

## **CASE STUDY: SHAM CONTRACTING IN THE CONSTRUCTION INDUSTRY**

One of Australia's leading construction industry experts, Professor Martin Loosemore, has concluded about the nature of sub-contracting in the contemporary construction industry that the:

All pervasive subcontracting model, which has fragmented the construction industry, leading to a multitude of problems which include abuses of human rights, corruption, under-investments in people and knowledge development and a confrontational culture of risk transfer where there is little incentive to innovate and where risk is passed to the point of least resistance and lowest capability (Loosemore 2015f).

Sham contracting is used to increase the profitability of employers but achieves this through means such as work intensification and greater health and safety risks, as well as through non-compliance with a range of employee statutory entitlements. . Research has also established that such forms of contracting reduce the incentive to achieve productivity gains through capital investment, workforce training and innovation. Indeed, as the CFMEU noted, sham contracting is also usually associated with employment and management practices that seek to compete not on equal terms with other firms, but in terms of undercutting a range of standards. This is the essence of the notion of 'a race to the bottom'.

"False self-employment can also be seen as direct employment stripped of all or most of its normal attributes: employment in terms of control, integration, economic reality, even mutual obligation, but no investment, and none of the standard employment rights. In some ways, this minimalist employment is the most vulnerable, subordinate and dependent form of employment, at the opposite end of the scale of genuine, independent, entrepreneurial self-employment. The impulse to drive down all costs of labour, triggered by tax evasion, has induced evasion of all social and economic obligations of employment. Degenerative competition of this kind is economically and socially damaging." (CFMEU 2011)

Sham contracting therefore enables some employers to asymmetrically exploit regulatory or supervisory loopholes in a way that reduces both efficiency and equity. We submit, along with labour market and industry experts that due to the inefficiency and inequity created by sham contracting and associated practices, there are grounds for much greater regulatory intervention and supervision to stamp out sham contracting. Among all the focus of regulatory attention on the militancy of organised labour in the industry, and alleged and as yet unproven links to illegality of building unions, their almost single handed role in attempting to stem the growth of sham contracting, and establishing the basis for efficient and equitable competition, has been almost totally neglected.

### **Definition and Scope of Sham Contracting in Australia**

Sham contracting is a device that attempts to disguise an employment relationship as one of client and independent contractor. The investigation of sham contracting usually begins by differentiating forms of work contracting based on contracts for and contracts of service. Unlike employees who are engaged under a contract *of* service, independent contractors are usually engaged under a contract *for* services. Dependent or sham contractors are employees who are engaged by employers under a contract for service without meeting the conditions for being an independent contractor. As a recent, and comprehensive analysis of the definition and scope of sham contracting in the construction industry found ‘sham contracting is an intermediate form of employment where a worker is engaged as a contractor... sham contracting occurs where employers wilfully and knowingly - and in some cases coercively - disguise workers as contractors’ (Queensland Ministerial Reference Group 2011:12).

While the distinction between an employee and contractor is thought to be clear in economic terms, in legal terms the distinction is based on common law and statute, and is generally determined by a range of factors (or indicia). The main differences are that an employee does not directly control their hours of work, how they do their work and where they work; the employer supplies working equipment and other inputs to production; employees receive statutory benefits from the employer relating to insurance cover and leave entitlements; the employer is responsible for paying tax and superannuation and the employee typically receives the bulk of their work-related income from one employer and receives regular frequent payment for work done (weekly, fortnightly or monthly). By contrast independent contractors are either incorporated or unincorporated business owners who work under commercial contracts; have much greater autonomy governing their work; typically contract with multiple different legal entities; carry the risk of making a profit or loss and face financial recompense for damage arising in the course of their work. They invoice for their work in progress payments or get paid at the end of their contract.

Research has shown that the incidence of sham contracting within the Australian construction industry is particularly high, and that this is due in part to the changing nature of the production and financing processes within the industry (the causes of sham contracting will be taken up in a later section). Australian labour law, and a range of other legal and regulatory mechanisms, hinge on the definition of someone as an employee. There is, however, a widespread view that it is very easy to convert an employee into a contractor. According to the Australian Taxation Office (2014) there are a number of ‘common myths’ amongst employers and some workers regarding the apparent ease of this conversion. Some of the myths surrounding the conditions required to convert an employee into a contractor include requiring an employee to do one or more of the following:

- obtain an Australian Business Number
- obtain a registered business name
- invoice their employer for work performed
- make the ‘contractor’ responsible for tax, insurance and superannuation liabilities

- create a contract converting the employee into a ‘contractor’
- have an employee express a preference to work as a contractor
- work on casual, part time or temporary basis.

