PROPERTY COUNCIL of Australia

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# Submission on Proposals Paper for improving bankruptcy and insolvency laws

## The Treasury: National Innovation and Science Agenda

02 June 2016

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27 May 2016

The Manager, Corporations and Schemes Unit
Financial Systems Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: For the attention of Mr. James Mason

Dear James

Thank you for the opportunity to comment on the Federal Government's Proposals Paper on Improving Bankruptcy and Insolvency Laws.

The Property Council is the peak body for owners and investors in Australia's $670 billion property investment industry. We represent, owners, fund managers, superannuation trusts developers and investors across all four quadrants of property investments: debt, equity, public and private.

We have enclosed our comments on the Proposals Paper in the attached technical submission, and we would welcome the opportunity to meet and talk through our industry recommendations at your convenience.

Yours sincerely

Glenn Byres
**Director – Policy and Housing**

## Submission: Improving Bankruptcy and Insolvency Laws Proposal Paper – April 2016

### General Comments concerning Proposed Amendments to Legislation

The Property Council of Australia provides the following submissions concerning the proposed amendments referred to in Part 3 of the Proposals Paper, which would restrict on the use of 'ipso facto' clauses in contracts –being clauses which provide a party certain termination (or similar) rights, in the event of another party's insolvency (**Ipso Facto Clause**).

Our general comments on the proposal are as follows:

1. Whilst we appreciate the underlying intent of the proposed restriction on Ipso Facto Clauses, the Property Council has some concerns that the current broad scope of the proposals and the potentially significant impact on (in particular) the development and construction industry, may have a number of unintended consequences.

2. In our experience, when a party becomes insolvent there is substantial delay stemming from an administrator, receiver or controller reviewing and considering the company's position before advising on the most appropriate course of action – whether that be continuing to perform the contract, placing the company into liquidation, entering into a Deed of Company Arrangement, or any other recommendation. The effect of this on the building and construction industry, when combined with a blanket restriction on Ipso Facto Clauses:

   **a)** could significantly worsen the solvency position of other stakeholders who will be constrained from moving swiftly to minimise risk and cost at the time of the administration; and
   **b)** seems to be moving in a differing direction from the position various State Governments are currently adopting in the allocation of administrative protections.

3. In relation to subparagraph 2a) above, in the development and construction industry, the insolvency of a head contractor will not only impact a principal, but also drastically impacts the entire subcontracting chain, often bringing construction on sites to a standstill. In our experience, the profit margins of most construction project stakeholders are relatively modest, and as such it is critical that a stalled development gets 'back on track' as quickly as possible in order to:
   **a)** minimise any loss associated with the delay to the developer;
   **b)** allow subcontractors to continue with the works (and therefore resume receiving payments); and
   **c)** minimise disruption to a project schedule – adherence to a construction program is important in preventing potential 'clashes' of subcontractors commitments on a current project and on future projects or sites, where unforeseen delays have pushed projects out leading to further delays and costs as a result.

   The proposal appears focused on administration rather than liquidation, on the assumption that an enforced window of administration would allow for the potential to "trade out" of any temporary financial instability. In reality, this commercial assessment already occurs as

it is in the interest of a principal or head contractor to allow a party in administration to trade out to minimise the disruption to the project. Yet this currently rarely occurs, as it is rarely feasible to allow this to occur without significantly worsening the solvency position of the supply chain and of the projects themselves.

If the proposal were implemented, it is possible that principal's and head contractors would impose higher financial standards on the supply chain and/or seek to secure the risk of potential insolvencies by increasing required levels of security. This would create barriers to entry into the construction sector and may make some smaller companies less competitive.

**4.** By exercising a right under an Ipso Facto clause, a principal is afforded the ability to try and extract a project from the 'domino effect' of a head contractor insolvency. A project that is running to a tight program or cost budget (which is common in the industry) will not remain viable if it is required to retain an insolvent head contractor whilst an administration / investigation process is underway. This can lead to a chain-reaction of financial strain affecting all parties involved in the project (including subcontractors and suppliers). If works are suspended or substantially delayed, all parties lose money – which can trigger a chain of insolvencies. Given a winding up order can be issued for as little as $2,000, where a company is unable to meet a $2,000 debt, a Principal or head contractor should have real and significant concerns regarding the contractor's financial viability that would suggest that a 'wait and see' response would rarely be successful.

