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INDUSTRY INSIGHTS

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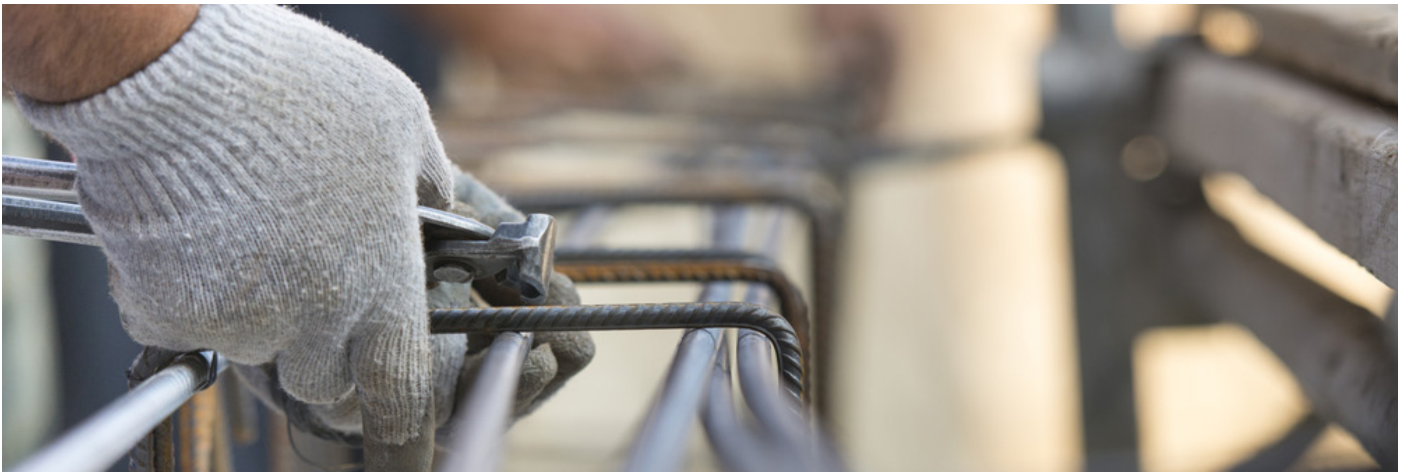
An introduction to insolvency in the construction industry



The Australian construction and property development industry is experiencing interesting times.

The property market, particularly in Sydney, has been exceptionally strong. As a result, the construction sector has grown exponentially and many new businesses have commenced operations.

With this growth comes risks. If the property market adjusts and work levels contract, a number of builders – particularly less-well-capitalised businesses – will face financial pressure.

Construction businesses may also suffer financial distress for more specific reasons.

They may have a problem on a contract that's out of money due to sub-contractor delays or increased costs. Alternatively, the business may have made a mistake in estimation or may have assumed risks they shouldn't have.

As a result, they may go from a certain profit to a small profit or a loss they can fund.

In some circumstances, however, they may face a loss they cannot meet. There may even be a situation in which a number of projects bring the business unstuck, or the loss on one or more projects outweighs the profit on others.

These are the types of circumstances where a business should seek professional guidance from an insolvency practitioner to determine whether they can, in fact, trade out of the situation or whether more serious measures should be considered.

This article summarises key issues that construction business and their stakeholders will need to consider if they encounter potential or actual insolvency issues. All parties, in such a situation, require accurate, relevant information to ensure they act effectively and appropriately.

This information includes:

- the differences between formal and informal insolvency appointments
- types of formal appointment
- the impacts of insolvency on construction projects
- directors' duties and key breaches
- the issue of unfair preferences

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Informal v formal appointments

When a construction business, its advisors, financiers or creditors first consult with an insolvency practitioner, they should know the difference between engaging such a practitioner in an informal arrangement or in terms of a formal appointment.

Each alternative has advantages and disadvantages.

An informal arrangement – such as pre-appointment advice that a practitioner gives to clients without the formal framework of a formal insolvency administration – has the initial advantage of avoiding contractual default provisions, so existing contracts can remain on foot.

It minimises the adverse publicity commonly associated with a formal appointment, as it involves only key stakeholders.

It facilitates open discussion for re-negotiation without pulling the trigger on a formal insolvency appointment, which may be difficult to undo once it happens.

An informal arrangement also tends to be less costly than a formal appointment.

The disadvantages of an informal arrangement include the fact that sometimes creditors don't take the insolvency practitioner seriously in that context and may not allow them to negotiate.

A practitioner in an informal arrangement has no formal control or ability to bind the company to a recommended process. They still rely on the acquiescence of directors or office holders.

In a construction context, where contracts are at a loss position, the practitioner is bound to continue those obligations.

There's no moratorium under an informal arrangement, of the kind that can be obtained through, for example, a voluntary administration.

The practitioner must also ensure they're not acting, or are seen to be acting, as a shadow or de facto director.

The advantages of a formal insolvency appointment in the construction industry – such as a voluntary administration (and possible deed of company arrangement), receivership or liquidation – include the fact that the insolvency appointee has control of the company. They can bind the company to a negotiated arrangement.

Creditors, in this situation, are generally more receptive to a negotiation, given that they understand that associated decisions are legally binding.

A moratorium is also placed on creditor claims, which allows the insolvency practitioner to undertake the required negotiations within a reasonable time frame.

The disadvantages of a formal appointment include the fact that, once it commences, it's usually more costly than an informal arrangement.

There are implications for contracts, which can be terminated if the principal so chooses, given that construction contracts generally include insolvency default clauses.

There are also issues for the insolvency practitioner to consider in relation to personal liability from construction contracts.