However, not only is misunderstanding common, there are also differences across employment related statutes and jurisdictions as to the precise definition of worker and contractor. The Australian Taxation Office (2014) advises employers that in the process ‘to correctly determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed’.

One direct consequence of imprecision in the demarcation between contracting and employment is that the categories can be, and increasingly are being, exploited. The reason, we submit, is fairly simple, in an environment of uncertainty and cost pressure, all businesses are under pressure to find competitive advantages, and there are quite clear costs and risk reduction benefits for such conversion, especially if the employer retains control over the worker (Stewart and Roles 2011). The unethical, but currently legitimate, conversion of employment contracts into independent contracts is becoming standard practice for law firms. As one of Australia’s leading industrial law academics Professor Andrew Stewart argues ‘... any competent lawyer can take almost any form of employment relationship and reconstruct it as something that the common law would treat as a relationship between principal and contractor (or contractor and subcontractor), thereby avoiding the effect of much industrial legislation.’ (cited in Office of the Employee Ombudsman 2009: 11).

In these ambiguities and gaps lies the potential for regulatory arbitrage, whereby firms can use their monopsonistic power and/or information asymmetries to contrive whatever combination of employment and contractual arrangements that allows them to maximize returns, with respect to costs and risks. The scope for exploiting this grey area of employment and commercial law is greatly enhanced as there are few, if any, restrictions on the engagement of non-standard forms of employment, such as temporary workers including, casuals and labour hire workers, who may operate or be required to operate as sham contractors.

Official ABS labour market statistics do not distinguish clearly between independent and sham contractors. This presents a problem for economic analysis, which tends to take such descriptive or legal categories as automatic proxies for economically meaningful ones. However, there have been a number of studies, importantly utilising a range of different data sources and methodologies that estimate the incidence of ‘dependent’ or sham contracting. An excellent summary of these studies is provided in a recent inquiry undertaken into sham contracting for the Queensland government (Ministerial Reference Group 2011:12).

- Workplace Health and Safety Queensland estimated the incidence of sham contracting in the Queensland construction industry at 13 per cent of the workforce covered by workers compensation, including independent contractors (Ministerial Reference Group 2011: 28)

- the CFMEU used ABS labour market data which classified working person by their ‘form of employment’, to estimate that dependent contractors accounted for between 27% - 50% of ‘independent contractors’ and 10% - 18% of total industry employment at November 2010 (CFMEU 2011: 28)
- the Workplace Research Centre, at the University of Sydney, used a sample of participants from their large scale *Australia at Work* survey and estimated that around one in ten of the total construction workforce were dependent contractors. This equates to approximately a quarter (24 per cent) of all contractors in construction being dependent contractors. The estimate was seen to be a lower bound of likely prevalence of sham contracting. Dependent contractors were defined as self-employed persons, who contract work with other businesses and receive 80 per cent of their income from one client (Ministerial Reference Group 2011: 16). The Ministerial Reference Group concluded that ‘the WRC result is likely to be a reasonable estimate of the potential scope of sham contracting in construction’.

Aside from these estimates of sham contracting as a share of total employment within the construction industry and as a share of contractors, the Australian Taxation Office undertakes audits of firms’ employment practices to identify potential tax avoidance and evasion. As a result of one study conducted during 2009-2010 the ATO (2011) stated they were ‘concerned about the extent of ‘sham’ contracting we have detected. Up to 35% of businesses visited by the ATO were incorrectly treating employees as contractors. These arrangements have been long prevalent in the building and construction industry. But we are now, as Professor Stewart noted, finding these arrangements across many different sectors of the community, including cleaning, call centres, security, logistics, retail, tourism and hospitality, restaurants and cafes, education, aged care, health, transport, entertainment and telecommunications’. Professor Stewart recommended that the detrimental effects of sham contracting were so significant that action to prevent sham contracting was justified for both efficiency and equity reasons. As he argues:

“...we would strongly argue that the freedom to choose to work or be engaged as a contractor rather than as an employee must be constrained, if the integrity of our labour law system is to be protected. The law does not permit an employee to agree – no matter how voluntarily, and no matter how well-informed they might be – to work for less than award wages, or to forego any right to take personal or carer’s leave, or not to bring an unfair dismissal claim. So why then should it be lawful to achieve such outcomes by contriving a worker to appear to be a contractor, even if the worker consents to (or even initiates) the arrangement?

