HOUSING INDUSTRY ASSOCIATION


Submission to the
Parliamentary Joint Committee on Corporations and Financial Services

# Effectiveness of Australia's Corporate Insolvency Laws

30 November 2022

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# contents




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## ABOUT THE HOUSING INDUSTRY ASSOCIATION

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry.

As the voice of the residential building industry, HIA represents a membership of 60,000 across Australia. Our members are involved in delivering more than 170,000 new homes each year through the construction of new housing estates, detached homes, low & medium-density housing developments, apartment buildings and completing renovations on Australia's 9 million existing homes.

HIA members comprise a diverse mix of companies, including volume builders delivering thousands of new homes a year through to small and medium home builders delivering one or more custom built homes a year. From sole traders to multi-nationals, 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 the 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 18 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

On 28 September the Parliamentary Joint Committee on Corporations and Financial Services announced an inquiry into the effectiveness of Australia's corporate insolvency laws (Inquiry).

HIA takes this opportunity to respond to the Inquiry.

As has often been highlighted, Australia's insolvency laws have not undergone a comprehensive review since the Harmer Inquiry 34 years ago. While there have been minor reforms over the years, the insolvency regime in Australia is a notoriously complex legal system. This sentiment was recently echoed in the *Review of the insolvent trading safe harbour - Final Report* (Final Report) which called for an in-depth look at Australia's corporate insolvency regime, which they described as an *'impenetrable quagmire that is scary, complex and unknown'.*

Financial failure for some firms will be an unavoidable consequence of the competitive forces of Australia's market economy. Australian construction companies have historically been overrepresented when it comes to insolvency. Higher rates of insolvency are a bad thing for productivity in any industry.

The impacts of insolvency in the construction industry, particularly in the residential building industry, can be wide ranging and devastating, but the causes are a result of a complex set of factors including:

- the cyclical ebbs and flows of the sector,
- the unique regulatory environment that applies to the industry across the country, and
- the high proportion of small businesses that operate in the industry.

Further the competitive nature of the industry, the cycles of building activity, restrictive consumer protection provisions together with the costs of complying with complex overlapping state, local and Commonwealth laws and regulations have a considerable impact on business operations, profitability and viability.

As the Committee has identified, the COVID-19 pandemic exacerbated the above mentioned and pre-existing contributors to insolvency. Industry slowdowns, shutdowns, the imposition of various and changing work restrictions on top of staff absenteeism, jeopardised the livelihood of all businesses, particularly small businesses in the sector. The flow on effects of price increases and labour and material shortages have meant that many businesses in the industry are still on the journey to a full recovery.

Noting the broad terms of reference which invite the Committee to inquire into matters such as trends in the use of corporate insolvency, existing legislative and other arrangements to respond to insolvency and the role of government agencies in the insolvency system, the above factors are informative when considering the appropriate approach to issues of non-payment and are elaborated on in this submission.

HIA also takes this opportunity to comment on the existing regulatory and other mechanisms in place to respond to those in financial distress.

HIA recommends that this Inquiry consider what steps can be taken to support businesses, particularly small businesses, when faced with financial hardship and the difficult decisions regarding how to manage and respond to that. Currently, the threat of insolvency and the uncertainty associated with it, in HIA's experience, simply causes those who are the most in need to ignore the warning signs.

An effective and efficient statutory framework is required to help business and creditors deal with the impact of insolvency but at the same time not be too obtuse as to impose unnecessary regulation that makes it even more difficult for firms to enter the market, grow, and hopefully prosper.

Methods to manage and respond to outstanding debts and the inability to pay those debts on time should not be used as a sword, but rather a shield to protect both those owed money by a non-paying entity and those experiencing financial distress.

## 2. THE RESIDENTIAL BUILDING INDUSTRY

The residential building industry includes detached home building, low, medium, and high-density multi-unit housing developments, home repairs, renovations and additions, along with the manufacturers and suppliers of building products and related building professionals. The industry has important linkages with other sectors, such as manufacturing, finance, real estate, and retailing, meaning its impacts on the economy go well beyond the direct contribution of construction activities.

The residential building industry builds, on average, 113,000 detached houses per year and in the last few years has constructed a record number of both high rise and low rise dwellings. It is anticipated that there will have been 131,740 detached starts in 2021/22, which is just 6.7 per cent below last financial years record, and 8.3 per cent above the previous peak in 2017/18.

The industry contributes to the economy in a number of ways providing hundreds of thousands of Australians with jobs, generating billions of dollars of economic output each year and stimulating spending on housing services. Specifically, it is estimated that the residential building industry engages over 1 million people representing tens of thousands of small businesses and over 200,000 subcontractor businesses reliant on the industry for their livelihood.

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 contributing over $100 billion per annum to the economy and accounts for 6.9 per cent of Gross Domestic Product.

