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WHITE PAPER

August 2022

An Update on Insolvency in the Australian Construction Industry

The construction sector in Australia has long been affected by insolvency and broader liquidity issues. In the last year, construction companies accounted for 26% of businesses that entered into insolvency, and insolvencies in the construction sector more than doubled. This year, contractors have been further squeezed by inflation, supply chain issues and labour market shortages. As the federal government has wound back its COVID-19 economic stimulus packages, further collapses seem inevitable.

In this *White Paper*, we set out the reasons for why the construction industry is particularly vulnerable to insolvency issues, outline the risks and red flags that owners, principals and head contractors should be aware of, and discuss how these risks can be managed.

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INTRODUCTION

Australian construction companies have historically been overrepresented in the insolvency space and recent data confirm that this trend persists. In the last year, construction companies accounted for 26% of businesses that entered into insolvency,[1] and insolvencies in the construction sector more than doubled.[2] Inflation, supply chain issues and labour market shortages are adding to the existing pressures contractors are facing as they recover from the impacts of the pandemic, especially when squeezed by fixed-price contracts.

As interest rates rise, further insolvencies in the construction sector appear inevitable.

In this *White Paper,* we outline how the insolvency regime in Australia plays out in the construction sector, discuss the red flags and warning signs and address how owners, principals and head contractors can manage the risks at every level of the contracting chain.

KEY ISSUES FOR CONTRACTORS

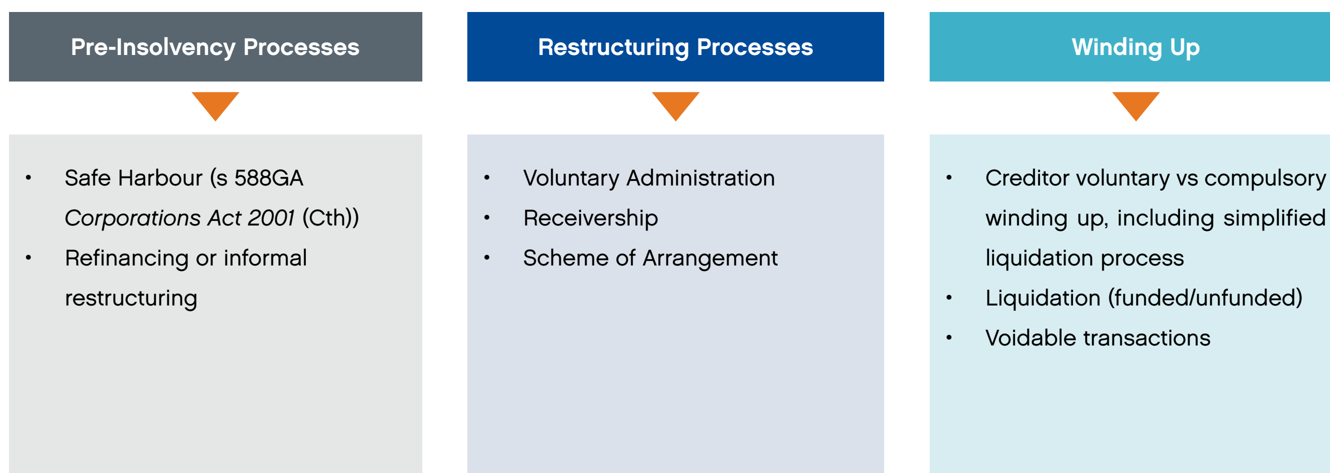
In the 2021–22 financial year, 1,282 construction companies entered into external administration and controller appointments, more than any other single industry.[3] According to the Reserve Bank of Australia's *Financial Stability Review*, more than one-fifth of businesses with low cash buffers—less than one month's worth of expenses—are businesses in the construction sector.[4] Additionally, contractors typically have unpaid receivables of around 1.25 times their monthly turnover.[5]

Contractors engaged under fixed-price contracts are uniquely vulnerable to inflationary pressures as costs increase and margins become thinner or disappear. These costs are only exacerbated by supply chain issues and infrastructure bottlenecks. Likewise, labour shortages can create delays or cause contractors to miss major milestones.