In relation to subparagraph 2b) above, various Australian States have in the last 2 years reviewed the operation of the 'security of payment' regimes with the aim of affording added protection to subcontractors in the event of a 'head contractor' insolvency. For example, the NSW and QLD State Governments have recently considered legislative amendments that would implement trust structures to protect retention monies held by head contractors on behalf of subcontractors. The intention of these proposed amendments to State legislation are to provide a greater level of protection to construction stakeholders rather than give priority to general creditors in a liquidation. The rationale for these amendments is to address the volatility in the construction industry and the frequent 'chain-reaction' scenarios discussed above.

## Responses to Specific Items in Proposals Paper

### Item 3.2a

**Question:** *Are there other specific instances where the operation of Ipso Facto clauses should be void. For example by prohibiting the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for credit?*

**Response:** As set out in our general comments above, if the Federal Government considers that the operation of Ipso Facto Clauses ought to be unenforceable, there is a concern that there may be unintended consequences in the construction industry, leasing and sale of land.

In any initial legislation amendment, the restrictions (if any) ought to be limited to restricting Ipso Facto Clauses themselves - with such restriction itself being narrowly drawn. If at a later date it is found that the amendment is being curtailed and requires expansion, then further consideration can be given to any necessary amendment.

### Item 3.2b

**Question:** *Should any legislation introduced which makes Ipso Facto clauses void have retrospective operation?*

**Answer:** No. Parties who have entered into commercial dealings on negotiated terms and conditions ought to be allowed to proceed on the agreed basis. It is likely the proposed amendments will raise a principal's risk profile (for example, when negotiating an appropriate amount of security or allocation of time for a project). To amend these terms without reference to or consideration of the affected parties is unreasonable.

Should the proposed amendments concerning Ipso Facto clauses be implemented without retrospective application, parties will be able to appropriately consider and allocate risk for future projects at the time of contract negotiations with the restriction in mind.

### Item 3.2c

**Question:** *Are there any other circumstances to which a moratorium on the operation of Ipso Facto clauses should also be extended?*

**Answer:** We refer to Item 3.3.2 below.

**Item 3.2.1**

**Question:** *Does this constitute an adequate anti-avoidance mechanism?*

**Answer:** Any anti-avoidance mechanisms will need to be extremely carefully considered prior to implementation and ought to be extremely narrowly drafted if implemented.

In the construction industry, there is scope for misinterpretation of what might constitute an 'anti-avoidance mechanism' and for such a restriction to be extended to clauses required for the ordinary and proper administration of contracts. For example, it could be asserted that any provisions dealing with the following issues constitute (or could be interpreted as) anti-avoidance mechanisms:

- clauses providing for the allocation of time / delay across the projects;
- clauses providing notice of dispute procedures;
- clauses allowing for termination in light of defaults (particularly where delay is concerned);
- clauses allowing for set-off rights to be exercised;
- clauses allowing for the removal of works from a contractor in events of default (including clauses allowing for emergency works by a principal to secure a site or protect persons or property); and/or
- clauses allowing for the direct payment of subcontractors by a principal in light of default by a contractor.

If any of the above are, or could, be interpreted as 'anti-avoidance mechanisms', the proposed amendments would have a drastic impact on the majority of contracts utilised in the development and construction industry and on the ability of parties to be able to control and allocate risk appropriately.

**Item 3.2.2**

**Question:** *What contracts or classes of contracts should be specifically excluded from the operation of the provision?*

**Answer:** Given the risk that the proposal could have on the development and construction industry (as discussed above), we propose that the following types of contracts as a minimum are excluded from the operation of the provision:

1. Contracts involving construction works or the supply of related goods and services (for example, as those terms are defined under the *Building and Construction Industry Security of Payment Act 1999* (NSW))
2. Facilities management agreements - many of these contracts involve necessary maintenance and/or security works, which cannot afford to be subject to a period of uncertainty in order to preserve the safety of persons and property should an insolvency occur, and
3. Leases, ancillary deeds, contracts for sale of land, development agreements and joint venture agreements.

**Item 3.2.3**

**Question:** *Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?*

**Answer:** In our experience, when an insolvency occurs in the construction industry, parties need the ability to act quickly to maintain the project timetable and budget. In these circumstances, the ability to revert to judicial redress will come with substantial time and cost implications. It is also asking specific stakeholders to bear the burden of the costs associated with enforcing contractual rights in circumstances where the counter-party is likely to be insolvent and it is unlikely to meet its agreed contractual obligations whether judicially enforced or not.

As discussed above, this is likely to place immense pressure on all other relevant parties to the development in question.

As an alternative a mandatory education program would directly address insolvency in the contractual chain, protracted and unjustified delays in payment for work done and the lack of financial management skills in many parts of the industry. In light of the ramification associated with the proposal, poor business management can be better addressed by more learning opportunities to better face the problem of insolvency within the industry.

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