the Independent Inquiry into Construction Industry Insolvency in NSW* (2012), p. 352.

60 *Final Report of the Independent Inquiry into Construction Industry Insolvency in NSW* (2012), p. 353, Recommendation 3.

61 Australian Institute of Building, *Submission 12*, p. 4; ETUA, *Submission 4*, p. 2; Cbus Super, *Submission 13*, p. 11.

62 Cbus Super, *Submission 13*, p. 11.

63 *Proof Committee Hansard*, 26 October 2015, p. 2.

position to enforce onerous contract provisions through deliberately delaying or reducing payments due to those beneath them. In short, the peculiar structure of the industry contributes to the incidence of insolvencies. The committee acknowledges that this is not the only cause of insolvencies in the industry, but it is the root cause. Measures that government should consider to address the misallocation of risk and abuse of market power are addressed in chapters 7–12.

2.60 The committee believes that the legislative and regulatory framework should operate to protect subcontractors down the contractual chain. The current regulatory environment and potential reforms will be addressed in detail in chapters 7–12. In particular, the committee will investigate whether security of payment legislation and statutory trusts, which aim to ensure payment to subcontractors, would reallocate risk back up the contractual chain and lessen the incidence of subcontractor insolvency. Similarly, it will assess whether tightening licensing requirements and measures to improve business acumen within the industry, would also have these beneficial effects.

2.61 The committee notes, however, that in the absence of accurate statistics, it is difficult to ascertain the incidence and scale of the problem, as well as to devise appropriate responses. The committee recalls its comments in its 2014 *Inquiry into the Performance of the Australian Securities and Investments Commission* and reiterates its recommendation that ASIC 'promote "informed participation" in the market by making information more accessible and presented in an informative way'.<sup>64</sup> In particular, the committee believes that more can be done to ensure that ASIC's insolvency statistics are comprehensive and up-to-date.

### **Recommendation 1**

**2.62 The committee recommends that ASIC conduct a review of administrators' and liquidators' reporting requirements and the range and extent of information it requires to be reported and, where necessary, make changes that will ensure the regulator is able to fully inform itself, the Parliament and the public with complete, relevant and up-to-date data on insolvencies.**

### **Recommendation 2**

**2.63 The committee recommends that the government provide an additional budget appropriation to ASIC in the 2016–17 budget and over the forward estimates, if required, which is sufficient to ensure that ASIC has the capacity to conduct analysis and provide a wide range of relevant, up-to-date insolvency data.**

### **Recommendation 3**

**2.64 The committee recommends that ASIC require all external administrators' reports to be lodged electronically in the Schedule B format.**

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64 Economics References Committee, *The Performance of the Australian Securities and Investments Commission*, 2014, p. 356, Recommendation 39.



**Recommendation 4**

**2.65** The committee recommends that ASIC make better use of external administrators' reports and other intelligence in order to improve the standard of publicly available information, provide early warning to industry participants about repeat and concerning insolvent practices and lead to a more effective market.