Principals and head contractors generally have less oversight of these sorts of issues and how they impact contractor and sub-contractor liquidity, as the shift towards the pyramid-style relationship in construction projects means that there are multiple layers of smaller, more specialised sub-contractors at the bottom. Nevertheless, the impact of delays and lower-level insolvencies for the head contractor can be significant.

AUSTRALIA'S INSOLVENCY REGIMES

Broadly, Australian insolvency regimes can be split into three categories.



Pre-Insolvency Processes

Prior to entry into a formal insolvency process, we typically see attempts at restructuring a business via an informal, voluntary process, especially as directors can now make use of the safe harbour provisions to protect from insolvent trading liability. The informal restructuring process allows directors to negotiate debts with creditors and suppliers in order to return the company to financial health, before the company approaches insolvency. An informal restructuring or turnaround may also stabilise the business, preserve jobs and generate positive cash flow.

WHAT IS A "SAFE HARBOUR" ARRANGEMENT?

- The safe harbour provisions were introduced in 2018 under s 588GA of the *Corporations Act 2001* (Cth). The regime is intended to allow directors who suspect that their company is or may become insolvent to restructure the company's affairs without the worry of facing personal liability for insolvent trading.
- To qualify for the safe harbour regime, directors must obtain independent advice and prepare a written plan for a course of action which is reasonably likely to lead to a better outcome than the appointment of an administrator or liquidator. The advice will need to come from appropriately qualified advisers, which in many cases will be a combination of registered liquidators and lawyers. A plan may include renegotiating key contracts, entering into payment arrangements or otherwise restructuring the company's affairs.
- Directors have an obligation to follow the plan, and to vary the plan if any director no longer believes that it continues to provide a better outcome than the immediate appointment of administrators or liquidators. Debts incurred in connection with that course of action are excluded from directors' liability.
- When action is taken early, the safe harbour provisions can save a contractor in distress and prevent defaults on existing contracts. In certain jurisdictions, such as in Queensland, it may also avoid the loss of a contractor licence which would occur in the event of a formal insolvency process.

- Companies are generally under no obligation to disclose that they are trading under the safe harbour regime. There are risks for principals, owners and head contractors who may be unaware that they are engaging with a sub-contractor under a safe harbour plan, and who may not have recourse against the directors if the sub-contractor ultimately goes into liquidation.
- If it appears that a contractor might be trading under a safe harbour arrangement, parties should obtain legal advice before engaging in any proposed transactions, as these may be found to be voidable if the company ultimately enters into liquidation (see below). Wilful blindness and avoiding making enquiries about the financial affairs of the contractor will not allow a principal or owner to avoid liability.

Formal Restructuring Processes

If a company is unable to successfully restructure its affairs via an informal and consensual process, the company may enter into a formal restructuring procedure under the Corporations Act. The directors of a company may also seek to place a company into a formal restructuring process if they are unable to avail themselves of the protection of the safe harbour regime (e.g. if there is no longer a plan for a course of action that is reasonably likely to lead to a better outcome than the appointment of an administrator or liquidator.)

