



HOUSING INDUSTRY ASSOCIATION



Housing Australians



Submission to the
Australian Small Business and Family Enterprise Ombudsman

Insolvency Practices Inquiry

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contents

1. INTRODUCTION.....	4
2. INSOLVENCY IN THE RESIDENTIAL BUILDING INDUSTRY	4
3. RESPONSE TO QUESTIONS	6
3.1 EDUCATION.....	6
3.2 TURN AROUND OPTIONS	7
4. CONCLUSION	9

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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.

As the voice of the residential building industry, HIA represents a membership of 60,000 across Australia. HIA members are involved in land development, detached home building, home renovations, low & medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA members comprise a diverse mix of companies including residential volume builders, small to medium builders and renovators, residential developers, trade contractors, building product manufacturers and suppliers and allied building professionals that support the industry.

HIA members construct over 85 per cent of the nation's new building stock.

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.

Contributing over \$100 billion per annum and accounting for 5.8 per cent of Gross Domestic Product, the residential building industry employs over one million people, representing tens of thousands of small businesses and over 200,000 sub-contractors reliant on the industry for their livelihood.

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."

HIA develops and advocates policy on behalf of members to further advance new home building 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 committees before progressing to the 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 22 centres around the nation providing a wide range of advocacy, business support services and products for members, including legal, technical, planning, workplace health and safety and business compliance advice, along with training services, contracts and stationary, industry awards for excellence, and member only discounts on goods and services.

1. INTRODUCTION

In December 2019, the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) released a discussion paper inquiring into insolvency practices in Australia (Discussion Paper). The Discussion Paper followed the launch of an Insolvency Practices Inquiry in October 2019 (Inquiry).

HIA understands that the Inquiry and Discussion Paper seek to examine how small businesses navigate Australia's current framework for corporate insolvencies with the aim of seeking feedback on what a best practice model might look like for both small businesses moving towards insolvency and for insolvency practitioners.

HIA sees merit in the work the ASBFEO is undertaking and provides this submission in response to the Discussion Paper.

HIA's submissions is made within the context of the unique circumstances faced by the residential building industry. The construction industry is not homogenous. The industry is divided amongst those businesses operating in detached residential, multi-residential, renovation, commercial, public infrastructure and civil works sectors. There are also a range of different categories of business and practitioner - from property developers and joint venture capital investors to commercial head contractors, builders, subcontractors and consultants.

Across the country those operating in the residential building industry must comply with and manage a large and complex web of regulatory requirements including licensing, warranty insurance, compulsory education and training, work, health and safety obligations, contractual, taxation and employment laws. It is important to note that a number of these requirements already look to prevent and mitigate risks of corporate insolvency.

The reasons for insolvency in the residential building industry may differ to the reasons for corporate collapses in other sectors of the economy. As such a 'one size fits all' approach may not be possible or appropriate when looking to improve the situation of small businesses facing solvency challenges.

HIA is open to the opportunity to work with the ASBFEO on these matters in the future.

2. INSOLVENCY IN THE RESIDENTIAL BUILDING INDUSTRY

According to ASIC the "construction" industry appears largely represented in the overall number of insolvencies across the economy. To some extent this is a natural reflection of the size and number of construction industry firms operating in the economy but is also highly correlated to underlying building and economic cycles.

Clearly, the risks to solvency of those operating in the residential building industry are complex and multifaceted; there are a plethora of factors that may impact a business financial position.

In HIA's experience, some companies in the sector fail because of poor business administration while others collapse due to the actions of third parties, most notably non-payment. It must also be acknowledged that the financial failure of 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.

During a residential building project, the first risk that threatens solvency is financial. Cost overruns can result from a number of reasons including poor estimating, under-budgeting, overly optimistic pricing or cut price tendering, poor coordination between design professionals and the trades, delayed project stage payments, and changing client demands.



The second risk relates to time. Time overruns (and delayed payments) can have devastating financial consequences for businesses in the construction industry.

A further risk relates to the design of the building. There is a risk that the completed building will not meet the owner's needs.

