

Security of Payment: Consultation Paper

Prime Constructions Pty Ltd – Submission & comments dated 19 September 2018

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1. Do you support the proposal to establish deemed statutory trusts in the Act?

No, I do not support the current proposal, it is my view that the proposed changes will not address the issue of “misuse” of progress payments and high levels of insolvency affecting the construction industry.

Further, I believe the proposed introduction of statutory trusts for progress claims will work against sub-contractors which as I understand, are the very level within the industry that the proposed changes are designed to protect.

The proposed statutory trust model will I believe have serious unintended consequences which include;

- The introduction of a statutory trust model would favour one unsecured creditor over another in the case of insolvency
- The introduction of a statutory trust model will meddle with the secured/unsecured status of creditors, this I believe will likely have a significant impact on businesses that operate from time to time using overdraft facilities. It would follow that banks who provide overdraft facilities would have an issue with assessing their risk if they become a secured creditor second in line to any legitimate beneficiary of a deemed statutory trust.
- The introduction of a statutory trust model will cause significant upheaval at a sub-contractor level in implementing, managing and verifying compliance. It may directly affect their ability to secure overdraft facilities, which is common in our industry and often used for short term cash flow management.
- The introduction of a statutory trust model will cause issues with suppliers who are basically pushed further back in the queue as an unsecured creditor. This could mean suppliers restricted their trading terms or withdraw them altogether for contractors or sub-contractor who may have a greater risk profile.
- The introduction of a statutory trust model will remove flexibility for entities to manage appropriately their cash flow when running a business.
- The introduction of a statutory trust model that demands ‘transparency’ could be manipulated by unions and provide them with a platform to badger and harass contractors and sub-contractors alike where they act on behalf of sub-contractors.

2. What alternative reform(s) could be implemented?

The proposed changes seek to address 'misuse' of progress claims by contractors and sub-contractors and tackle the problem of 'insolvency' brought about as a result of the 'misuse' of progress claims.

On the question of 'misuse' there is I believe an over statement in the prevalence of misuse of progress claims and how and to the extent that it is the reason for the high level of insolvency in the construction industry.

To define 'misuse'?

- The proposed statutory trust model is I believe, designed to tackle the issue of timing when companies find themselves in difficulty. The scenario that administrators are appointed and there is a time gap between being appointed and determining whether the entity can trade their way through or have to be liquidated. Manipulation of this timeline could be 'misuse' where the time is unduly extended in order to secure incoming progress claims for the benefit of all unsecured creditors?
 - o The timing issue does expose unsuspecting sub-contractors and sub sub-contractors to a period of time where they could be working on projects without the prospect of payment.
 - o This is an issue that is to an extent, addressed by the proposed changes, however why is it that one currently unsecured creditor should now have more rights over any other unsecured creditor in the contracting chain?
 - Is this gap risk a widespread issue?
 - Is there a better way to address the gap risk by notifying sub-contractors and prescribing timelines to determine whether a company is viable?
 - Should there be added protections for the company and sub-contractors to suspend works until matters are made clearer?
 - o Further, where administrators are appointed there are usually stringent provisions in head contracts and obligations of the contractor to notify the client where consequences follow which may include holding back payment claims until the extent and reasons for appointing an administrator are understood. It follows that in this scenario the notification would have to occur and the flow of payment will likely be stopped by the client, put simply the proposed statutory trust will be ineffective if there are no progress claims paid into it.
- Is it where contractors and sub-contractors draw funds from an operating account to pay for the ongoing operations of the company to in effect "keep the company afloat" for any number of reasons it could include, which is not uncommon, the case where a client has not paid on time or client progress claims have been reduced on assessment? No.
- If the contractor or sub-contractor is unable to meet their liabilities, and has no way to trade through the period by deed of arrangement or other agreement then this is trading insolvent.

- Is it 'misuse' where payments are withheld by the client or contractor because the contractor or sub-contractor has not performed the works in accordance with the contract? This is not misuse if under the contract, it is a breach where parties have clear remedies and protections in any contract agreement provided of course that there is one in place. No
- It is 'misuse' to use progress claims on ventures, developments and asset purchases that are unrelated to the entity, clearly yes however;
 - o will the proposed changes stop this? I do not believe so.
 - o Is this widespread and one of the main causes of insolvency in the industry, I do not believe so.