Procedure	Key Features
Voluntary Administration	Designed to provide "breathing space" to resolve an insolvent company's future in one of three ways: either (i) return the company to the directors; (ii) enter a deed of company arrangement ("DOCA"); or (iii) liquidate the company. The outcome is voted on by creditors at the "Second Creditors' Meeting". The administrator has control of the company's business and property, including the power to sell assets or close the company's business. The administrator investigates the company's affairs and makes recommendations to creditors as to its future. There is a general stay on enforcement action by creditors, except if the creditor has security over all or substantially all of the debtor's assets. These secured creditors generally sit outside the voluntary administration process and may appoint receivers to take control of the company's assets. Unsecured creditors can be "crammed" under a deed of company arrangement, subject to majority creditor approval at a creditor meeting and compliance with Part 5.3A of the Corporations Act. A secured creditor is bound by a DOCA only if the secured creditor voted in favour of it. Unlike a scheme of arrangement, a DOCA cannot effect releases of claims against third parties (unless they sign up to the DOCA); this can be problematic where the restructuring of a group is attempted via a voluntary administration process only at a Holdco level, and there may be guarantees by other group members.
Receivership	Receivership is a form of external administration, usually triggered by the failure of a company to comply with the terms of a secured loan instrument. The appointed receiver works to realise the interest of the financier rather than the creditors generally. In some instances, such as where a creditor has security over all or substantially all of the debtor's assets, both a receiver and an administrator might be appointed. The receiver will take control of the assets that form part of the security, whilst the administrator will investigate the insolvency and provide reports to the other creditors. The receiver typically will have the power to sell the assets over which the receiver is appointed. Under s 420A of the Corporations Act, the receiver must obtain at least the market value for the asset or (if there is no market value) the best price reasonably obtainable.
Schemes of Arrangement	The company can stay in control and does not need to be insolvent to make use of the scheme process. The court has oversight of the scheme process. There are two court hearings – the first to convene scheme meetings; the second to approve the scheme. Secured and unsecured creditors can be bound by the arrangement. The process is available outside of insolvency procedures, but it is expensive. 50% in number and 75% in value of each "class" of creditors is required for a class to accept a scheme. 75% approval in value of each affected creditor class is required at the scheme meetings, giving some creditor classes veto / greenmail power in circumstances where they are otherwise "out of the money" (i.e. there is no cross-class cram down).

Winding Up

In a winding up, liquidators work to realise the assets of the company for as much value as possible and distribute the proceeds to creditors.

At this stage of the process, transactions entered into between companies and creditors may be unwound if a creditor had reasonable grounds for suspecting that the company was insolvent at the time, or would become insolvent by reason, of the transaction. These are known as voidable transactions. This is a critical point for those involved in project delivery: payments made by insolvent companies to principals, owners or head contractors may be subject to claw back.

SPOT THE WARNING SIGNS

Insolvencies in the construction sector are often preceded by a common set of events. Ensuring that employees and contractors—including those on the ground—keep an eye out for warning signs during the project phase can help to anticipate potential contractor insolvencies.

These signs can be difficult to spot as they often manifest as problems going to contractor performance. In fact, these issues can be rooted in a number of different causes, not all of which necessarily indicate insolvency. Notwithstanding this, these issues require timely on-project management, whether in the context of possible insolvency or otherwise.

It's helpful to think about these warning signs in two broad categories, **project execution issues** and **commercial issues**. Applying this framework can allow for a more systematic focus on insolvency risk and highlights the need for everyone in the project to keep watch.

Project Execution Issues

- Slowdowns in work progression and failure to achieve major milestones may be indicative of cash flow problems.
- Delays in procuring materials or removal of plant and equipment from the site can signal non-payment to suppliers.
- Liquidity issues may be felt in personnel and labour losses, especially of those in key project leadership positions. Project directors, construction or commercial managers and the like are often in the know—they either see the writing on the wall, or are removed for lower-cost options.
- High turnover of staff generally and any decrease in craft labour on site can signal that workers are not being paid.