The final risk manifests after the construction phase, as ongoing responsibility for defects and warranties is a key risk to the future viability of a residential building business.

The risk of insolvency is dealt with through elements of the regulatory framework that apply to residential (domestic) building work nationally, including the unique licensing and homeowners warranty insurance system. These arrangements reduce the ability for directors of residential building companies to get caught with solvency issues.

In all states and territories residential builders need to obtain a builder's licence or registration to contract with a consumer, sub-contract or advertise, to undertake residential building work.

As part of the licensing eligibility process, applicants are subject to strict financial and personal probity requirements. There are existing exclusions for bankrupts. Directors who have controlled an insolvent company may be automatically excluded or otherwise will fail the "fit and proper" person requirements.

In Western Australia, for instance, under the *Building Services (Registration) Act 2011*, a building company is strictly prohibited from trading without a nominated supervisor and risks significant fines for non-compliance.

Under Section 18, the WA Building Commission has the power to require an applicant or renewing practitioner to satisfy the Board about sufficient material and financial resources. The Commission also has inquisitorial powers to investigate a builder's activities, including financial competence.

There are also ineligible person provisions within this section that prohibit certain persons involved in previous company and business failures from taking part in the management and supervision of building work. Similar laws exist in all states and territories.

Another defining feature of the residential building industry is the mandatory regime of builder's indemnity or Home Warranty Insurance (HWI). HWI operates in every jurisdiction except for Tasmania.

Since 2001, HWI schemes have been one of "last resort". This means that a consumer can access the benefit of the policy of insurance when the builder dies, disappears or is insolvent.

In New South Wales, there is also a fourth trigger that enables a consumer to claim on the policy of warranty insurance when a builder fails to comply with a monetary order issued by the Court or Tribunal.

The operation of mandatory HWI under which the insurer provides a completion guarantee to a home owner in the event of a builders' insolvency means that a builder's financial position is consistently monitored by their insurer.

Before granting eligibility, an insurer reviews a builder's business history and finances to assess their risk. Insurers impose an annual turnover limit on builders based on their assessment of the value of works that a builder can prudently undertake given their financial position.

In some circumstances, insurers require a financial security or deed of guarantee or indemnity of some form before granting eligibility.

These types of measures do not apply in other sectors of the construction industry and they should be recognised in considering any potential additional measures regarding corporate insolvencies and the activities of insolvency practitioners.

3. RESPONSE TO QUESTIONS

3.1 EDUCATION

7. *Should it be mandatory for individuals seeking to be directors of companies to undertake core education on running a business and the potential risks of personal exposure to liabilities before being eligible for appointment?*
8. *Should it be mandatory for individuals seeking to start a company or register an ABN to undertake core education on running a business and the potential risks of personal exposure to liabilities?*

HIA holds the view that in the residential building industry continuing improvement and professional development are important in order to achieve acceptable standards of building quality delivered by a competent and skilled workforce.

HIA leads, promotes and provides professional development services and advice to the housing and construction industry and strongly encourages industry participants to keep up to date with industry developments.

Any proposals that would seek to impose mandatory education requirements must be considered within the context of the current regulatory framework for the residential building industry, which, in some jurisdictions, includes mandatory education, called Continuing Professional Development or CPD.

Since 2005, NSW and Tasmania have had mandatory CPD schemes in place. At that same time, Victoria introduced a voluntary scheme.

In 2016, the Victorian government legislated to introduce both CPD and licensing and registration for trade contractors. The reforms were intended to be in place in 2018, however the roll out of CPD has stalled while the licensing and registration arrangements are resolved.

Most recently, the Queensland government has now announced they would be proceeding with the introduction of a mandatory CPD scheme for residential builders and all other license categories. In Queensland it is proposed that licensees will be required to obtain points in at least three of the four skill focus areas which are Business, Safety, Trade and Professional. The Queensland regulator will approve CPD material and may target such materials towards certain areas.