I believe, contractors and sub-contractors in the construction industry already have sufficient measures at their disposal to manage their contractual risks, these include;

- Sub-contract agreements, which should be carefully considered by both contracting parties.
- Reference checks and investigations, prudent for any party seeking to enter into a contract with a commercial entity that they do not know.
- Employing prudent and rigorous business practices, lack of which, this is one of the underlying reasons for insolvency in our industry.
- Current Security of Payments legislation which provides cost effective, efficient and simple access to measures to securitise payments in the construction industry.

The proposed changes should not be implemented to re-define secured and unsecured creditor status, or protect contractors, sub-contractors and sub/sub-contractors who choose not to engage in carefully considered contractual arrangements, sensible and prudent business practices or decide not to make use of the current Security of Payments legislation or lastly fail conduct reasonable checks and reference checks of parties they contract to.

I believe there are alternative initiatives that could be implemented to improve the performance and productivity in the industry, which would have the effect of reducing insolvency and constrain rogue operators and limit contractors and sub-contractors that are taking on work in sectors that are beyond their means and capability.

To that end, the most obvious efficient and I believe effective measure would be to introduce a licensing structure for commercial works to "lift the bar" as it were for contractors.

For contractors Licensing you would need to include;

- A hierarchy based on either project size or some other measure that places the contractor in at a defined sector level.
- A measure of proficiency, standards and education – to ensure the licensee has capability and competency in the sector that they operate in.
- Financial checks and balance – where license assessment would provide a measure of what sector you could operate in to avoid having situations where contractors operate outside of their financial capability.

- Mechanisms in place to ensure that contractors can expand with measured controls. All too often in our industry companies fail at all levels because of rapid expansion, loss of control and undercapitalisation.
- In the case of a private company the licensee must be a Director of the company.

To some extent this hierarchy already occurs in the public sector where there is an accreditation process and a list of 'approved' contractors who can tender and construct public works of a certain size. There is no such licensing arrangement for the private sector. Determining competency and financial stability of the contractor is a commercial matter left to the client, their consultants, financiers and private financial checks prior to appointing the head contractor on any project.

The licensing of commercial contractors would improve the industry by providing;

- Minimum criteria and standardisation across the industry.
- Could provide a transparent platform to ensure financial statements and balance sheets are available and submitted annually for clients and sub-contractors to have access down the 'chain' to see and complete their own assessment of the contractor. This would allow contracting parties direct access to be better informed when deciding if and when they may enter into agreements with the contractor.
- It would provide a centralised register of licensees where entities and change in entities can be monitored and tracked to tackle the issue of rogue operators, serial offenders and phoenix operations which are blight on the construction industry.

When it comes to rogue operators at contractor and sub-contractor level, licensing would improve the ability to track operators who seek to avoid their liabilities through phoenix operations where, in most cases, the unsecured creditor is more likely the Australian Taxation Office. It is my view that a significant number of insolvencies are driven by those operators who seek to avoid their tax obligations.

I point to the Home Owner Warranty scheme where the current deficiencies in funding is a direct result of insolvencies in the residential sector. Statutory trust structures will not address these operators. The underlying cause for insolvency is not progress claim and mismanagement but tax avoidance and phoenix operations of contractors and sub-contractors alike.

When it comes to sub-contractors the industry already operates with a competency licensing structure for key sub-contractor such-as electricians, plumbers and gasfitters however other trades such as gyprockers, carpenters and concretors along with many others require no licensing to conduct business.

The introduction of Licensing at a sub-contractor level would in effect;

- Improve and provide a measure of competency at a sub-contract operating level which is essential for our industry.

- Lead to more competent sub-contractors which are less likely to fail or become insolvent as a result of poor performance, poor workmanship or poor management.
- It would provide a centralised register of licensees where entities and change in entities can be monitored and tracked to tackle the issue of rogue operators, serial offenders and phoenix operations, this is particularly prevalent across the sub-contractor and sub sub-contractor level.

To a certain extent contractor and sub-contractor competency is regulated through the Work Health & Safety Regulation 2017 in all things relating to safety. However, this does not address the question of 'trade' competency or the underlying ability to run a business.

3. Do you support the proposal to apply a cascading 'deemed' statutory trust model?

I do not support the introduction of a statutory trust model because I do not believe it will provide any further protection for sub-contractors, in fact it is my opinion that it would be the opposite.