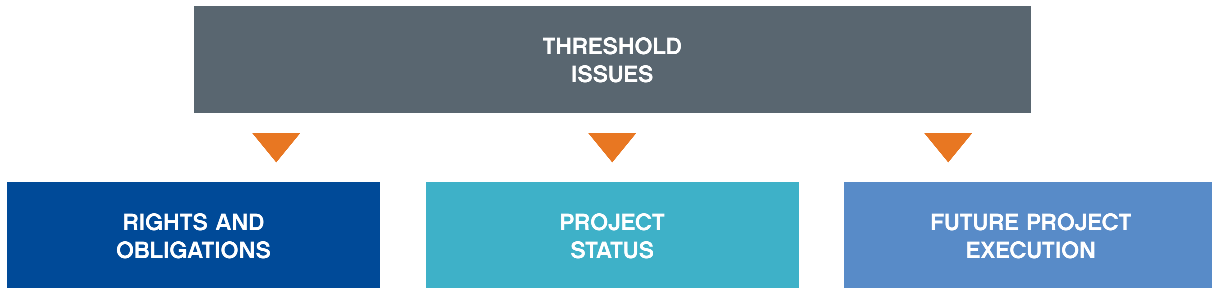
Commercial Issues

- Requests for changes to the payment mechanism, whether in terms of timing, dollar amount, or otherwise, are red flags and should be investigated. Any requests for advance payments, for example, should prompt a financial health check of the company. Be cautious when agreeing to these types of variations.
- Aggressive invoicing in progress claims, including bringing amounts forward, issuing multiple invoices or inflating progress claims, are all warning signs that a contractor or sub-contractor may be insolvent or nearing insolvency. Likewise, aggressive claims behaviour in respect of variations and extension of time requests often reflects cash flow problems.
- Keeping an ear to the ground can often be the best way to stay abreast of any potential trouble. Look for publicly available financial reporting by the contracting entity or its parent and any related entities, especially any late filing of compulsory financial reports. Likewise, rumours of unusual financial borrowing activity, proposed company restructures and movements of assets, safe harbour arrangements, and issues on other projects, should prompt pro-active inquiries into the company's financial health and legal advice should be sought.
- Monitoring publicly available information is a helpful way to assess whether project execution issues are performance based or indicative of a deeper liquidity problem. Consider engaging outside assistance to make these inquiries, and seek advice on whether a contractor can enforce any contractual audit powers on your behalf, such as back-to-back rights in sub-tier contracts and supply agreements.

Principals and owners can benefit from implementing a system in which these types of issues are documented, rather than noting them ad hoc. Conducting regular financial health checks and asking staff on the ground to be aware of these issues can assist in anticipating potential liquidity problems for contractors down the line.

THRESHOLD ISSUES: WHAT TO CONSIDER BEFORE YOU MOVE FORWARD

There are several key threshold issues which should be considered if a party becomes aware of or suspects a contractor may be experiencing cash flow problems.



Contractual / Statutory Rights and Obligations

As a principal or owner, understanding the company's contractual and statutory rights and obligations is critical and should be the starting point whenever assessing the company's options. That includes ancillary or associate contracts that apply beyond any core development agreement or construction contract, such as interfacing or coordination agreements.

Key factors to consider include:

- Any security available to be called upon under the various agreements, as well as the enforceability of bonds, bank guarantees and parent company guarantees;
- Upstream implications, whether for the head contractor, owner, shareholders to any joint venture agreement, investors or financiers;
- Rights of novation or assignment with sub-tier sub-contractors and suppliers;
- Any rights of termination in the event of an insolvency under *ipso facto* clauses (discussed in "Restrictions on Ipso Facto Clauses", below).

Project Status

The status of the project will of course affect the options available and the best course of action. Obtaining an assessment of the project—its progression, estimated cost to completion and any outstanding claims—will factor into any decision whether to retain, terminate or step-in. Assessments should include documentary evidence (such as photographs) of any known or potential defects or other shortcomings in the work.

Future Project Execution

Identifying important elements of a project is essential to driving completion, irrespective of which course is taken. Consider:

- Key personnel of the contractor, especially those with significant historical knowledge and strong performance;
- Contacts at major sub-contractors and suppliers, and the relevant contracts of engagement;
- Anything else necessary to complete the contract—for example, design documentation or permitting documentation. This information will need to be passed on quickly to any new contractor or sub-contractor to avoid slowing down the process further.