However the desire to slow the economy through higher interest rates will end the current building boom. Sales of new homes are falling; loans for new housing have retreated to pre-pandemic levels and along with other leading indicators, this shows a market slowing.

It typically takes 6 to 12 months for a change in the cash rate to fully flow through to the wider economy. In this cycle, the lags are treacherously long. When the cash rate was increased for the first time in this cycle, in May 2022, there was a record volume of homes under construction. There was also a record volume of homes 'approved but not yet commenced'; a record volume of homes 'sold but not approved'; and sales of new homes remained strong.

This large pipeline of building work is still being completed and will continue to ensure that starts remain robust to mid-2023. This will delay the full adverse impact of the first increase in the cash rate on building activity, employment on site and consumption of materials, until 2024. This treacherously long lag raises a very real risk that the RBA goes too far, too soon, in this cycle of rate increases. The consequences of overshooting the cash rate in this cycle are a deeper slowdown in building activity in 2024 and beyond, which will slow wider economic activity, without necessarily lowering inflation to the RBA's target range sooner.

In contrast to the RBA's attempts to slow activity, the Australian Government has announced an ambitious goal to build more than one million homes over the next five years (2024-2028). This target will only be achieved with deliberate, supporting policy reform from all levels of government. This feasibly includes settings that respond to financial distress and insolvency – keeping businesses in business in the sector will be a key piece to supporting the achievement of this target.

## 2.1 CONSTRUCTION INDUSTRY INSOLVENCY

The construction industry is admittedly largely represented in the overall number of insolvencies.

In the 2021-22 financial year, 1,282 construction companies entered into external administration and controller appointments, more than any other single industry[1] and the construction industry, particularly the residential building industry is often subject to extensive media coverage in the event of an insolvency.

This to some extent, is a natural reflection of the size and number of construction industry firms operating in the economy. As will be elaborated on below the residential building industry is characterised by a large number of small firms and a small number of very large firms.

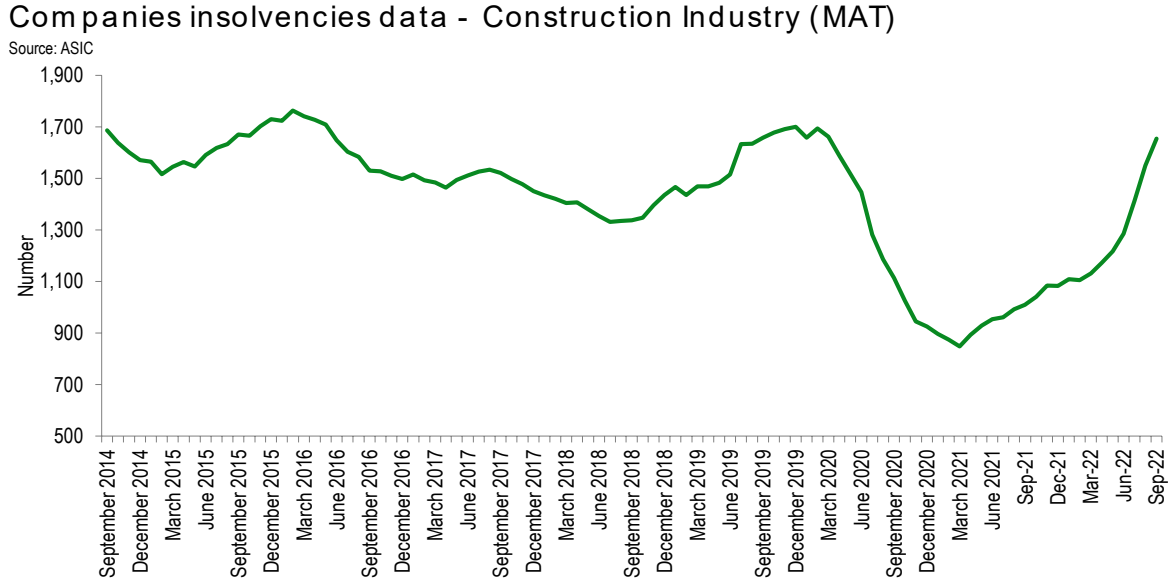
However, HIA challenges the proposition that there has been a 'surge' in construction industry insolvency. The volume of insolvencies within the building and construction industry fell significantly during the pandemic. This could be partially attributed to the temporary change in reporting requirements but also reflects a period of government stimulus where demand for new home and renovations grew rapidly.

Recent data suggests that insolvencies in the construction industry appears to be returning to pre-pandemic levels, with indications that they will continue to rise. This change has occurred since mid-2021 due to rapidly rising construction costs, combined with the restrictions imposed in Fixed Price Contracts, which saw builders of detached homes exposed to difficult trading conditions.

[1] Australian Securities & Investments Commission, ASIC Insolvency statistics, Series 1A: Companies entering external administration and controller appointments by industry, July 2013-August 2022 (August 2022).