It is sometimes said that if businesses are denied the freedom to engage workers as contractors, valuable ‘flexibility’ will be lost. But if this is suggesting that an employment relationship is inherently less flexible than an independent contracting arrangement, that argument can be (and often is) considerably overstated. In terms of the ease of ‘hiring and firing’, or of varying hours of work, there may be little to choose between a contractor and a casual employee. More often than not, in our view, a business that is seeking ‘flexibility’ is really endeavouring to avoid minimum conditions (whether in a statute, award or a collective agreement that the business itself has negotiated) which it regards as being inconvenient or costly. Which brings us back to the real point of principle –whether it should be possible to contract out of

labour standards.”

If the Productivity Commission wishes to endorse or even countenance this sort of destructive competition by employers to lower labour standards, it should say so explicitly and justify the reason for such an approach. If, as we hope, such pernicious forms of rent seeking are not to be supported, we would expect that the PC makes its views against sham contracting quite clear.

### **Causes of Sham Contracting**

There are many factors that drive the use of sham contracting in the construction industry, and this section outlines several of the more important of these factors. From the perspective of the construction project client, head contractor and for larger subcontractors the use of sham contracting creates a competitive edge by lowering labour costs and reducing a range of employment related risks. An immediate problem here, however, is that it creates a competitive advantage for those firms that engage in such quasi-legal activities. The ATO (2011) concluded that sham contracting tilts ‘the playing field’ against construction firms that do not use these employment arrangements.

‘Under these ‘sham’ arrangements, employers sidestep their obligations to... their employees...This gives them an unfair competitive advantage over complying employers’ businesses. Employees miss out on their rights and entitlements such as leave, superannuation, workers compensation insurance and award wages and conditions’.

The competitive dynamic we see occurring here is very much consistent with what researchers at UCLA called the low road to building profitability, and the CFMEU referred to a ‘race to the bottom’.

Another factor that is widely understood as driving sham contracting is that for the worker there may be opportunities to reduce tax or other regulated payments. While Professor Andrew Stewart identified an inherent asymmetry in negotiating power as one of the drivers of sham contracting, the ATO also notes that some workers may also be complicit because they ‘...are happy to accept these arrangements to evade their own tax obligations, and escape detection by other regulatory authorities including Centrelink and the Child Support Agency’. While it is hard to estimate the balance between workers that are coerced into converting from employee to contractor and those that do so as a mechanism of tax arbitrage, it is clear that both forms have adverse consequences for economic efficiency and welfare. The submission provides some estimates of these negative effects.

Importantly, once a cycle of unchecked regulatory arbitrage becomes established, there is a self perpetuating momentum to the process including sham contracting as it intensifies competitive pressure which, in turn, puts pressure on even compliant firms to employ the same methods, even if they are aware of the longer term adverse implications for themselves and the wider industry. To fully understand the use of dependent contracting it is necessary to look deeper into what drives the unusual intensity of competition within the construction industry that promotes this form of employment. The submission identifies the key driver of

this intensification of competition as the changing industry structure that is resulting in the shifting of risk down the contractual chain through increased subcontracting within the industry. In this sense, sham contracting is just one, even if a particularly onerous and inequitable, adverse manifestation of this key method of risk and cost shifting.

There is, of course, a legitimate role for subcontracting reflecting the production process within the industry, such as the sequential use of occupations during construction; the long-recognised economic advantages in terms of efficiencies in the division of labour, and the cyclical nature of construction output both in its volume and its geographic location. However, the significant scale of illegitimate forms of subcontracting, such as dependent contracting, clearly indicates that other factors are at work prompting these forms of employment.

Given that the premise of the argument of the submission is that sham contracting, along with other forms of subcontracting, is driven by risk shifting it is necessary to briefly identify what are the risks being shifted and how subcontracting shifts these risk, and whether that risk shifting is efficient and equitable.