Terminating a contract is a serious decision with potentially significant implications. This is an "all or nothing" decision that can permanently alter the course. Principals, owners and head contractors should seek advice early to understand termination rights and consider other options before proceeding.

RETAIN, TERMINATE, NEGOTIATE: WHAT ARE MY OPTIONS?

When dealing with an insolvent or potentially insolvent contractor or sub-contractor, time is of the essence. Seeking legal advice earlier rather than later will expand the options available, depending on the circumstances of the project.

Retain or Terminate?

Generally, there is under statute a prohibition against enforcing a contractual right to terminate (or take some other course of action) that is triggered by the counterparty becoming insolvent (known as the prohibition on ipso facto clauses, discussed in "Restrictions on Ipso Facto Clauses", below).

As the consequences of an unlawful termination are serious, seek legal advice early to understand the company's rights and obligations, including whether there are any prohibitions on termination.

Terminating is a serious step and any decision around retaining or terminating a contractor will have cost consequences. Principals, owners or head contractors who wrongly terminate can be exposed to protracted litigation and significant damages in addition to the costs of engaging another contractor. There may also be broader rights of termination under the contract, including under ipso facto clauses, set-off or step-in rights, or assignment and novation rights.

Adjust the Contractual Model

Whether you retain or replace the contractor, it may be worthwhile tinkering with the contract model in use, for example, by swapping from a cost-reimbursable model to a lump-sum model, or vice versa.

Look closely at specific risk allocations and the root cause of any cost and time overruns to date. Adjustments may be able to be made at a granular level, including the pricing, cash flow and execution terms, that could support the existing contractor or help ensure the replacement contractor doesn't run into the same issues.

Keep Key Sub-Contractors and Suppliers on Board

Maintaining sub-contractors and suppliers is vital to reaching completion regardless of whether the contractor is terminated. This may require novating contracts (if those rights are available). Engaging with those rights where the contractor is not actually in insolvency or where there is a dispute over any termination can expose principals, owners and head contractors to claims for interfering in the contractual relationship or for inducing breach of contract.

Call on Security

When calling on security, timing and correct enforcement is key. Understanding the triggers under the relevant contracts is essential to ensuring that the benefit of the security is obtained. For example, often security can only be called upon once a debt has crystallised, which may or may not be the case once the contractor's solvency status appears precarious. If the security is called too early, it may be open to attack and leave the principal or contractor in no better position than any other creditor in the liquidation. Moreover, calling upon a security could be seen as enforcing an ipso facto clause, which, as we discuss in "Restrictions on Ipso Facto Clauses", *below*, is generally prohibited.

Review PPSA Interests

Technical and expensive plant and equipment can be caught in an insolvency procedure, and questions over the applicability of the *Personal Properties Securities Act 2012* ("PPSA") may arise. Preparing an inventory of the contractor's equipment may assist. If a principal or owner holds a security backed by these assets, it should be identified whether they are subject to interests registered on the PPSA.

Leased and bailed equipment may be caught up in the regime and the owner of that equipment risks losing its interest if not registered.

RELEVANT CONSIDERATIONS

- What are my rights and obligations under each of the relevant contracts?
- What are my obligations upstream and downstream?
- What are my funding obligations?
- Do I have a current assessment of the project?
- Are any defects in the project properly documented, for example, in photographs?
- If I change contractors, how can I ensure that key labour personnel stay on?
- Do I have current copies of the relevant design or permitting documentation?
- What are the timing considerations relevant to calling on security?
- Is my equipment secured on the PPSA?

RESTRICTIONS ON IPSO FACTO CLAUSES

Overview

Recent reforms to Australia's ipso facto regime operate to stay the enforcement of contractual rights triggered when a party enters into certain restructuring and insolvency processes. Ipso facto clauses allow a party to exercise a right under a contract if there is an insolvency event on the part of the other party, such as the appointment of an administrator or receiver, regardless of whether the contract is being performed.