The data on insolvencies can be misleading. The graph below shows insolvencies across the construction sector, meaning all civil, commercial and residential businesses. The number of businesses is not evenly shared across each sector meaning the data hides the actual trends across each. For example, there are a large number of small sub-contractors in the residential building segment of the industry, compared to a very small number of large civil construction businesses.

With sub-contractors, civil contractors and commercial builders experiencing strong market conditions, the bulk of the insolvencies currently being reported are likely to be focused on the relatively small segment of builders and trade contractors involved in detached home building.

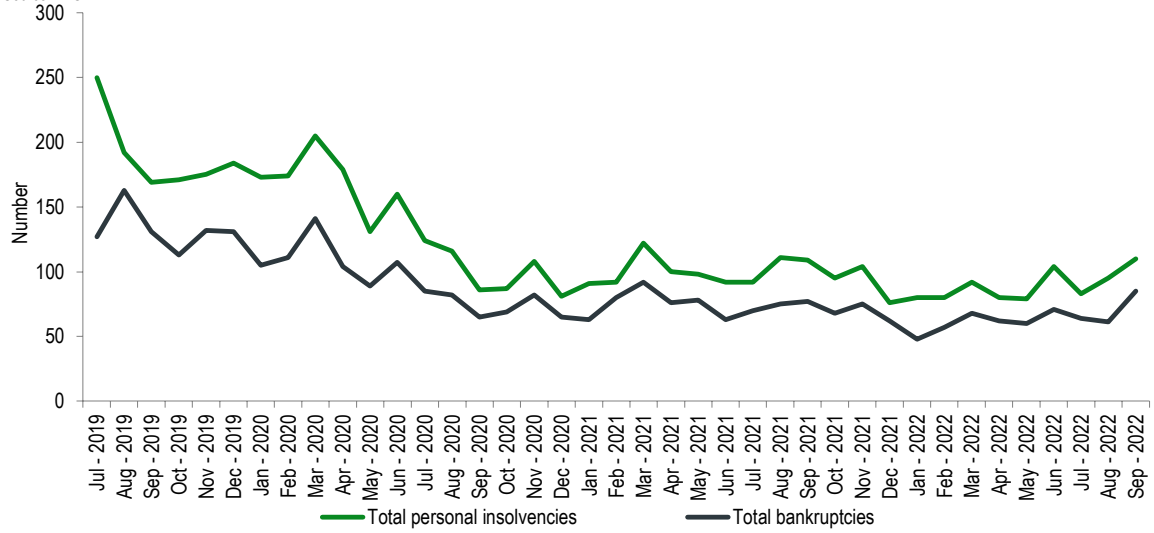



The graph below shows personal insolvencies where the individual reports to be employed in the construction industry. This data likely includes many sub-contractors operating as Sole Traders. The decline during the pandemic is consistent with the period of increasing trade rates and business protection measures.

As market conditions change, rates start to decline and the volume of work slows, insolvencies in the sector should also return to pre-pandemic levels.

Insolvencies and bankruptcies - Construction Industry

Source: AFSA



## 3. INSOLVENCY AND CAUSES OF BUSINESS FAILURE

There are a range of factors which might explain the incidence of insolvencies in residential building.

Importantly not all businesses become insolvent or bankrupt. Many close down after meeting all their outstanding obligations. But when business failure occurs, it is usually the precursor of an event of insolvency. A formal insolvency appointment/process is a response to an event of insolvency. The law enables the process of insolvency to be initiated by the directors, the secured creditors or the unsecured creditors.

No matter how stringent the regulation or how effective a business is managed, some corporate business failures may be an inevitable consequence of the competition, entrepreneurship and risk taking inherent in Australia's free market economy.

Government policies should be directed to promoting and preserving these cornerstone values.

The residential building industry is a high cost, highly regulated industry and the nature of firms in the industry means that they are especially susceptible to economic cycles and adverse government policies and regulation.

The industry is both cyclical in nature and highly competitive. Profit margins, purchasing power and overheads are three of the key factors that builders look at when analysing their competitive position. Profit margin is often reduced in order for builders to price their product competitively in this highly competitive environment.

Further, even though the industry is highly cyclical, even during boom cycles, margins remain low due to rising labour (and material) costs. Overhead costs as a percentage of turnover are also affected as production and cash flow slows down. In sum the residential building industry is highly input costed, highly taxed and a heavily regulated sector and these elements can and do play a role in the departure of firms from the industry.

A common situation amongst failed builders is that they allowed the market to determine their profit margins, rather than setting their margins based on the financial needs of their business. Whilst producing and relying on proper management accounts information is always recommended and preferred builders often rely on financial figures generated for taxation purposes.

During the rapid upward phase of the economic cycle, inflated prices, rising labour costs and reduced competition can lead to a fall in production whilst the downward phase leads to competitive cost-cutting and reduced margins and pressures on quality.