It is clear the proportion of insolvencies occur at the sub-contractor and sub sub-contractor level in our industry. If the proposed changes were to proceed then in any model this would be ineffective if it did not apply a cascading effect.

If statutory trusts were to be adopted it must cascade down. However, there are serious doubts that sub-contractors can both administer and even cope with the effect this would have on their cash flow management practices and business given the inherent design and structure of traditional contracting. The entire system is based on defined payment terms, top down and bottom up, coupled with the complication of claim assessments where sub-contractor and contractor payment claims and payments in valuation do not always align.

In many cases, sub-contracting businesses are hand to mouth operations, administratively unsophisticated and typically leave minimal equity in their operation (for one reason or another not least of which is the fear of losing it all). This is one of the main causes of sub-contracting insolvency.

4. What would be an appropriate point in the contractual chain to limit the requirement for 'deemed' statutory trusts?

It is my view that the proposed changes will be in effective.

5. Do you support the proposal to apply the requirement for 'deemed' trusts to construction contracts valued at \$1million or more?

No I do not support the proposal to introduce deemed trust for progress claims.

It is my view that more data analysis is required to determine where and why insolvencies occur. Implementing it across the entire industry when no other industry has such trust

structures makes no sense and I believe fails to acknowledge the volume of transactions, the complicated process of assessing claims at a number of levels in the contracting 'chain' and the fact that current Security of Payment legislation is already available for contracting parties to use to protect their position.

It is simply not the case that insolvency is caused predominantly by contractors and sub-contractors who do not pay progress claims. Progress claims are not paid for any number of valid reasons including but not limited to;

- Contractor/sub-contractor failing to perform works in accordance with the drawings and specification (which can be discovered anywhere along the time line between Progress Claim, payment and the time when sub-contractors must be paid and beyond).
- Contractor/sub-contractor failing to perform works in accordance with the contract program causing delay where liability for damages may arise.
- Other breaches of contract by the contractor or sub-contractors.
- Inability or failure to provide a declaration that all wages and entitlements have been paid to workers, considered to be a serious breach of contract.

6. What would be an appropriate alternative monetary threshold?

It is my view that the proposed changes will be in effective as outlined above.

7. Do you support the proposal to limit the application of the requirement to the value of contracts between specific parties (rather than the value of the head contract)?

No I do not support the current proposal however I would say that should the proposed changes be adopted then this question would require more careful consideration to avoid unintended and damaging consequences.

8. What would be an appropriate point to limit the application of the monetary threshold?

It is my view that the proposed changes will be in effective.

9. Do you support the proposal that the requirement for a deemed trust should arise immediately when the contract monies are received by the trustee?

No, it's my view that the proposed changes will be in effective.

10. What would be an appropriate point in the contract lifecycle for the deemed statutory trust to be established?

It's my view that the proposed changes will be in effective.

11. Do you support the proposal that responsibility for managing 'deemed' trust monies is placed on the trustee?

Yes, if the system of 'deemed' statutory trusts are introduced then it must be managed by the trustee. To introduce alternate parties would significantly increase administrative costs. I do not believe any alternate structure could cope with the tight time frames and transaction volumes involved in the contracting structures in the construction industry.

12. Do you support the proposal to allow trust monies on multiple construction projects to be held in a consolidated account?

Yes, if introduced, it should only be held in one nominated consolidated account. A contracting party could have anywhere from 10-50 clients where projects have a defined lifespan which changes. Multiple accounts would be an unnecessary complication and costly exercise to administer though I'm sure larger construction companies with larger projects are likely to work on an account/project basis.

One option maybe to consider

- all progress claims are deposited automatically into the deemed statutory trust account
- the contractor can transfer out creditor amounts to an operating account for what are unsecured creditors
- sub-contractors are paid out of the deemed statutory trust account and any residual amount is the contractors and can be transferred to the operating account.
- This works where claims are more than liabilities from month to month however that is not always the case.
- It doesn't work if,
 - o Contractors and sub-contractors are working with an overdraft facility
 - o Progress claims for one reason or another do not align with sub-contractor payment terms
 - Some may be paid in advance of client progress claims – 14 day payments
 - Some may have deposits payable that are not claimable until either additional security is provided or the goods are on site and in some case installed.
- I cannot see anywhere in the proposal where the incoming progress claims which may be less than the sub-contractor claims.