Also relevant is that in 2017, Building Ministers engaged two experts, Peter Shergold and Bronwyn Weir, to undertake a wide ranging review of the building system. Their report Building Confidence: Improving the effectiveness of compliance and enforcement systems for the building and construction industry across Australia was provided to Ministers in early 2018 with 24 recommendations to reform licensing and registration, building approvals, building inspections and other related matters.

With respect to CPD, the third recommendation put forward a proposition that would see all key building professionals required to undertake mandatory CPD on the National Construction Code based on a national consistent approach to that training. Ministers unanimously agreed to adopt all of the recommendations in the report, while recognising that each state would do so in their own manner.



In July this year Ministers made a new agreement to fund the Australian Building Codes Board (ABCB) to develop a nationally consistent implementation plan on behalf of the states and territories and deliver the intended outcomes over the next two years. The Commonwealth committed \$2 million towards the work with the states and territories matching this. A work plan has now been approved by the ABCB Board which includes CPD as part of the first priority actions to deliver in.

Where mandatory CPD currently applies licensed individuals and companies must undertake certain training to obtain the requisite number of points to satisfy the CPD requirement. Non-compliance with mandatory CPD can have implications for a license and therefore the ability to carry on a residential building business.

There is clearly a significant amount of reform in the space at present, as such, HIA suggests a cautious approach be taken when considering further measures regarding the same, or similar matters.

To that end, the introduction of any continuing education requirements with respect to business acumen, financial management or contracting practices, needs to be considered in light of which building practitioners will most benefit and how any such requirements can be implemented without unnecessary red tape.

3.2 TURN AROUND OPTIONS

10. *How can the safe harbor provisions be improved to encourage small businesses to take action early and gain time to assess the viability of the business?*

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 company directors who allow a 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 concluded 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).

The insertion of the safe harbour provisions were aimed at fostering a culture of restructuring in amidst an insolvency regime that imposes tough penalties on directors that continue to trade a company while it is insolvent. The penalties are of such severity that often directors will act early to appoint an insolvency practitioner at the expense of exploring restructure options. In fact the Explanatory Memorandum to the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (2017 Bill) that introduced the safe harbour provisions highlight that:

'The threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent have long been criticised as driving directors to seek voluntary administration even in circumstances where the company may be viable in the longer term. Concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason that early stage (angel) investors and professional directors are reluctant to become involved in a start-up.'

Further the purpose of the new laws was aimed at:

'...driving cultural change amongst company directors by encouraging them to keep control of their company, engage early with possible insolvency and take reasonable risks to facilitate the company's recovery instead of simply placing the company prematurely into voluntary administration or liquidation.'

Despite this, the provisions are complex, for example section 588GA(1)(a) directs attention to the specific time that the director *'starts to suspect that a company may become insolvent'*. However 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.

In addition, to have a positive practical impact the company must be allowed to trade on whilst restructuring is taking place. However there is little clarity regarding debts that continue to be incurred as part of the ordinary trading activities of a 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 to 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.

HIA see value in awaiting the independent review of the safe harbour provisions as prescribed by section 588HA of the *Corporations Act 2001* before any other recommendations are made regarding their operation

11. *How can accountants and bookkeepers best support small businesses to seek help early?*

Accountants and bookkeepers can assist small businesses by identify financial 'red flags' early and bringing them to the attention of the business owner. In addition, were red flags have been identified, these professionals should be able to offer further information, advise and options tailored to the businesses needs in order to respond to any areas of concern.

12. *Should increased funding and resources be provided to the financial counselling sector to enable them to provide services to small businesses experiencing financial difficulty?*

Yes. Providing additional funding and resources to the financial counselling sector would seem sensible and appropriate. Also useful may be for the financial counselling sector to engage with other industry associations and representatives who have existing connections with businesses, particularly small businesses. Through these channels further education can take place, regarding for example, the warning signs of insolvency and where to go for support and guidance.

4. CONCLUSION

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 systems way of saying that the resources consumed in creating the firm's output exceeds the benefit of that output.

On the one hand, 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.

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

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

In looking for such a framework, 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.