### **Risk in the construction industry**

The principal sources of risk for construction firms, especially head contractors and subcontractors, include:

- high volatility in construction output, which increases the risk of unemployment for labour and the risk for construction firms engaging labour in a permanent contract of employment. It also increases the risk of volatility in labour and material costs as these prices are also often pro-cyclical
- volatility also increases the risk attached to businesses investing in workforce training, capital investment, and undertaking R&D that can improve a firm's productivity as high volatility heightens uncertainty about the return on these sunk costs
- at an individual firm level the project based nature of construction work, whereby each firm has to bid for projects that may only have a short duration, amplifies the risks that arise from volatility in construction output at an industry level
- head contractors, subcontractors or building material suppliers can be incompetent or corrupt and leave workers and firms out of pocket through the use of mechanisms such as 'phoenix contracting'
- head contractors and subcontractors can endure unpaid delays due bad weather; engineering risks such as unpredictable geology for ground works and the bespoke nature of many building designs can create problems as to their actual 'constructability'. Innovative technologies may not work according to plan
- construction activity is 'dirty and dangerous' for workers and assuming responsibility for OH&S management may pose a significant risk for firms.

Whilst many of these risks apply to project developers and financiers there are other risks which apply with particular weight to these two groups, including

- as an asset class buildings and infrastructure are ‘illiquid’ in that the planning and approval process can take considerable time, and once built they can be difficult to convert into a ‘liquid’ asset, namely cash, since the number of buyers for a particular building, say an inner city hotel, is limited and the alternative uses to which a structure designed for a specific purpose can be put are also limited. Another aspect of risk from illiquidity is the potential gap between projected demand for projects with a long lead-time, such as hotels, toll roads, mines or power stations, and the actual demand upon completion
- in previous decades private and public financiers and developers of construction projects had significant internal expertise to design, manage and even substantially build their projects. This internal expertise has now largely, or entirely, been abandoned. This exposes financiers and developers to a variety of new risks regarding control over the design of the structure, quality of construction and its ‘fitness for purpose’.

Finally, for all parties within the construction contractual relationship, due largely to the desire to shift risk between parties, there is a high probability of being involved in disputes that lead to uncertain outcomes in court. The construction industry is one of the larger, if not largest fields of contract litigation.

### **Risk shifting**

There are numerous means of managing the constellation of risks entailed in a construction project. Financial loss can be reduced by insurance cover; a financier, developer or contractor can elect to unilaterally assume all risk; parties can increase their tender price to reflect the anticipated loss adjusted for the anticipated probability of the risk occurring or a party can reject a risk by declining to take on the job (Baartz and Longley 2003: 2-3). Illiquidity of buildings and structures can be addressed through securitisation when ownership of and income from a structure is converted into securities which are traded on financial markets (Toner and Coates 2006). Parties can engage in ‘alliance’ contracting, where participants collaborate to share risks, and, generally ‘agree to a no blame – no suit principle’ (Department of Infrastructure and Transport 2011: 11).

However, the most common method of managing risk is through a traditional legal contract.<sup>1</sup> The literature on risk management in construction is strongly bifurcated between a ‘model’ or idealised prescription of how contractual risk management should be conducted and the description of how, in reality, contract negotiation occurs. The latter emphasises the capacity of more powerful parties to ‘shift’ risk down the contractual chain onto the weaker party, so

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<sup>1</sup> Department of Infrastructure and Transport (2011: 11-28) provides a detailed description of the main contractual obligations of parties in a standard construction contract and the differences with alliance contracting.

that risk is often borne by parties least capable of managing them. It is in this destructive form of risk shifting that we can understand sham contracting.

The idealised prescription for contracting in the construction industry suggests all parties seek an efficient and equitable allocation and acceptance of risk through subcontracting. This typically relies on the party that assumes a risk having the:

- capacity to assess the financial scale of the risk assumed
- responsibility to manage the construction risk assigned to them
- authority to control the factors that give rise to and mitigate against the risk occurring
- technical competence and economic incentive to fulfil these tasks
- and the financial resources to deal with the risk if, despite all efforts at mitigation, it occurs.<sup>2</sup>

This same literature, and indeed the same writers, observe that the weaker party is often least able to control, manage and finance risk. Within the construction industry the weaker party is invariably the subcontractor, smaller building firm or individual self-employed worker. Loosemore et al (2003: 108) notes that

‘...there is a wealth of literature going back many years which points to the inequities contained within construction contracts, particularly towards subcontractors’.

Similarly, Weaver and Hyde (2005: 11) note that ‘[o]ne of the more disturbing trends in the Australian construction industry has been the tendency for clients to attempt to transfer all the project risk to the contractor (and the apparent willingness of many contractors to accept these risks)’.