The failure of a business in this environment can occur from a number of causes including cashflow problems, poor management; external shocks; actions taken by third parties; competitive forces; changes in government policy and regulation and fraud.

A consistent challenge for builders is determining their price and profit margins by their actual overheads and the financial needs of the business and not by market pressures.

Builders in the industry ordinarily fund their works by way of overdrafts and trade credits and are paid in arrears by clients. Yet, their undertaken activities are subject to a high level of risk.

There are inherent uncertainties in contract prices which arise from the fact that prices are usually required to be fixed many months before construction commences and will be based on technical, financial and workforce assumptions.

The builder's reliance on cashflow to manage growth and cyclical conditions exposes them to an even greater extent in the event of non-payment by client.

In HIA's experience, many failed builders may also have encountered one or more of the following situations:

- Lack of accurate aged creditors and job costing information so individual jobs do not pay for themself and hence do not contribute to a positive cash flow.
- Relying on progress payments received from clients or principals to fund growth.
- Balance sheet assets overstated in respect to work in progress and realisable debtors.
- Financial records not current enough or only prepared for taxation requirements.
- Investments in non-core business activity using cash flow rather than earned profits.
- Lost production due to boom trading or adverse weather.
- Estimating errors and lack of accurate budgets for jobs.
- Major contractual disputes with clients locking up progress claims
- Time delays.
- Progress payments not paid on time.
- Cost Variations.

## 3.1 THE RESIDENTIAL BUILDING INDUSTRY IS UNIQUE

An additional complexity is that the practice and paradigm in the residential building industry differs significantly from those businesses operating in commercial construction. The reality that the sector is not homogenous is often overlooked.

Firstly, the terms and conditions for commercial builders and those engaging in government contracts are significantly different from the conditions a builder faces when working on a residential job.

Commercial projects and government works are generally characterised by:

- a tendering process;
- the use of retentions;
- longer payments terms (up to 45 days compared to 21 days in residential);
- limitations on a builder's ability to select subcontractors;
- contract administration by a superintendent/architect;

- significant amounts for liquidated damages; and
- longer defects liability periods.

Such elements are not present in the residential sector, which faces equally as challenging, yet different factors such as:

- the homeowner, whose significant emotional and financial investment places additional pressures on the builder and trade contractors;
- complex and extensive statutory consumer protection requirements;
- quasi regulation of payment terms through the involvement of financial institutions;
- ineffective and time consuming mandatory dispute resolution methods;
- demanding terms of trade from suppliers;
- significant exposure to uncontrollable events such as inclement weather; and
- the fluctuation in supplies of building materials and price of subcontract labour.

Secondly, the is a heavy reliance on the use of subcontractors in the residential building industry, particularly in the detached housing and renovation markets. Central to the notion of subcontracting arrangements and the use of independent contractors is that the contractor is running their own business, which is generally a small or micro business.

HIA estimates that more than 80 per cent of the residential building industry is comprised of small businesses and sole traders meaning that the sector is particularly vulnerable to the negative impact of additional red tape, government regulation and complex regulatory arrangements.

The flexibility of the subcontract system and the highly competitive nature of the residential building industry have interacted to secure a high degree of efficiency and productivity for many decades. This interaction also inflates the number of insolvencies in the industry.

## 3.2 REGULATORY ENVIRONMENT

Under the statutory consumer protection frameworks across the country the usual allocation of risk in favour of home owners.

Residential builders across the country must incorporate a number of mandatory terms and conditions into their contracts for the benefit of home owners.

For example, statutory limits on deposits and limits on progress payment claims mean that the builder essentially ‘finances’ a job.

It is generally accepted practice in the residential sector for the builder to claim upon defined progress stages being completed. Except for the deposit, it is uncommon for builders to claim in advance of work being undertaken. In fact, draw downs on project finance is normally only available upon lenders being satisfied with completion of certain recognised building stages but these milestones do not always correlate with the way expenses are incurred.

In addition, a builder is required to obtain all variations in writing and is required to have these signed by the parties. If these requirements are not strictly complied with, a builder may not be paid for the variation.

Progress payments are generally at least one construction stage behind (for example, the frame stage is well under way by the time the builder receives payment for completion of the slab). Clients are not generally charged interest for late payments, although builders have the right to do so.

Large volume builders undertake a significant number of projects at one time – sometimes hundreds of jobs – so the aggregate impact may be very significant. This places a heavy reliance and large amount of pressure on working capital.

Where a negative cash flow situation applies, a builder must find other sources of working capital to make regular sub-contractor and supplier payments. These payments have to come from borrowed funds or resources from previous jobs.

Delays in the approvals of claims by client's banks and valuers aggravate the pressure on builders' working capital and on the negative cash flow model.

The "unfair contract' provisions of the *Competition and Consumer Act 2010* and the Australian Consumer Law provide additional protections around the use of standard form industry contracts.

