

# Construction Alert

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## Construction Industry Insolvency – Inquiry Rejects Insurance Based Solution

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The final report of the Independent Inquiry into Construction Industry Insolvency in NSW by Bruce Collins QC was delivered to the NSW Government in November 2012 and released publicly for comment in February 2013.

In this update, we focus on the insurance implications arising from the inquiry and report.

### Background

The inquiry was commissioned by the NSW Government in August 2012 following a series of high profile corporate collapses in the construction industry.

Insolvencies in the construction industry accounted for almost 25% of all insolvencies in NSW in the 2011/2012 period which was the highest in any industry category aside from the ill defined category "other (business and personal) services".

As at May 2012, the construction industry in NSW employed over 308,000 people, representing 8.5% of total employment in NSW, amply demonstrating the importance of the industry to the state economy. In the same period the NSW Government accounted for more than 35% of spending on all building work in NSW.

### Recommendations

The recommendations set out in the final report are numerous and wide-ranging. Perhaps the most significant recommendation is for the creation of a statutory construction trust for any project with works valued over \$1million. The recommendation is such that payments by a principal to a head contractor (or payments by a head contractor to a subcontractor for works by others) would be held in a segregated trust account for the benefit of subcontractors (or sub subcontractors).

Other significant recommendations included:

- + amendments to the **Building and Construction Industry Security of Payment Act 1999** (NSW) to extend the scope of that Act to deal with disputes relating to retention monies;
- + the proposed introduction of a licensing scheme for commercial building work, similar to that already in place for home building works such that commercial builders would be required to obtain a licence; and
- + the creation of a NSW Building and Construction Commission with powers to investigate the financial health of builders and contractors.

Separate Consultation Papers were released relevant to each of those recommendations.

### The insurance issues

The Terms of Reference for the inquiry required it to consider the creation of a compulsory insurance scheme to secure payments to subcontractors. The inquiry sought the views of insurers. Submissions were made on behalf of the insurance industry by the Insurance Council of Australia (ICA).

Unsurprisingly, the response of the ICA was to the effect that there was no appetite among its members for a compulsory insurance scheme. It was submitted that such a scheme would inevitably involve little more than a transfer of risk from principals and head contractors to insurers and that would not advance the aims of the inquiry.

The inquiry's response to the suggestion of a compulsory insurance scheme was that such a scheme would:

*"not directly address the issues at hand. Insurance provides little or no incentive to avoid behaviour that could bring about insolvency or financial stress and could in fact provide a perverse incentive for some contractors to take disproportionate risks knowing that should their business fail, they will not bare personal responsibility for the repayment for their debts. The insurance company picks up the tab and the construction industry pays the price."*

In much the same way as the concept of a compulsory insurance scheme was dismissed, the creation of a discretionary mutual fund (similar to a sinking fund) was also dismissed for essentially the same reasons.

At the heart of much of the discussion by the inquiry was the need for structural and cultural change in the way that many principals and head contractors operate. Behaviour such as failing or refusing to make payments to subcontractors, fraudulently disbursing funds received from financiers, deliberately obstructing payment processes and engaging in phoenixing were also discussed by the inquiry.

The inquiry considered that ASIC had a role to play in monitoring the activities of corporate entities as well as the creation of a Construction Commission to address the construction industry generally.

### **Implications**

Assuming, as seems likely, that the NSW Government will accept the inquiry's recommendations particularly in relation to insurance and mutual funds, there is unlikely to be any overall changes to insurance arrangements in NSW. This means that insurers will not be faced with increased exposure to the effects of corporate insolvency (other than that which already exists) and insureds will not need to obtain yet another insurance policy.

The inquiry's recommendations in relation to insurance arrangements appear sensible and proceeds on a sound basis that problems facing the construction industry are largely cultural rather than financial, and the imposition of compulsory insurance scheme would, in fact, exacerbate the problem rather than cure them.

The period for submissions responding to the final report has now closed. The NSW Government is yet to announce any response to the recommendations of the inquiry.

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