11 January 2010

Mr Richard Willis
Secretary
Legislative Council Standing Committee on Finance and Public Administration
Parliament House,
Spring Street
EAST MELBOURNE VIC 3002

Dear Mr Willis,

Re: Inquiry into Builders Warranty Insurance

We refer to your letter of 19 October 2009, inviting QBE Insurance (Australia) Ltd to make a submission to the Victorian Legislative Council Standing Committee on Finance and Public Affairs inquiry into Builders Warranty Insurance and thank you for the invitation to contribute to this inquiry.

Below are our responses to your terms of reference contained in your letter.

1. The effectiveness of the current mandatory last resort Builders Warranty Insurance scheme in providing necessary and appropriate consumer protection and industry management.

An important precursor to determining the effectiveness of a mandatory last resort Builders Warranty scheme is understanding that it is only one tier of the consumer protection framework.

Simply put, last resort Builders Warranty insurance in Victoria provides cover in the event an owner suffers loss that is unable to be recovered from the builder directly due to the death, disappearance or insolvency of that builder. At all times the builder is responsible for the performance of work performed or to be performed. This is supported, to the benefit of consumers, by statutory warranties implied into every building contract, i.e. timely delivery, fit for purpose and quality of work among others. Builders Warranty insurance effectively provides cover where the builder is unable rather than unwilling to abide by its responsibilities.

The cost of Builders Warranty – in the case of new home construction, being below 1% of the cost of building – is considered to have little, if any, impact on the affordability of construction. This insurance is a long tail product where cover is provided for 6 years post completion and claims can be made for up to 7 or 8 years, or in certain circumstances possibly more, after commencement. Considering this insurance requires a one-off payment, generally less than $1,000, and cover is provided for many years it remains a very cost effective means of providing consumer protection.
In addition to the builder licensing regime, private insurers assist in industry management through the financial assessment and ongoing risk management of builders. The fact that a small number of builders are not successful in obtaining Builders Warranty cover and therefore cannot trade (because they are either under capitalised or inexperienced and therefore have an unacceptably high probability of failure) should be seen as further evidence of the effectiveness of the current scheme. Although it is not possible to calculate the cost saving to consumers as a consequence of these builders not trading, it is none the less an important aspect of the current scheme.

2. The specific role of government agencies in their effectiveness in managing and representing Victoria's registered builders under the current Builders Warranty Insurance scheme.

Dispute resolution is an important part of providing adequate consumer protection and the Victorian Government has been active in establishing mechanisms and avenues for consumers to seek redress. The establishment of Building Advice and Conciliation Victoria is seen as an important mechanism for consumers to resolve building disputes and enforce their rights. This is then supported by the Victorian Civil and Administrative Tribunal.

In order for these agencies to deliver on both government and consumer expectations, cost effectiveness and timely resolution are paramount factors. There is increasing sentiment that this first layer of consumer protection is becoming cost prohibitive and subject to undue delays. We therefore suggest the Victorian Government undertake a review of the operation of these agencies to ensure they continue to deliver on these government and consumer objectives.

Licensing is also an important mechanism in terms of industry management. Not only does it ensure only qualified builders are able to trade, it can also be the mechanism by which information on the building trade can be collected and disseminated to the general public.

By way of example, in NSW, various licensing measures have been implemented over the past few years to improve transparency through the reporting of builder performance. This reporting, coupled with continually enhanced industry / field investigation and monitoring, assists in enhancing consumer confidence in the state building industry. Implementing a similar approach in Victoria will help the government in raising and maintaining an appropriate level of consumer confidence, as well as provide other stakeholders with data on builder performance.

One issue we would like to draw to the government's attention is the impact of phoenix companies on both scheme costs and consumer sentiment (where "phoenix companies" is the term used to describe a company comprising director(s) or management from a previously failed business).
As the government is aware, phoenix companies tend to be more prevalent in the building industry (see the attached recent media report incorporating Dun and Bradstreet research into phoenix activity). Given these companies have a significantly higher risk of failure, the more the Government can do to reduce their number, better results with respect to consumer protection and scheme affordability should be forthcoming.