Types of formal appointment

Three different types of formal insolvency appointment are available to a company or creditor:

1. Voluntary administration and deed of company arrangement
2. Receivership / controller / agent for the mortgagee
3. Liquidation

Voluntary administration (VA) is a common choice in the Australian construction sector. It gives a company 28 days of breathing space to reach a compromise with its creditors and facilitate some form of business continuation.

At the end of 28 days, creditors vote on whether they should place the company into liquidation or consider a **deed of company arrangement** (DOCA). A DOCA is a form of compromise with creditors. It's tailored to the specific circumstances and facilitates continued business operation.

A third, less likely, outcome is a direct return of the company to directors.

Receivership is rare in the construction industry – due to the nature of construction businesses and the fact that they rarely have tangible assets that can be realised through receivership.

Financiers (particularly banks) are also unlikely to appoint a receiver to a construction business, due to concern about reputational issues.

Liquidation is a more conclusive outcome. It doesn't give the company any ability to trade out or restructure. However, it's quite common where unsecured creditors are pursuing a claim.

The impacts of insolvency on construction businesses

An insolvency practitioner has a series of considerations when undertaking a formal appointment in the construction industry. They include:

- the impact on contracts
- bank guarantees
- set-off
- home warranty (residential)
- environmental issues and occupational health and safety

In terms of the **impact on construction contracts**, when an insolvency practitioner is formally appointed, principals usually have the right to terminate. It's therefore key for the insolvency practitioner to negotiate with the principals, particularly where contracts are still profitable, to reach a compromise that will keep them on foot.

Labour unions, representing employees and sub-contractors, are also key stakeholders in the arrangement. Failing to engage early and keep them in the loop presents a risk that they will 'black-ban' a site and limit the ability to continue a project.

Bank guarantees are an asset that an insolvency practitioner will try to maintain or protect to achieve recoveries. However, in most cases, bank guarantees will be called due to 'contract on performance', and principals will seek to apply them against their losses.

Again, it's key to try to reach an agreement with contracting parties to protect bank guarantees and contracts to maximise the outcome for creditors.

Set-off is an important consideration where there is a 'principal and agent' or 'principal and contractor' arrangement on a number of projects, and where the principal has the right to 'set off' losses sustained on one contract against money due to the company on another.

Home warranty (residential) is a responsibility that an insolvency practitioner can carry with them for a period of seven years, post completion of works. Practitioners are therefore not inclined to conduct residential construction work, because they carry responsibility for defects for that period.

Ultimately, they will seek to obtain indemnities where they are completing works. Alternatively, they will seek to assign such work out to another party.

While **environmental and occupational health and safety (OHS) issues** are not common, they present the insolvency practitioner with substantial financial risk for personal liability.

This is the case particularly in circumstances where there is environmental contamination caused on a site.

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Directors' duties and key breaches

Company directors have two key duties under sections 80 and 81 the Corporations Act. They are to act:

1. with due care and diligence
2. in good faith.

This means directors have an obligation to discharge their duties in a reasonable manner, using the 'reasonable person's test' – i.e. that an independent person could confirm the director acted with a proper purpose, placing the interests of the company before their own personal interests.

Civil and criminal penalties can stem from breaches of these duties.

Assuming a director has not met their obligations, the issues for which an insolvency practitioner can pursue a director include:

- **Insolvent trading** – where a director trades an insolvent business and incurs debt on behalf of a company to the detriment of a creditor. In proving an insolvent trading claim, the insolvency practitioner would have to substantiate the company was insolvent and the director was aware (or should have been aware) of the insolvency and that someone suffered loss as a result of the insolvent trading.
- **Unreasonable director-related transactions** – which centres on directors avoiding self-interest, whereby payments, asset transfers or property dispositions have occurred to the detriment of the company or its creditors, and to the benefit of a director or a director's close associate. These actions can be investigated by a liquidator for the previous period of up to four years before the commencement of a liquidation or relation back-date.
- **Transactions for the purpose of defeating creditors** – where a director knowingly enters into a transaction with the intent of misappropriating assets or funds for the purpose of avoiding payment to creditors.

Unfair preferences

An unfair preference involves a creditor receiving a payment from an insolvent company within the six months prior to the relation back-date, whereby they receive a higher amount than they would have, had their claim been addressed at the time the company was wound up.

To prove an unfair preference, the liquidator needs to show that the company was insolvent at the time the payments were made, and that the recipient had reasonable grounds at the time to suspect the company's insolvency (or potential for insolvency as a result of the payment).

It's costly for a liquidator to pursue such preferences. In undertaking a preference investigation, they will look for round payments in the specified period as well as correspondence, such as creditors' demands, threat of legal action, requests for cash on delivery or the cessation of supply.

This issue is an important one for suppliers and sub-contractors in the construction industry.

Payment terms in the construction industry tend to be quite lengthy, and it's common for sub-contractors to apply pressure and to threaten to stop work.

At the same time, construction businesses are often under-capitalised and rely on delaying sub-contractor payments to manage cash flow.

Principals will be concerned about preference payments, because sub-contractors will be less likely to complete works if they are subject to an unfair preference action.

Conclusion

In most industries, and in the construction sector especially, directors tend to be very reactive in responding to a change in financial performance.

Often they will rely on potential new contracts or successful variations to trade out of their financial issues.

Construction businesses, generally, do not have physical assets on their balance sheet that they can

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sell or assets they can realise to meet short-term demands. Cash flow management, therefore, is key.

When companies start having cash flow issues, sub-contractors become reluctant to perform on contracts. The prices they have to pay for sub-contractors then increases and the potential for profit on projects diminishes.

That's why construction businesses need to address issues early and seek professional advice. There may be avenues to negotiate with sub-contractors or principals, and to reach an early solution that may facilitate the completion of projects and the minimisation of fallout for all stakeholders.

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BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

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