Unlike the heavily regulated consumer to builder market, business to business contracting in the subcontracting market is largely based upon the common law and the freedom of contract principle. It is true that some parties in the transaction might not always have equal bargaining power and it is true that some of the risks borne by the builder are necessarily shared down the contractual chain to subcontractors and consultants.

HIA produces standard form trade contracts for use by builders and subcontractors in the residential sector. These contracts reflect accepted industry practice. The Trade Contractor's obligations include rectifying within a defects liability period and providing suitable insurances but also include a right to be paid in progressive drawdowns.

In addition to the use of contracts, legislation such as *Building and Construction Industry Security of Payments Act 1999* (SOP) and the *Contractors Debts Act 1997 (NSW)* influence the management of risk in favour of the subcontractor.

For instance, the standard payment terms for subcontractors are generally 7 or 14 days, with a maximum of 21 days. The security of payments system ensures a disproportionate level of protection for contractors in this system by mandating payment within 10 days of the issue of a payment claim.

Set up to provide speedy and inexpensive management of disputed claims, the SOP legislation has the following features:

- It provides subcontractors with a statutory right to progress payments.
- Claimants who have a dispute over payment can lodge an adjudication application to have the matter determined by an adjudicator.
- Creating liability for claimed amounts that are not rejected within a stipulated time frame.
- It establishes an expedited dispute resolution procedure (adjudication) by which disputes concerning payment are resolved, by way of written submission, within a very short period of time.
- Adjudication determinations are then able to be enforced as court judgments.
- Provides a statutory right to suspend work for non-payment.

HIA have long held the view that the rapid adjudication process should apply to home owners in order to expedite the overarching payment process. Without including client payment adjudications, the builder is reduced to a credit providing project coordinator who is ultimately responsible for everything.

***Warranty Insurance***

One defining feature of the residential building industry is the mandatory regime of builder's indemnity or Home Warranty Insurance which operates in nearly every jurisdiction. A scheme in Tasmania is expected to commence in 2023.

Since 2001 these 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 some jurisdictions 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 warranty insurance 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. Providers of this form of insurance essentially act as a 'quasi regulator'. They monitor the amount of work that can be carried out often placing limits on that work depending on the financial situation of the business.

In Victoria for instance, under the *Domestic Building Contracts Act 1995*, each time a builder enters a domestic building contract over $16,000 with a customer, they must take out a domestic building insurance project certificate specific to the works covered by the contract.

The operation of mandatory warranty insurance has two significant implications for the broader insolvency regulatory framework.

Firstly, 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 financial security or an indemnity of some form before granting eligibility.

Similarly, under the *Home Building Act 1989* (NSW) (HBA) any residential construction project over $20,000 must obtain insurance under the Home Building Compensation Fund (HBCF) prior to the receipt of money or the commencement of work.

To obtain insurance under the HBCF, a builder must be deemed 'eligible' by iCare. In determining eligibility, iCare examines a range of financial and non-financial information provided by the business to assess the risk of potential threats to solvency.

Secondly, a claim can be made in the event of the insolvency of the builder. For example, in NSW, 'insolvency' can mean the insolvency of an individual under administration, a corporation that is being externally administered or the insolvency of any partners in a partnership. Additionally, if related to any loss that is subject to a New South Wales Civil and Administrative Tribunal order against the builder, insolvency includes the suspension of the builder's licence[2].

Unfortunately the definition of 'insolvency' for the purposes of triggering warranty insurance is not the same across the country. Under the Queensland arrangements. 'insolvent' includes, 'external administration, including, for example, liquidation, receivership or compromise entered into with creditors, under the *Corporations Act* or a similar law of a foreign jurisdiction'[3].

Whether a builder is 'insolvent' may have a different meaning for a state-based consumer protection authority versus the commonwealth insolvency framework. Or, and perhaps more complex, is that they may mean the same thing, however under a commonwealth arrangement there may be a mechanism to support the business trade through such an event which is not recognised at a state level for the purposes of warranty insurance. This outcome would effectively negate options for 'business rescue'.

***Licensing***

People that carry out residential or domestic building work must be licensed or registered. This license or registration gives an individual or a business permission to carry out that work. It is the basis on which they can trade.

The license or registration of a builder can be adversely impacted when an insolvency event occurs.

In order to be licensed most builders (as well as many trade contractors) are subject to strict financial and personal probity requirements. Directors who have controlled an insolvent company may be automatically excluded from consideration or will typically fail the "fit and proper" person requirements.

In Queensland, Section 56AC of the *Queensland Building and Construction Commission Act 1991* currently applies to "excluded" individuals and companies. Section 56AC will apply to:

[2] [pp5-6] iCare HBCF Policy of Insurance under Part 6 of the *Home Building Act 1989* (NSW) Version 4.0 Effective 1 June 2018
[3] Section 2, Part 1 of Schedule 6 – *Queensland Building and Construction Commission Regulation 2018*

- individuals that take advantage of the laws of bankruptcy or become bankruptcy and 3 years have not elapsed since the bankruptcy event;
- individuals if they were a director, secretary or influential person of a construction company (either at the relevant time or within 2 years before the insolvency event) has a provisional liquidator, liquidator, administrator or controller appointed, or is wound up, or ordered to be wound up and 3 years have not elapsed since the insolvency event;
    - An influential person means 'an individual, other than a director or secretary of the company, who is in a position to control or substantially influence the conduct of the company's affairs'[4].