One option to reduce the exposure to these builders is for the government, through the licensing mechanisms, to implement measures to remove the ability of failed builders to operate under the guise of a new structure whether as a director, partner or shareholder or in an indirect, yet controlling management function.

3. Any possible alternatives to the current Builders Warranty Insurance scheme in Victoria.

The current Victorian Builders Warranty scheme is administered by the State Government and any changes to the current scheme would, in our view, be a matter of policy for government. We remain committed to working with government to achieve the most equitable and effective scheme for the benefit of all stakeholders.

While there are a number of alternatives, broadly discussed below, we remain of the view the current Victorian Builders Warranty Insurance scheme is both efficient and effective and therefore there is little reason to make substantive changes. This position is supported by the fact that the vast majority of builders continue to be able to secure Builders Warranty insurance.

Notwithstanding the above, the recent withdrawal of two of the five insurers from the Builders Warranty market, coupled with the NSW Government announcement to substantially change the operation of its scheme, has provided the Victorian Government with an opportunity to review the current arrangements.

In assessing the viability of any option, consideration needs to be given to mitigating both real and emerging risks to consumers and insurers in the transition to a new scheme. If after review government conclude that scheme reform is required, we recommend government engage and consult with all relevant stakeholders prior to final determination of the scope, timing and implementation of those changes.

Some options available to government include (but are not limited to):

- APRA approved insurers continue providing Builders Warranty insurance and government providing greater flexibility within the existing reinsurance arrangements such as program structure and deductibles.

- Government becoming the sole insurer and outsourcing operational functions such as claims and underwriting management to current APRA approved insurers as service providers;
• Private insurers continuing to offer Builders Warranty insurance and
government becoming an 'insurer of last resort' for those builders that
cannot source cover from the current APRA approved insurers;

Of course there are a range of additional options, although most would appear to
be a variation of the above.

Conclusion

Builders Warranty is a vital and effective component of the residential building
consumer protection framework providing tangible cover to consumers. The insurance
market provides a valuable contribution to the Victorian Builders Warranty scheme in
terms of protecting consumers from loss when a builder fails and in limiting the
frequency of builder failures through contributions to industry management.

We appreciate the opportunity to contribute to this inquiry and confirm our support for
the Victorian Government in their review of this scheme.

Yours Sincerely,

[Signature]

Colin Fagen
Executive General Manager
Intermediary Distribution
Phoenix directors are feeding off failure

Adele Ferguson
November 14, 2009 - 12:00AM

An illegal practice is cheating creditors, writes Adele Ferguson.

CORPORATE Australia is littered with company directors who have managed to survive multiple company failures, a trend that suggests illegal "phoenix" companies are on the rise.

Research compiled exclusively for BusinessDay by Dun & Bradstreet indicates a 25 per cent jump in the number of companies entering external administration during the 2009 financial year that had at least one director who had already been involved in a wound-up business.

Even more alarming, of the 10,264 companies that went belly up in the year to June 30, a staggering 43 per cent involved companies with directors of previously wound-up companies.

The research indicates the worst offenders tend to gravitate to the building and construction sector, employment agencies, labour hire, security and infrastructure.

In some cases the statistics may merely point to nothing more than coincidence, or a run of bad luck. But in some extreme cases, the company failures were part of a nefarious - and illegal - practice known as a phoenix scheme: closing a company one day only to open another soon after with the same assets and similar name. The new company, which rises from the ashes like the bird in Greek mythology, leaves behind a pile of debts, cheating creditors of their rights.

It is a practice that is costing the country more than $2.5 billion a year and, despite plenty of rhetoric from governments and regulators, it is reaching epidemic proportions.

BusinessDay asked federal Assistant Treasurer Nick Sherry a series of questions on what the Government is doing to improve poor legislation that allows the proliferation of phoenix companies. A spokesman merely responded: "The Government is committed to ensuring that companies and business owners are held accountable to their obligations to tax, staff and creditors. The Government is keeping a watching brief on the issue, and the ATO [Australian Taxation Office] and ASIC [Australian Securities and Investments Commission] continue to investigate claims where appropriate."