Echoing the shift from project to financial engineering, a former senior manager of one of Australia’s largest head contractors has observed that:

“...I believe there’s an arbitrage of knowledge between clients and head contractors, and head contractors and sub-contractors, and the arbitrage is unreasonably leveraged to the benefit of the head contractors almost all the time” (cited in Rafferty et.al 2011)

Mead (2007) has also identified a change in the way risk is managed in construction in Australia. In addressing those developments he specifically identifies the growing role of financial engineering instruments and techniques.

“There are a number of developments impacting, or likely to impact, upon approaches to risk allocation and risk management going forward. There has been a rapid convergence between insurance and financial markets in recent years. In the same way that the reinsurance market has been developing the concept of catastrophe bonds, financial engineers should ensure new and innovative ways to lay off risk via

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<sup>2</sup> Within the construction contract and risk management literature these principals are universally acknowledged (Crittall 1997: 432; Weaver and Hyde (2005: 10) and Mead (2007). The original statement of the model approach to risk allocation in construction is Abrahamson (1984).

accessing the pool of worldwide capital now looking for a home. The emergence of the financial engineers themselves and their heavy involvement in major infrastructure consortia may increasingly see the risk/reward profile determined less by an assessment of traditional construction risk, and more so by the ability of the project to service the facility, meet the requisite financial return, and the management of completion risk.”

The key point to note is that, from a systemic point of view, shifting risk through intensified subcontracting from the strong to the weak does not reduce risk, or improve efficiency. It simply permits parties with market (monopsonistic or monopolistic) power to move it onto other parties, to subcontractors directly and indirectly onto the broader construction industry, consumers and the taxpayer. This process is then not about efficiency, but rent seeking behaviour. The nature of these risks and problems with intensified subcontracting will be taken up in the final section.

However, the literature also makes it clear that the balance of power between parties within the construction industry, and therefore of the ability to shift risk, is not fixed but to varying degrees itself shifts. Two of the most important determinants of the power balance between the finance sector and developers on the one hand and head contractors and sub-contractors on the other are mentioned here. The first relates to the business cycle. In a ‘boom’ period of high construction activity, when demand for construction firms and labour rises faster than supply, subcontractors can often ‘push back’ against inequitable contracts by seeking higher margins and accepting lower risk projects. Conversely, when supply exceeds demand for contractors and subcontractors ‘work may be undertaken for a lower margin and at greater assumed risk in areas in which it has less expertise’ (Mead 2007:28). As a leading international construction law firm observed: ‘In a very competitive market, contractors are more willing to accept more risk’ (Ashurst et al, 2014: 10).

According to the same law firm during the last decade the balance of power has shifted towards financiers and developers. ‘Tight market conditions remain after the global financial crisis. Funding for projects remains scarce. Banks and other financiers remain cautious and risk adverse, and they want to see risks passed to other parties in the contracting chain. Others say that principals themselves are adopting a more cautious approach coming out of the global financial crisis, especially after having experienced themselves or having seen reports of high profile projects with undesirable outcomes – delays and cost blowouts. Principals want to take the safest option, and this approach is more acceptable from an internal accountability perspective. While those are valid reasons, the reason which is cited most often by principals and contractors is that principals adopt the ‘risk shifting’ approach **because they can**’ (Ashurst et al, 2014: 54 emphasis added).

The second relates to ownership of a completed structure so-called ‘supply-side’ building occurs when developers build for speculation and immediate sale for anticipated large capital gain (Weaver and Hyde 2005:11). Given the need to minimise their own internal costs and absent any long-term interest in the quality and performance of the structure speculative

developers typically use a ‘design and construct’ (D&C) contract to outsourcing both design and construction to a single head contractor. These ‘contracts transfer substantial risk to the contractor’ because cost escalation from conception to completion of a project can be ‘...in the order of 30%. In D&C contracts many contractors are accepting these development risks at traditional contracting margins’ (Weaver and Hyde 2005:12). The argument goes that shifting risk from the developer to the contractor ‘...requires the D&C contractor to seek the cheapest possible solution to its contractual obligations so as to maximise its profits (or minimise losses)’ by squeezing their subcontractor margins and lowering building quality (Weaver and Hyde 2005:12).