Under section 56AE, the Commission must not grant a person a licence if the person is an excluded individual for a relevant event, or an excluded company.

In South Australia, section 9 of the *Building Work Contractors Act* provides that an applicant for a building license cannot be insolvent or subject to a deed or scheme of arrangement with or for the benefit of creditors over the last 2 years, or over the last 5 years has not been a director of a company that was wound up for the benefit of creditors.

The HBA in NSW similarly provides that a license must be cancelled if the holder of the licence becomes bankrupt or insolvent or is a deregistered company (see section 22).

In addition, section 20 provides that a license application must be refused if:

- the applicant has been disqualified under the Act the regulations from holding a contractor licence, or
- a close associate of the applicant who would not be a fit and proper person to hold a license exercises a significant influence over the applicant or the operation and management of the applicant's business.

Under the HBA a person is disqualified from holding a license (other than an owner-builder permit) if the person:

- is in partnership with a person who is, or is a director of a body corporate that is, disqualified from holding a license under this Act, or
- is in breach of any provision of this Act or the regulations that is prescribed by the regulations as a disqualifying breach.

There are also grounds to refuse an application if the applicant is not a "fit and proper person to hold a licence".

In Western Australia while there is no automatic ban or exclusion for directors/officers of an insolvent company from holding a building practitioner registration in their own individual capacity and/or seeking to obtain registration for themselves or a new company as a building services

[4] Section 4AA QBCC Act

contractor. This issue is a relevant consideration when it comes to applying for or renewing registration.

Under sections 17 and 18 of the *Building Services (Registration) Act 2011* in assessing fitness and probity, consideration would be given to the financial background of the applicant, including whether they were ever a director of an insolvent company or have been bankrupt.

Similarly, in Victoria the Building Practitioners Board (BPB) may refuse to register an applicant if a number 'good character' requirements are not met (s170(c)) and instances of insolvency under administration is a relevant factor.

Those operating in the residential building industry are placed in the unenviable position of needing to hold a license to trade in order to pay their debts but, if facing insolvency, may be prevented from doing that which would see them move out of financial distress.

## 4. EXISTING MECHANISM TO RESPOND TO FINANCIAL DISTRESS

HIA supported a range of measures aimed at allowing businesses the opportunity to trade out of financial distress in response to COVID-19. For example, raising the statutory demand threshold and extending the time frame to respond and providing temporary relief from liability for trading while insolvent all provided some 'cushioning' and confidence for businesses to stay in business and reassess their financial position once the height of COVID-19 passed.

HIA notes that since then the statutory demand threshold has been permanently increased. A change also supported by HIA.

Other changes to support small business through financial difficulties have also been of benefit. HIA understands that eligible small businesses have been taking advantage of the simplified debt restructuring process, however the simplified liquidation process remains underutilised.

HIA would also support the recommendations and observations made in the *Review of the insolvent trading safe harbour - Final Report* (Final Report) particularly the need for a holistic in-depth review of Australia's insolvency laws.

### 4.1 THE CURRENT PUNITIVE APPROACH

The Final Report notes that the Director Penalty Regime would appear inconsistent with the safe harbour provisions. HIA would go further and suggest that the regime embodies contradictory policy intents as stated in the Final Report:

> *'If the purpose behind the safe harbour provisions is to encourage companies to seek advice early and put their companies in the best possible position for a viable future (including improving the books and records, lodging taxes and paying employee entitlements), then DPNs act as a disincentive and, in practice, may be counterproductive to those aims'*[5].

[5] Pg.80

On the one hand recent reforms directed at supporting small business to trade out of financial distress and the approach taken during COVID-19 support businesses coming forward and seeking advice and help to address whatever issue they may be facing; on the other hand, there are a number of Commonwealth laws in place to address and regulate corporate insolvencies that, in practical terms, act as a strong disincentive for business operators to 'pull their head out of the sand'.

Director Penalty Notices (DPN) previously included an option to enter into a payment arrangement for the outstanding debt. This option appears to have been removed following the decision in *Clifton (Liquidator) v Kerry J Investment Pty Ltd trading as Clenergy*, which found that entering into a payment arrangement did not cause a tax debt that was due and payable to cease being due and payable. As such, having a payment arrangement in place does not necessarily prevent a business from trading while insolvent.