There is now a general prohibition against the enforcement of ipso facto clauses in circumstances where a counterparty enters into administration, a managing controller appointment (such as a receivership) over substantially the whole of a company's property, and a scheme of arrangement. The prohibition does not apply where a company enters into a controller appointment that is not over substantially the whole of the company's property, a deed of company arrangement, or a liquidation.

The regime does not prohibit all ipso facto clauses, but rather regulates their application. It is not every situation in which enforcement will be stayed, and there are exceptions. For this reason, express ipso facto clauses should still be included in contracts.

Ipso facto clauses have typically been a critical tool in managing risk. There is no general law right to terminate an agreement on the basis that a counterparty has entered into an insolvency procedure. When an ipso facto clause is exercised properly, principals and owners can avoid spending money and time on the delays and disruption that occur as a consequence of a contractor's insolvency. However, termination puts greater pressure on distressed contractors and may prevent a successful debt restructure. The exercise of an ipso facto clause may therefore destroy any goodwill between the principal and the contractor. To that end, the purpose of the regime is to permit a counterparty that has entered into an insolvency procedure to continue to trade throughout the restructuring process.

The stay on enforcement works both ways. Contractors are not permitted to ask for a new advance of money or credit from the principal or owner for the duration of the stay. Moreover, the moratorium does not prevent termination for any other reason, such as non-performance.

Exceptions

As noted above, there are exceptions to the prohibition. These fall into two categories:

- Excluded types of contract, whereby the regime applies to the exercise of any right under that contract triggered by an insolvency event; and
- Excluded types of rights, meaning that certain types of rights, regardless of the type of contract, are not enforceable when the counterparty enters into an insolvency procedure.

There are certain excluded types of contracts and rights which are particularly relevant in the construction industry:

- Contracts entered into before 1 July 2018, including where those contracts are novated or assigned prior to 1 July 2023;

- Contracts for building works projects exceeding $1 billion (this exception falls away in July 2023);
- Contracts for projects that are important to the state and Commonwealth governments (e.g. defence, national security or critical infrastructure);
- Rights to change the priority or order in which amounts are paid, distributed or received;
- Rights of set-off and netting, to net balances or combine accounts; and
- Rights of assignment or novation, and certain step-in rights.

Excluded Contracts	Excluded Rights
Arrangements relating to laws, international obligations and public services	A right to change the basis on which an amount in respect of a financing arrangement (such as a finance lease, operating lease, bond, or hire purchase agreement), a guarantee or an indemnity in relation to a finance agreement is calculated
Arrangements relating to securities and financial products	Rights to indemnities for loss or liabilities arising from the preservation or enforcement of rights
Complex arrangements between sophisticated parties (such as contracts which involve a special purpose vehicle and that provide for securitisation, public-private partnership or project finance)	Rights to change the priority in which amounts are paid
Agreements relating to debt and the ranking of creditors	Rights of set-off and netting, including a "right to take action" to enforce rights of set-off or netting, or to appoint administrators/receivers in certain circumstances
Agreements relating to financial markets, and clearing and settlement facilities	Rights of assignment, novation and set-off
Real-Time Gross Settlement (RTGS) systems and netting arrangements within the operation of the *Payment Systems and Netting Act* 1998	Termination rights in a standstill arrangement
Agreements prescribed for a certain period of time (i.e. contracts entered into before 1 July 2018, including where those contracts are novated, assigned or modified before 1 July 2023)	Rights of secured creditors (including all-assets secured creditors) to appoint a receiver or other controller to an asset in certain circumstances

Options

As noted above, ipso facto clauses should be expressly drafted into contracts in the event that an exception applies. The contract should also include broader rights for termination (e.g. for convenience, or on a certain number of days' notice). However, there is a risk that exercising these broader rights in the context of insolvency will be considered repudiatory conduct, which could place a principal or owner at risk of a claim for wrongful termination. Seek legal advice when exercising these rights and ensure that records of the reasons for the termination are adequately maintained.