By contrast with ‘demand side’ or build-to-own structures, especially where the developer will own and operate the structure for many years, the incentive is for the construction contract to be ‘focussed on long term quality, whole of life costing, and a long-term view of value’ (Weaver and Hyde 2005:11). Under these circumstances the developer is incentivised to maintain greater control over design and the construction process and seeks a more efficient and equitable distribution of risk between developer, head contractor and subcontractor. Build-to-own structures are more conducive to the use of alliance contracting, as noted above (Weaver and Hyde 2005:14).

### **How subcontracting and non-standard forms of employment are used to shift risk and lower costs**

Shifting risk is, of course, a key means for shifting costs when these risks are realised as financial liabilities in the construction process. There are demonstrable competitive advantages to financiers, developers, head contractors and subcontractors in subcontracting and not engaging labour on the basis of a permanent contract of employment (Toner and Coates 2006). Some of these include:

#### ***(a) Numerical flexibility***

Engaging labour on a temporary basis for a limited duration to perform specific tasks rather than on a permanent contract of employment allows a closer matching of labour utilisation to the cyclical demand for construction output. The short duration of many construction projects also creates a demand for numerical flexibility. In addition, the sequential nature of the construction process where each stage of the process requires a different mix of trade and other skills also benefits from subcontracting. Casual employment contracts achieve similar ends.

#### ***(b) Cutting immediate labour costs***

Subcontracting, including sham contracting, can be used to cut direct labour costs through competition between sub-contractors to obtain work. In deregulated work sites in which subcontracting is especially prevalent, such as residential and commercial construction, intense competition means labour can be engaged at effective rates that are below those paid to direct employees. Reductions can be achieved in direct wages and on-costs that apply to the direct employment of labour, such as payroll tax, superannuation, long service leave,

redundancy pay, sick pay, holiday pay, workers compensation and the administration of these costs. Firms can use subcontractor arrangements to ‘hire and fire’ without exposing themselves to any unfair dismissal claims. Similarly, subcontracting can be used to avoid OH&S management responsibilities. In many situations the OH&S risk is passed down the contractual chain, to be borne by the party in the worst position to manage it effectively (Loosemore et al 2003: 228).

***(c) Transaction costs***

The use of subcontracting reduces transaction costs associated with human resource management functions such as recruitment, induction and training.

***(d) Apparent costs***

Firms improve their apparent financial performance by shifting from direct employment to indirect employment through use of subcontractors and labour-hire. Performance measures such as output per employee or profit per employee can be improved when a firm reduces its direct employment and outsources its use of labour (KPMG 1998). This is a ‘creative accounting’ technique much favoured by corporatised utilities to improve their apparent performance (Toner 1998).

***(e) Intensification of competition and work***

Loosemore (2003: 6) finds that the predominance of very small firms and self employment in the industry means that standards and working conditions are ‘extremely difficult to monitor and control, and this is one of the reasons why the construction industry is renowned for poor HRM practices in areas such as training, safety, exploitation of illegal migrant workers, and avoidance of tax payments, workers' compensation payments and other legal rights. The dangerous result of not being able to control such practices in such a competitive industry is that other companies are forced to lower their performance to the lowest common denominator in order to survive’.

Work intensification is a management strategy to increase worker effort without a fully compensating wage increase (Quiggin 2014). Work intensification is achieved for example by reducing union influence in workplaces and increasing unpaid overtime. Another strategy is the use of outsourcing, such as use of labour hire and contractors, as a means of introducing more ‘market discipline’ into a firm. The actual use of retrenchment and outsourcing or the threat of such measures could have a galvanising effect on a firm’s remaining workforce.

**Decline of the Public Sector as a Developer and Employer**

The scope for competitive processes within the construction industry has been greatly widened by large-scale withdrawal of the public sector over several decades from directly financing, designing, developing and building infrastructure projects using its own large directly employed workforce. Large scale employment within public works departments involved for example in building and maintain public housing, schools, road and water and electricity infrastructure provided job security, training and career paths for construction

workers. This large, directly employed workforce in the public sector mostly no longer exists, as these building and maintenance functions have been transferred to the private sector. This withdrawal is the result of the privatisation and corporatisation of government activities such as utilities, introduction of compulsory competitive tendering for the delivery of remaining government services, expansion of public-private partnerships and growth of an ideology favouring the unfettered expansion of private capital and ‘smaller government’ in many countries over the last three decades (ILO 2001: 25).