While entering into a payment arrangement is no longer listed as an option on a DPN, a director should still consider this arrangement. Section 269-15(3) of Schedule 1 of the *Taxation Administration Act 1953 (Cth)* (TAA) provides that the Commissioner of Taxation must not commence or take a procedural step as a party to proceedings to enforce an obligation or recover a penalty if an arrangement that covers the company's obligation is in force.

If a DPN has been issued to a director in circumstances where the company has not lodged an activity statement or superannuation guarantee charge statement, or it was lodged more than three months after it was due, the only way for the director to avoid liability is to pay the tax debt in full.

Under the *Corporations Act 2001*, directors have a direct and positive duty to prevent their company from trading if it is insolvent. A company is insolvent if it is unable to pay all its debts when they are due. Directors must prevent their company from incurring debts where the company is insolvent or becomes insolvent by incurring the debt(s) and at that time, there are reasonable grounds for suspecting the company is insolvent or would become insolvent.

There are various penalties and consequences of insolvent trading, including civil penalties, compensation proceedings, criminal charges and/or disqualification from managing a corporation.

A company must also keep financial records to correctly record and explain transactions and the company's financial position and performance. A failure of a director to take all reasonable steps to ensure a company fulfils this requirement contravenes the legislation.

Directors' also have fiduciary duties which include the duties to act in good faith and in the best interests of the company, to act for proper corporate purposes and to avoid conflicts of interest. It has been held that the duty of directors to act in good faith and in the best interests of the company includes consideration of the interests of creditors upon insolvency.

Under taxation laws, directors' personal liability may arise where the Commissioner of Taxation issues a Director Liability Notice (DLN) under Section 222AOE of the *Income Tax Assessment Act 1936* to the directors at a time when the company has failed to remit tax. The objectives of these

provisions are to ensure that a company satisfies particular income tax obligations or is promptly placed into voluntary administration or liquidation.

Liquidators and external administrators have obligations to investigate causes of failure and identify and report breaches of law to ASIC. This is aimed at ensuring inappropriate director/corporate behaviour is identified and addressed by the party capable of taking disciplinary action, generally the corporate regulator.

Liquidators also have powers to investigate and void certain transactions such as unfair preference payments.

ASIC, in turn, has a number of powers to take action against such reported breaches.

## 4.2 Illegal Corporate Phoenixing

HIA has supported a range of measures targeted at illegal corporate phoenixing including those introduced by the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020.*

HIA does not support individuals who engage in illegal phoenixing. Individuals who hide behind the shield of a company to incur debts such as payments due to employees and subcontractors without any intention of paying those debts, abuse the corporate form. Those individuals obtain an unfair competitive advantage over the majority of businesses that comply with their obligations and are acting outside their legal obligations and community expectations. Strong punishment and sanctions should apply to such individuals.

However, the desire to identify illegal activity must should not be at the cost of allowing legitimate steps to be taken to respond to difficult financial situations.

The incorporated entity remains the chosen (and best) legal structure for hundreds of thousands of businesses. Any additional laws should not dilute the economy-wide benefits of incorporation nor simply be another means to address revenue shortfalls.

Further measures to address phoenix activities should primarily target those directors and persons who engage in the practice. Ordinary businesses, many of whom are “mums and dads”, never intend to phoenix and should not be penalised merely because at some point their business might fail.

For example, the Combatting Illegal Phoenixing Act extended the director penalty regime for unpaid goods and services taxes (GST). This measure was targeted to all companies, not just those engaged in wrongdoing. HIA remains concerned that this will unnecessarily adds to the day-to-day risks of running a small company. Both the Commissioner of Taxation and the ATO have broad and extensive asset and debt recovery powers. New laws should not be a substitute for better resourcing and the better use of existing laws.

A more appropriate measure would be the introduction of a statutory definition of phoenix behaviour. This would provide directors with clarity and improved certainty in relation to what conduct is captured. An offence of illegal phoenixing must be directed at the deliberate and

systematic liquidation of a corporate trading entity which occurs with the fraudulent or illegal intention to:

- avoid tax and other liabilities, such as employee entitlements; and
- continue the operation and profit taking of the business through another trading entity.

The offence should include a defence that a company and/or a director will not be guilty of illegal phoenixing were the behaviour was directed at the honest resurrection of a company.

Clarity and certainty regarding activity that *is* and *is not* illegal would encourage industry participants to seek assistance when facing financial challenges.

## 4.3 Education and training

The Final Report also recommended that a 'best practice guide' to safe harbour provisions be developed.

HIA would encourage the development of such guides in relation to many aspects of the insolvency regulatory framework. Training and support for non-lawyers and non-insolvency practitioners is imperative. As has been outlined throughout this submission, the consequences of insolvency can be devastating and, in the case of those operating in the residential building industry, prevent them from operating a business and carrying out a trade, both now and in the future.

HIA would be open to discussing how industry associations can support the industry through the development of industry specific education and training.

## 4.4 Role of Government agencies

A part of the complexity within the current framework is the multiple regulatory agencies that play a role in the insolvency framework.