13. Should there be any further obligations applied to trustees and/or beneficiaries to support the efficient flow of monies in/out of accounts (e.g. a requirement for transaction certificates of some form)?

Progress payments at the contractor level are already handled by way of RCTi's, I would have thought this would be sufficient transactional history, which account the money comes from is irrelevant to the recipient.

When it comes to verifying progress payments from sub-contractors to their sub sub-contractors, this is another level of administration and verification that would be required, incurring more cost, time and complication to the process of payments at all levels within the 'chain' in what are already tight time frames.

When the contractor seeks to take out their component of the claims I would have thought this could be simply handled by way of a separate ledger to demonstrate money in, money out any residual then belongs to the contractor and can be transferred to their operating account.

In my view this would be unworkable and even if it were it would be for little to no benefit to all parties.

14. Do you support the proposal to not require auditing of trust records?

No, to have a system without auditing would mean rogue operators, the largest risk within the industry when it comes to insolvency could continue 'business as usual' without constraint. Any statutory trust structure should require annual auditing as a minimum.

15. Do you consider that the compliance and enforcement powers proposed in the exposure draft Bill are sufficient to support the operation of 'deemed' statutory trusts?

I believe this requires further discussion should the proposed changes be adopted.

16. What type of compliance and enforcement powers or framework would be preferred?

I believe this requires further discussion should the proposed changes be adopted.

17. Do you support the proposal to allow the trustee to withdraw funds from the account before a subcontract has been paid?

Yes, provided it can be demonstrated that the progress claim payments are more than the combined sub-contractors claims. The concern is this proposal now changes the structure of unsecured verses secured creditors in the contracting 'chain' and the effects of this could be widespread with suppliers re-assessing their terms of trade, banks restricting access to over-draft facilities.

In the case where short term cash flow issues arise contractors and sub-contractors could be faced with the choice to either breach the statutory trust provisions or be constrained in managing their business to trade their way through.

Arrangements between contracting parties would in some cases become constrained, less flexible and run the risk of causing more damage through insolvency. This is more so at the sub-contracting and sub sub-contracting level.

18. When should a trustee be permitted to withdraw funds?

I believe this requires further discussion should the proposed changes be adopted.

19. Do you support the proposal to allow funds to be distributed on a pro-rata basis as a proportion of their payment claims?

By pro-rata I assume you mean where there would be a deficiency in funds because progress claims received are less than payments due in the space of the month? If that's the case then this could only be the equitable way to distribute limited trust funds to the beneficiaries.

20. What other model of distribution would be preferred?

I do not have anything else to add at this stage.

21. Do you support the proposal relying on the existing dispute resolution mechanisms in the Act?

I do have concerns that the dispute process under the act can in many ways be seen as a David & Goliath exercise or at times a kangaroo court where errors at law are made and avenues to seek recourse take too long and are too costly. I would have concerns because the sums we are considering are significant as opposed to being contractor to sub-contractor or one on one.

22. Are any new or amended mechanisms required?

I do not have anything else to add at this stage.

23. Do you support the proposal to allow the investment of 'deemed' statutory trust monies?

Yes, however any investment would need to be prescribed as an Australian Bank.

24. Are any further provisions necessary to support the operation of this proposal?

I do not have anything else to add at this stage.

25. Do you support the proposal to allow the beneficiaries to inspect the records of 'deemed' trust accounts?

No. It is not uncommon to see sub-contractors who engage Unions and in some cases industry associations to represent them in matters. This proposal could see unintended consequences where you've effectively introduced a platform for Unions to become the sub-contractors 'pay-collector' mounting vexatious and nuisance claims to gain access to accounts for industrial purposes to frustrate both contractors or sub-contractors.

26. Is there an alternative approach that would provide beneficiaries with a similar degree of awareness?

I would have thought annual audit statements would ensure that the contractor or sub-contractor is complying with their obligations. The audit requirement would be an enormous burden at the sub-contractor level and in turn it would be extremely difficult for contractors in turn to verify sub-contractor compliance.

Without any form of verification at all levels the proposal is ineffective and likely to be unenforceable.

27. Do you support the proposal to apply executive liability to directors and other relevant persons for breaches?

No. This is a particularly complicated matter when it comes to large organisations where there are a significant number of transactions in play involving any number of employees. This is not a one size fits all scenario.

