Builder demolition – how councils can reduce construction company failures and protect against them when they happen

Authors: David Creais & Mark Glynn

The recent collapse of one of Australia's largest construction companies, Probuild Construction, adds another chapter to the sad and predicted ongoing occurrence of construction company failures across Australia.

Despite the current strong pipeline of work, led by the significant NSW Government's $107 billion in infrastructure projects, some sector participants suggest that the sustainability of the construction industry is on a knife's edge.

Increased material prices, increased fuel prices, labour shortages and wafer-thin margins (Probuild is reported to have most recently earned a stunningly low 0.3% profit off $1.3 billion turnover) support the view that further insolvencies in the construction industry are likely.

Such low levels of profitability are unsustainable and unreasonable when considered against the risks and complexity involved in construction projects of any considerable size.

The Master Builders Association (MBA) NSW recently reported that building materials are increasing at their fastest rate since 1980, with the cost of materials used in house building increasing by 4.2% in the March 2022 quarter alone.

MBA NSW further identified the following significant material increases for the year ended March 2022:

- Reinforcing steel (+43.5%)
- Steel beams/sections (+41.5%)
- Structural timber (+39.2%)
- Plywood and board (+29.8%)
- Electrical cable and conduit (+27.1%)
- Plastic pipes and fittings (+26.5%)
- Copper pipes and fittings (+25.7%)
- Terracotta tiles (+21.5%)
- Metal roofing and guttering (+19.9%)
- Insulation (+14.0%)

Builders locked in to fixed price (lump sum) contracts are most vulnerable as project owners push escalating price risk onto construction companies.

Supply chain disruptions caused by reasons beyond the control of both project owners and contractors are well documented. The last couple of years has been characterised by disruptions caused by COVID, decrease in timber production due to bushfires, constraints on international materials production and international freight and more recently exacerbated by Russia's invasion of Ukraine.

There is also a widely held view, with which we largely agree, that the trend in Australia is for principals to look to push all project risks onto construction companies, typically through fixed price contracts and a disproportionate allocation of risk for the price.

However the adage that 'risk equals return' is not holding true in many construction projects. A project in which one party assumes much of the project risk without adequate return carries a greater risk of failure.

Consequently, despite a nationwide building boom, construction accounts for 28% of all insolvencies against only about 10% of GDP.

One corollary of these sobering numbers is that any organisation engaging a construction firm for a major project must be prepared for the prospect that the firm may not remain viable long enough to finish the work.

Engaging a construction company based on lowest price or greatest assumption of project risk including shortest delivery times is surely inviting trouble.

Australian Constructors Association Chief Executive Jon Davies was recently quoted as saying that contractors will continue to fail unless radical action is taken to improve the sustainability of the industry.

> *"I don't think there are too many surprised by Probuild becoming another sad statistic of Australia's construction sector, unfortunately, and industry reforms are urgently needed or more contractors will go under,"*
>
> *"The current focus of selecting contractors based on the lowest price and the greatest transfer of risk is unsustainable. Lowest price doesn't mean greatest value.*
>
> *"We have to move away from the idea that construction is a zero-sum game with winners and losers.*

"Contractors are being asked to lock in prices for risks that they cannot control such as material price escalation and pandemic risk for projects that in many cases will take years to deliver."

This article proposes two simple points on this issue. The first is that a council engaging a construction company has as its objective the successful delivery of the project as planned. Simply transferring as much project risk as possible to the contractor puts that objective at risk.

Using the tender or other procurement process to drive parties below, and risk transfer above, a level that generates value for all parties can often work against the successful delivery of the project. It is estimated that the collapse of a builder midway through a project will result in up to a 30% increase in cost to a project owner to deliver that project, not to mention the significant delay to the build program.

It also invites human misery (construction has one of the highest suicide rates of all industries).

The second point is that councils must protect themselves against the possibility of construction company failure. How to do that in a way that doesn't prejudice the successful completion of the project is the second point covered here.

IT'S TIME FOR A NEW MODEL

The current, combative model for construction projects is unsustainable. Every time a project is halted because of a company collapse, the cost of the project rises dramatically – often well beyond what it would have cost if the client had been realistic from the start.