HIA takes this opportunity to comment specifically on the role of the Australian Tax Office (ATO).

***The Australian Tax Office***

The role of the ATO in the bankruptcy and insolvency framework should not be understated; unpaid taxes are very common in insolvencies. The ATO's own data on the 'tax gap' which seeks to estimate the amount of taxes unpaid for a variety of reasons including insolvency is also instructive. According to the ATO's latest annual report for 2019–20, the overall net tax gap was estimated to be 7.0%, or $33.4 billion[6].

HIA understands that the ATO ranks as a non-priority unsecured creditor in a liquidation, however has some unique or enhanced creditor powers, in addition to its regulatory powers, that make it a formidable enforcement agency.

In its capacity as a creditor, the ATO can apply for the winding up of non-compliant companies, as other creditors can do, but with some enhanced powers. Unlike the debts owed to general

[6] ATO Annual Report pg. 43

creditors, the ATO's debt may be an estimate of liability, and the statutory demand is conclusive proof that the debt is owed. The ATO can also apply for companies to be wound up on the just and equitable ground, may apply to set aside a deed of company arrangement, or apply to have the company's assets frozen to prevent dissipation.

The fact that the ATO can (basically) send an individual bankrupt or cause an insolvency would appear to stand out as a 'moral hazard'.

On the one hand, the ATO should (and does) have a role in supporting and educating businesses, and the community more broadly, about their taxation obligations and that role extends to the collection of those amounts and enforcement of the underpinning laws. How does the ATO balance the emergence of a desire to focus on 'business rescue' with a mandate to ensure the laws are complied with to the greatest extent possible, including that lawful legal action can be taken to secure amounts owed? Certainly, in the past, the latter has taken priority over the former.

The COVID-19 pandemic stands out as a situation in which the ATO was required to take a different approach. As is well known the ATO imposed a moratorium on the collection of tax debts, however, have recently announced a resumption of their usual arrangements regarding these matters.

HIA understands that the ATO has engaged in an awareness campaign to notify businesses where there is a significant outstanding tax debt or where there is a possibility of the issuing of a Director Penalty Notice.

The aim is to encourage taxpayers to take steps to manage the outstanding tax debt, either through paying the debt (in full) or entering into a payment arrangement. A failure to respond could result in the disclosure of the tax debt to credit reporting bureaus or be pursued personally for the tax debts of the company in respect of unpaid tax debt relates to PAYG withholding, Superannuation Guarantee Charge or GST.

This approach is echoed in the ATO's most recent annual report:

> *Implementing targeted strategies to address collectable debt:*
>
> *As the economy recovers, one of our key priorities is to address the collectable debt that has accrued over the past 3 years. This has increased from $26.5 billion at 30 June 2019 to $44.8 billion at 30 June 2022 – up $18.3 billion or 69%. The increased debt is a result of disrupted economic activity due to lockdowns and cash flow impacts on small businesses and households. During the early stages of COVID-19 we deliberately shifted our focus away from firmer debt collection action to assist businesses and the community experiencing challenges because of the pandemic. While most payments are made on time, debts that remain unpaid and accumulate over time require firmer and stronger action. Due to these increased and enduring debts, we expanded our enhanced engagement program through a series of awareness campaigns, advising clients of the potential firmer and stronger actions they could be subject to if they do not engage – including director*

*penalty notices, garnishee, disclosure of business tax debts or legal remedies including insolvency.*

*In March 2022, we wrote to approximately 30,000 businesses and 52,000 directors with significant tax obligations outstanding, through 2 key client awareness programs that focused on transparency of clients' obligations, actions and remediation. In total these clients owed $10.4 billion. As a result of this initiative:*

- *over 25,000 clients have contacted the ATO*
- *more than $2.21 billion has been paid outright*
- *over 13,000 clients entered into payment plans worth $2.16 billion*
- *over 3,200 clients no longer have a debt, and more than 850 others have debts that are now less than $10,000.*

*For those that did not engage with us, we escalated to enforcement actions – including issuing director penalty notices with respect to more than 2,800 companies since 1 May 2022*[7]*.*

While HIA is not suggesting that the ATO not carry out their compliance and enforcement role, the directive of the ATO should be reviewed and they should be empowered with a range of compliance and enforcement tools.

For example, legislation currently before the Federal Parliament proposes to introduce a new compliance option in cases where the ATO finds that a business has failed to comply with its tax-related record keeping obligations. If passed the *Treasury Laws Amendment (2022 Measures No.2) Bill 2022* would allow the ATO to issue a tax-record education direction as an alternative to the current financial penalties for such failures in cases where there is no deliberate intention to avoid their record keeping obligations.

A modern and responsive regulator supported by a flexible compliance and enforcement framework is essential to ensure responses to non-compliance can be tailored, measured and appropriate as opposed to the only option being to force bankruptcy or commence winding up proceedings.

[7] ATO Annual Report