Cascading deemed statutory trusts in the construction sector

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This is an extract. The full working paper is available from advocacy@asbfeo.gov.au

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Small business subcontractors in the construction sector

- Small businesses with less than five employees made up 64 per cent of all construction sector insolvencies[i].
- Subcontractors perform over 80% of all work in the Australian construction industry. They contribute resources and are promised payments later.
- Small business subcontractors have complained to our office about delayed or non-payment by mid-tier operators in the construction supply chain. They either delayed payments to their subcontractors to manage their own cash flow or they went into administration leaving the subcontractor receiving very little as an unsecured creditor.
- When a business becomes insolvent, its employees have access to the fair entitlements guarantee (FEG) to cover their losses. Suppliers have protections of the personal property securities register (PPSR) to secure payments.
- Subcontractors do not have these protections. However they have provided labour and materials to the same project – adding to its value.
- Statutory trusts can protect these payments to subcontractors in the event of an insolvency[ii]. They also remove the temptation to use subcontractor's progress payments as their own.

Cash flow – playing by different rules

The rules are different for small businesses in the construction supply chain.

Principals and head contractors are among the ASX100 or multinationals with access to sophisticated financial advisory services and resources to manage working capital. Their business size and operations provide numerous and complex levers for profitability and financing options.

The mid-tier operators reported to our office for poor behaviours were managing cash flow by delaying payments and underquoting to win work. Some used phoenix models or used other structures to side step payments to subcontractors. These mid-tier firms were easily tipped into trouble by events such as unseasonal rain, disputes with head contractors, or delays with planning approvals.

Small business subcontractors are at the bottom of the supply chain pyramid and are squeezed on margins and payments from poor mid-tier operators higher in the supply chain. Small business is only viable with regular and certain cash flow. Close and longstanding relationships with employees and suppliers make small business pay their bills, so cash flow is king. The need to maintain relationships for future business makes small business reluctant to raise disputes with their contractor, or to access state and territory security of payments dispute resolution.

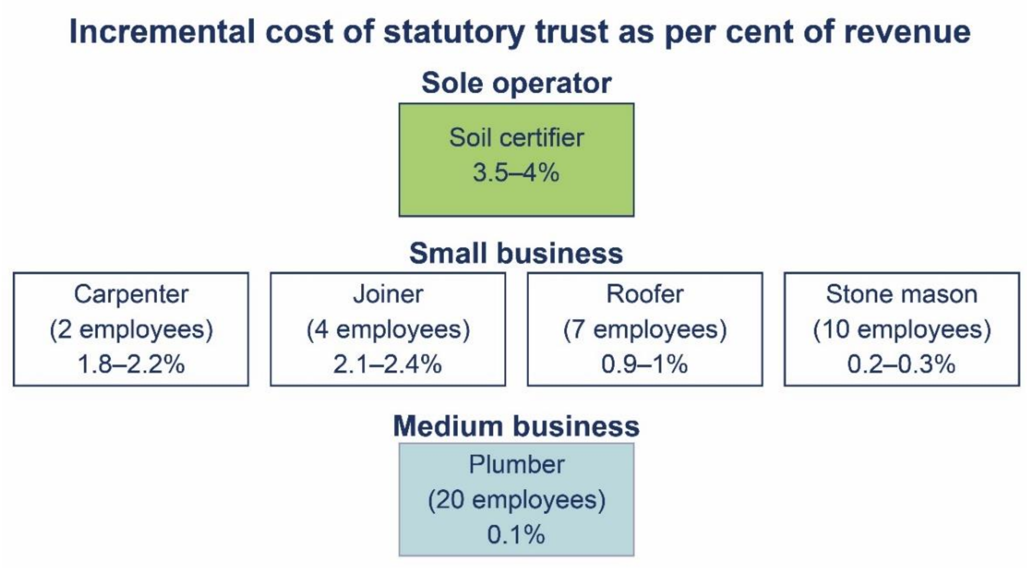
Late payments impacts small business viability and creates social problems such as mental health and family issues[iii].

Our findings on cascading deemed statutory trusts

We had an expert in SME accounting work through some scenarios to find out the costs of running statutory trust accounts.

We found that for medium businesses (20 employees), the cost is small at 0.1% of annual revenue.

The costs are moderate for businesses with 2-10 employees at around 2% of annual revenue, but are higher for a sole operator at 3.5 to 4% of annual revenue.



Recommendations

- Statutory trusts be implemented to protect payments to subcontractors in the event of their contractor's insolvency and to decrease payment times.
- While we support cascading deemed statutory trusts for commercial projects with a value of at least $1million, consideration should be given to a higher project value to avoid capture of the private residential housing sector.
- Imposing statutory trusts on very small business is not warranted given their limited resources. We recommend setting a floor to exclude low value sub-contracts within a project. Consideration should be given to a floor value between $100,000 to $200,000 to exclude small business operators.

The future of small business in the construction industry

These measures will help small business when a contractor becomes insolvent. If the contractor has received money to pay a progress claim, the trust means the money will go to the contractor.

Money will be paid faster on a day-to-day basis because it does not become part of the contractor's cash flow. Businesses will need better management to ensure they are operating on a truly profitable basis and with sufficient cash flow. Some operators will exit the industry but those remaining will operate on a more sustainable basis and contribute to growth and employment.

Statutory trusts will also reignite a culture of fair payment for work done and of protecting small players.

[i] ASIC, Insolvency Statistics, external administrators' reports (July 2016 to June 2017)Table 3.2.2.1

[ii] The Commonwealth Review of Security of Payments Laws (the Murray Review) recommended introducing deemed statutory trusts in Recommendation 85:

> 'A deemed statutory trust model should apply to all parts of the contractual payment chain for construction projects over $1million. The deemed statutory trust model outlined in the Collins Inquiry provides a suitable basis.'[iii]

The Collins Inquiry recommended the trust legislation of Maryland in the United States of America:

> 'Any moneys paid under a contract by an owner to a contractor, or by an owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for the purposes of paying those subcontractors.'

[iii] ASBFEO Working paper No. 3 Payment times and Practices Inquiry https://www.asbfeo.gov.au/sites/default/files/ASBFEO_WP3.pdf