The ATO was unavailable for comment but it is believed that behind the scenes it is lobbying to toughen up the legislation, and its phoenix unit is cranking up to target some repeat offenders.

ASIC commissioner Michael Dwyer told BusinessDay the commission was "very" serious about combating illegal phoenix activity, and was clamping down on advisers who encourage it.

Australia has seen a huge rise in the number of company directors associated with multiple incidences of external administration, lending weight to ATO concerns that phoenix companies have been on the rise during the global financial crisis.

But the ATO's attention is not limited to the small end of the market, where phoenix companies are suspected to flourish. As ASIC closes in on Westpoint founder Norm Carey, and the liquidators of Babcock & Brown aim for a November 25 court investigation of former directors, including Phil Green, a study of past directorships and legal action shows that such collapses should not have been a surprise.

In the case of the secretive property developer Carey, who is facing numerous ASIC actions against him relating to

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his role in one of the country's worst property investment failures, his first flirtation with collapse and legal action dates back almost 30 years.

Back then, Carey ran Norm Carey Homes Constructions, which went under with debts of more than $150,000. Creditors received a few cents in the dollar.

Using Dun & Bradstreet research that a company is eight times more likely to fail if one of its directors has a court action against them, and the likelihood of failure increases by 33 per cent for court actions valued at more than $10,000, then the odds seemed to be stacked against Carey.

Between his first collapse and the spectacular demise of Westpoint in 2006, Carey has an estimated 30 external administrations listed on the ASIC historical directors extract, and many of these are related entities.

While devastated retirees face a long wait for any return from Westpoint, company searches reveal that Carey remains a director of Acebid, Andrianni and Ann Street Brisbane Pty Ltd.

The directors of Babcock & Brown face a grilling in the courts on November 25 by liquidators Deloitte over a possible breach of directors' duties and insolvent trading claims arising from its collapse.

Deloitte has filed applications to examine former Babcock & Brown chief executive Michael Larkin, Phil Green, Jim Babcock, Michael Sharpe and Susan Glenton in the courts.

Interestingly, the roll call doesn't include former Babcock & Brown chairwoman Elizabeth Nosworthy. She may seem a far cry from Carey and no one is suggesting she runs a phoenix operation, but Nosworthy has a track record when it comes to company failures.

In the past two years she has been a director of some of the more spectacular collapses, including Babcock & Brown, medical equipment company Ventracor, and Commander Communications. Nosworthy is now sitting on the board of three businesses: Baldwin Pastoral Holdings, Logan Downs Pty Ltd and Russell Estates.

The Dun & Bradstreet research shows the increased number of corporate directors associated with multiple external administrations in the 2009 financial year was more than six times greater than those with no prior associations.

There are thousands of directors who have been associated with four or more incidents of external administration that currently sit on the boards of operating entities. And the number of directors associated with at least four external administrations has increased by 18 per cent in the 2009 financial year.

Tax Commissioner Michael D'Ascenzo recently told a Senate Estimates Committee hearing that there had been a significant increase in phoenix companies being established and that the ATO was disappointed with the lack of prosecutions and severity of sentences handed down by courts to those involved.

It is not hard to see why the ATO is increasing its focus on phoenix operations. According to Andrew Robinson, principal of Robinson Legal in Sydney, fines range from $500 to $2000, and in most cases when a director is banned, he uses his wife or another relative to take on the business.

In 2003, Robinson wrote to ASIC detailing at least 16 voluntary administrations, deregistrations and liquidations between 1987 and 2001 of companies that were associated with Brian John Baker and his son.

On May 20, 2003, ASIC replied to Robinson: "At this stage, ASIC is unable to complete an assessment and will be calling for further information to conduct further inquiries to see if we should take any action."

After some adverse publicity, ASIC took action in 2006 to ban Baker and his son for 4½ years and three years respectively.

Brian Baker was banned after an investigation into his involvement in the management of eight failed companies that were wound up owing more than $10 million and were unable to pay creditors more than 50c in the dollar.

Robinson is currently investigating another phoenix-like structure in the marine manufacturing sector, but has not written to ASIC.
"Whatever systems they have in place aren't working," he said.