Set-off rights, rights of assignment, rights of transfer or novation, and step-in rights are not impacted by the stay. It's worth considering each of these rights both when drafting agreements and exploring options alternative to termination.

In particular, where drafting clauses regarding novation or assignment rights, including a power of attorney provision will allow a principal or owner to effect the assignment or novation without the assistance of the contractor (who will likely obfuscate or delay given the state of distress).

BEWARE OF ILLEGAL PHOENIX ACTIVITY

"Phoenix activity" occurs when a company is liquidated, wound up or abandoned for the purpose of avoiding its debts. A new company then "rises from the ashes" (phoenix-like) to continue the same business activities unencumbered by that debt. Phoenixing is an avoidance scheme and an offence under the Corporations Act. According to a 2018 report from PricewaterhouseCooper, phoenix activity costs the Australian economy up to $3.5 billion per year.[6]

Phoenix activity is illegal, but is prevalent in the construction industry. The Cole Royal Commission investigating the Building and Construction Industry found that "there is significant phoenix activity in the building and construction industry, particularly in the eastern states".[7]

Signs of phoenix activity can be difficult to detect. The following warning signs should prompt principals and head contractors to seek legal advice before further engaging with contractors or sub-contractors:

- Assets transferred (or quoted) at lower than market value;
- Company directors who were previously involved with liquidated entities;
- Requests made for payments to a new entity;
- Changes to the company's directors and name, whilst the manager and staff remain the same; and
- Statutory declarations that are suspicious or appear to be false.

Recent amendments to the Corporations Act specifically target illegal phoenix activity. New offences were introduced which carry civil and criminal penalties for contraventions by directors, pre-insolvency advisers and others. The reforms also empower Australian Securities and Investments Commission ("ASIC") and liquidators to recover dispositioned assets and seek compensation from officers and others involved in the disposition. However, counterparties should not rely on these when making decisions pre-insolvency. Recovery costs will eat into any assets recovered, and added time pressures and uncertainty make recovery all the more difficult.

In addition, the introduction of director identification numbers in 2021 will enable ASIC to track director involvement in phoenix activity.

If a principal, owner or head contractor suspects a contractor may be engaging in illegal phoenix activity, we recommend seeking legal advice as soon as possible, particularly given the potential for accessorial liability for third parties knowingly involved. Consider also reporting the activity directly to ASIC or the Australian Taxation Office ("ATO").

KEY TAKEAWAYS

- Actively make inquiries and be alert for any warning signs of insolvency.
- Establish a system to review progress and to keep track of any issues that arise. Ensure that all staff, including management and those on the ground, are keeping lookout for any problems that may signal insolvency.
- Understand your contractual rights, particularly in relation to termination, security, step-in, novation and audit rights, if a contractor collapses or is nearing collapse.
- Ensure you have access to critical documentation to enable a smooth transition in the event you decide to terminate or otherwise replace an insolvent contractor.
- Identify key contractors and suppliers, and review their agreements to understand how they may be impacted by an insolvency in the chain.
- Manage your obligations inside and outside the project chain: maintain strong relationships with all levels of project management, financiers and suppliers.

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ENDNOTES

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).

2 *Ibid*.

3 *Ibid*.

4 Reserve Bank of Australia, *Financial Stability Review* (April 2022), p. 31.

5 *Ibid*., p. 32.

6 PricewaterhouseCooper, *The Economic Impacts of Potential Illegal Phoenix Activity* (July 2018), p. iii.

7 ASIC, *Submission 11 to The Royal Commission into the Building and Construction Industry* ("the Cole Royal Commission"), Final Report (2003), p. 11.

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