When it comes to Director liability this would effectively become Director guarantees beyond the Proprietary Limited liability.

Further this does not apply in other sectors within the economy, why then should it apply in the construction industry?

28. Do you consider these are the likely benefits associated with the proposal?

Statutory trusts can offer additional protections beyond what can be provided by other means.

I do not agree. I believe current contracts and sub-contracts along with the current Security of Payments Act provisions coupled with prudent business management practices all provide sufficient protections for contracting parties at all levels in the industry.

Statutory trust can provide beneficiaries with more remedies when breach arise.

I do not agree. The introduction of statutory trust model serves only to complicate the payment process when there are clear measures in contracts to deal with breaches of payment. Further there are already adequate cost effective and easy access to measures under the current Security of Payments Act.

Separate bank accounts can improve financial detection of non-compliant or inappropriate activity.

I would agree if the proposed changes were to be implemented. If that were the case it would be essential to separate operating accounts and any statutory trust accounts.

29. Are there any other significant benefits that are relevant?

There are no significant benefits to the industry as I do not believe the proposed changes will address or define the 'misuse' or reduce the more obvious reasons for insolvency within the construction industry.

Further I firmly believe that the introduction of statutory trust model for progress payments would cause unnecessary upheaval, confusion and burden to the industry and increase the risk by:

- Increasing the risk of insolvency at the sub-contractor and sub sub-contractor level, due to
 - o Restricting cash flow management
 - o Potentially seeing a contraction of access to over-draft facilities commonly used through-out the industry
 - o Changing the secured/unsecured creditor status within a significant section of the contracting 'chain'.
- Adding significant administrative costs at all levels within the industry,
- Leading to substantial and possibly unrestrained increase in construction costs,
- Leading to attrition in the industry which is already challenged by ongoing skill shortage and supply constraints.

30. Do you consider these are the likely costs associated with the proposal?

The proposed changes will reduce the ability of businesses at all levels to manage cash flow which could have serious unintended consequences not the least of which is an increase in insolvency.

Statutory trusts I believe are ineffective given the industry operates on a contracting basis with complicated projects, numerous contracting parties. We operate with a high number of transactions within a tightly structured time frame. These matters call for careful and flexible cash flow management. The proposed changes will burden contractors and sub-contractors alike with unreasonable constraints on their ability to manage their cash flow.

More significantly is the knock on effect these measures may have on the ability to secure credit or overdraft facilities which are common place in the industry.

The proposed changes I believe, do not address the underlying causes of insolvency being under capitalisation. It does not address competency of contractors and sub-contractors and it does not protect contractors and sub-contractors. In my view, it is a misguided measure albeit with the best of intentions that will damage the very entities that it seeks to protect.

In the medium term the proposed changes will cause significant upheaval and disruption in the supply chain and flow of funds between contracting parties. There are significant deficiencies in the self-regulation of the proposed statutory trusts. In real terms, this will likely lead to the measures being ineffective, inefficient and overly complicated.

I believe the proposed changes will increase construction costs predominantly at a sub-contractor and supplier level. This poses a number of risks to the industry at a time where there is a significant work pipeline and a clear and mounting skills shortage affecting the industry.

You will see contractors and sub-contractors;

- Passing through increased administrative costs.
- Passing through increased margin allowances as a result of increased risk.
- Increased insolvency due to cash flow restraint.
- Increased non-compliance should these proposed changes proceed.

You will see suppliers;

- Re-assess their risks as they move to the back of the queue as an unsecured creditor.
- Re-assess their cost and increasing their prices to take account of the risk where possible.
- Possibly withdraw supply agreements with sub-contractors who they may deem to have a higher risk profile.

You will see financial institutions;

- Re-assess their secured creditor status in the chain of contracting.

- Possibly increase restriction and cut access to overdraft facilities, particularly so for the sub-contractor and sub sub-contractor level.
- Costs for overdraft facilities will likely increase as a result of the change in risk.

31. Are there any other significant costs that are relevant?

My concerns are that the proposed statutory trust model has not adequately considered the unintended consequences which are likely to be far reaching and disruptive to what is a finely tuned industry where a such a significant change to the contracting chain could damage and cause more insolvency that adversely affect the industry.