In another case, James Soong was banned as a director in 2005 for four years over his role in various construction companies that failed. Indeed, Soong's Fyna group came into the regulator's orbit more than 15 years ago, was mentioned in the Cole royal commission on the building industry, and cited in a joint parliamentary inquiry into insolvency in 2004.

ASIC found that Soong had been a director of five failed companies in seven years, and that these companies, when being wound up, could not pay secured creditors more than 50¢ in the dollar.

The ban has expired, but Soong is yet to return as a director. His wife, Desley Soong, replaced him as a director and secretary of 10 companies days before ASIC's banning orders where made.

She remains on numerous boards, including some Fyna group companies, and based on company searches has sat on at least five boards that have been put into external administration. Desley Soong did not return our calls.

John Melluish, a partner at Ferrier Hodgson, said given the amount of work that ASIC puts into prosecuting delinquent directors, the fines handed out by the court - usually not more than $1000 - are laughable. "They will never be a deterrent," he said. "Notwithstanding the phoenix company problem has been talked about for more than 10 years, little has been done to deter those responsible."

Melluish said insolvent trading legislation should be the tool to address phoenix activity, but criminal prosecution of directors for insolvent trading has been negligible.

ASIC commissioner Michael Dwyer said the corporate regulator was clamping down on advisers who encourage illegal phoenix activity. He noted the recent victory in the NSW Supreme Court where eight directors of unrelated companies were banned for two years, and their legal adviser, Timothy Donald Somerville, was banned for six years (Somerville is appealing against the verdict).

"This was ground breaking because it is the first time an adviser has been found guilty," he said.

Dwyer said that in the past four years ASIC had banned 200 directors, and of them, 139 related to Assetless Administration Fund-assisted investigations, and supplementary reports by liquidators under 533 (2) of the Corporations Act. Another 60 banning briefs are in the pipeline.

"We are serious about director banning and we are serious about illegal phoenix activity," Dwyer said.

Phoenix trading goes way beyond the cost to creditors, many of them small businesses that can ill afford such losses, the taxes forgone by government, or employees and their lost wages and entitlements.

At its core, phoenix activity raises questions about the role of insolvency practitioners, the regulator, the issue of assetless liquidations, the priority regulators give to pursuing serial offenders, how much support they get from the government, and how phoenix activity is exploited by "legitimate" companies to gain an edge. By planning not to pay their bills once work is complete, phoenix companies have a huge commercial advantage over their competitors.

Research by Dun & Bradstreet sheds light on just how big the problem may be. While external administration does not necessarily mean a business has failed, and multiple incidences of association with wound-up entities does not necessarily equate to the existence of phoenix activity, a search of more than 2.8 million credit-active entities in Australia on the Dun & Bradstreet database reveals a disturbing trend in directors winding up companies only to become associated with others in a short time.

The research shows that nearly 400 directors have been associated with 10 or more company collapses and currently sit on the board of a business.

Of those, four directors currently sitting on the boards of operating entities have been involved with 100 or more previous incidents of external administration.

In several instances there are directors who sit on the boards of 100 operating entities who have previously been
involved with more than 200 external administrations.

The findings should come as a warning sign to creditors, as further Dun & Bradstreet research shows that directors on the board of a business that has gone into external administration are 250 per cent more likely to be involved in an insolvent wind-up at some stage in the next 12 months.

Those entities are also nearly twice as likely to default on a trade payment during this time.

The problem is not likely to go away. Dun & Bradstreet has identified 38,000 firms as being at high risk of experiencing financial distress over the next twelve months.

Dun & Bradstreet chief executive Christine Christian said there were many warning signs pointing to potential loss based on a director's history, in addition to an association with companies that have entered external administration.

Dun & Bradstreet research reveals that a company is eight times more likely to fail if one of its directors has a court action against them.

The likelihood of failure increases by 33 per cent for court actions valued at more than $10,000, making the business 11.1 times more likely to fail than an organisation with no director court actions present.

This story was found at: http://www.theage.com.au/business/phoenix-directors-are-feeding-off-failure-20091113-ietw.html