We encourage councils to adopt a collaborative approach that supports the reasonable financial stability of their provider. Such an approach would include principles of fair return, improved benchmarking, and shared risk allocation.

That would likely mean an end to or variation of the traditional "fixed price, fixed scope" contracts, which inherently encourage adversarial behaviour and often results in costly disputes, delays or worse still court action.

Queensland, which has a $62 billion major-projects pipeline over the next five years, allows companies to try to push the rising costs of prefabricated steel, steel bar and mesh and ready-mix concrete back onto taxpayers if prices rise significantly after tenders are submitted or materials purchased.

This is one way to build flexibility into contracts. There are others, and we encourage councils to explore options that will work for them and the companies they engage.

IT'S ALSO TIME TO BE EXTRA CAREFUL

Acting ethically towards suppliers does not mean councils should expose themselves to undue risk. In fact, the shakiness of the construction industry is a sign to take extra care when engaging building companies. Here are some critical steps to follow.

1. Due diligence

Ensure that the builder you are engaging is financially sound and can be relied on to deliver is basic good practice.

Perform a Google search, check sites like productreview.com.au, seek client references and do an ASIC search. Ask the builder for details of similar sized projects it has completed.

Engage through platforms such as Local Government Procurement or check NSW Government lists of approved contractors.

2. Contract terms

Wherever possible, negotiate these contract terms:

> security for performance of the builder's obligations, usually by retention of progress payments or bank guarantees

> a right to assume the builder's obligations, or have a third party perform them, or both

> liquidated damages for late completion

> no payment for materials or equipment before it is on site

> a right to terminate in case of the builder's insolvency

> immediate access to project documentation, preferably transferring title but at least giving a licence for the project

> evidence of payment to sub-contractors and the right to make direct payments to subcontractors if necessary

> a right to assignment or novation of subcontracts and rights to certificates of compliance necessary for a certificate of occupation on completion

> progress payments subject to independent certification of the value of work carried out or completion of stages, and the right to set off the cost of rectifying defective work.

3. Watch for warning signs of impending builder insolvency

Sub-contractors and suppliers are first to know if a builder is feeling the pinch. An occasional quiet chat with them can be revealing. Also watch for them allocating resources to other sites or simply refusing to work.

Credit reporting agency CreditorWatch said Probuild's average repayment time went from just under 28 days in March 2021 year to 58 days in February 2022. The industry as a whole maintained an average repayment time of seven days over that same period.

Other signs of distress include:

> overclaimed progress payments

> adjudication applications by subcontractors

> a drop off in the quality of site management (poor programming, shortcuts in health and safety, etc)

> requests for direct payments in advance.

4. Act when warning signs appear

It's important to act quickly when signs of insolvency emerge. The earlier the intervention the greater the prospects of minimising the harm. Do these things:

Enforce rights under the contract
Examine the contract with the builder and identify relevant rights such as the right to terminate, to have recourse to security and to take over the builder's obligations.

Identify defective works
Lack of funds leads to cost-cutting, which results in non-compliance with relevant standards or approved plans and specifications. Have an independent, qualified building consultant undertake a thorough review. Their report will allow the principal to identify relevant rights under the contract.

Deal with ransom subcontractors
If sub-contractors have not been paid, they may refuse to complete work or provide necessary certificates of compliance. Finding new sub-contractors to complete work left unfinished by others is notoriously difficult.

You may need to negotiate with critical sub-contractors to get them back to site, and pay them money you have already paid to the builder, but which they didn't receive. Such costs, while painful, are small compared to starting from scratch.

Secure project documentation
Key construction documentation (and the right to use it) must be secured to ensure a new builder can complete the project and comply with consent conditions. Documentation includes warranties and sub-contractor compliance certification needed to obtain a certificate of occupancy.

Secure key personnel
Depending on the size and stage of completion of the project, you may consider employing key people such as the builder's project manager or site supervisor to provide continuity.

Seek independent assessment
Retain an independent building consultant to identify defects and assess the time, cost and tasks needed to complete the project.

This will ensure all forecasts, assumptions and estimates made by those who have been involved in the project (including the builder) are objectively tested and future decisions are made with complete information.