Some idea of the scope of this reduction is that in 1984 a total of 445,000 persons were employed in the construction industry in Australia of whom 51,000 or 11.4 per cent were in the public sector at all levels of government (ABS 6204.0: Table 11; ABS 2013a: Table 6a). In 1984 more than 1 in every 10 persons in the construction industry were in the public sector. By calendar 2013 an average of 1.001m persons were employed in the construction industry, but the number of direct public employees had collapsed to just 6,100 or just .6% of the total (ABS 6291.0.55.003: Table 4; ABS 2013b: Table 6a).

Large reductions also occurred in the public sector share of all elements of construction expenditure, residential, non-residential and engineering and total construction.

**Table: Public Sector Construction Expenditure as Percent of Total**

Calendar year	Public as % of total Residential	Public as % of total Non-Residential (excl Engineering Const.)	Public as % of total Engineering Const.	Public sector as % of total Construction
1986	7.7%	32.2%	76.4%	36.2%
2013	1.8%	29.4%	23.8%	19.6%

Source: ABS 2013c: Table 2; ABS 2013d: Table 1

The dramatic fall in the public sector share of employment and expenditure is important to the growth of subcontracting, sham contracting and intensified competition between firms. This decline is important for a number of reasons. Recent studies suggest that public sector procurement, especially the various forms of Codes of Practice for publicly funded construction projects across state and federal governments are influential in ‘setting industry standards for construction’ (Rafferty et al 2011: 43). These standards ‘prohibit arrangements or practices that are designed to avoid obligations under relevant legislation, awards or agreements, including inappropriately treating a genuine employee as an independent contractor and inappropriate application of taxation arrangements’ (Ministerial Reference Group 2011: 27). Publicly funded construction projects are also important in setting standards for compliance with OH&S and training. Directly employed government construction workers were offered permanent jobs with career progression.

This large decline in the public sector construction workforce also includes a similar decline in the employment and training by government of construction professionals, such as engineers and architects. This has resulted in a marked decline in the capacity of the public sector to design projects, assess tenders and manage projects which it funds. The Institution

of Engineers, Australia, identified many adverse effects on efficiency and quality of publicly funded construction resulting from this loss in the capacity of government to be ‘an informed buyer’ (Yates 2000). Professional Engineers Australia cites a variety of studies on this issue

‘In a recent Australian National Engineering Taskforce survey, 93 per cent of private and public sector engineers said they believed that governments (of all types) lack essential engineering capacity to deliver projects on time and on budget.

When governments do not have sufficient in-house engineering knowledge and expertise, industry research shows that projects are delayed and that there is waste, cost blowouts, disputation between private and public partners and, most concerning, heightened risks and hazards to public safety.

Research undertaken by Blake Dawson in 2008, and confirmed by a Senate inquiry into the shortage of engineering skills (2012), showed that these problems resulted in 26 per cent of projects over \$1 billion running more than \$200 million over budget. Extrapolating that out, across all governments, it is estimated that \$6 billion is wasted every year on contract disputes and other losses during project implementation’’ (Davies 2014).

In addition, the gradual elimination of the public sector capability to design and engineer projects that it funds has the effect of shifting power in the contractual relationship to other parties in the construction process, especially to the private head contractor.

### **Effects of Sham Contracting**

As noted earlier, shifting risk does not eliminate risk and indeed, such shifting ironically generates other important risks that are transferred to subcontractors, individual workers, the taxpayer and the construction industry more broadly. This section identifies a number of adverse effects on the quality of working life and construction productivity caused by intensified subcontracting and sham contracting. The central argument of this section is that the effect of intensified subcontracting and sham contracting is to lift the rate of profit for the construction finance industry, developers and head contractors. It does this not by improving productivity of the construction process but by shifting risk and cost to smaller firms and self employed workers. The result is simply a transfer of income from labour to capital.

### **Illegal/Unethical use of legal forms to reduce working conditions**

As noted earlier a major motivation for head contractors and larger subcontractors to use subcontracting and sham contracting is that workers can be denied their lawful entitlements to superannuation, minimum wages, annual leave, sick leave and redundancy payments.

### **Increased supervisory costs and quality problems**

The idealised model of market exchange and contracts which underpins the world view of the Productivity Commission and, therefore its economic policy recommendations, is based on agents having complete information of all past and future prices and the efficient allocation of resources so that the prices of factors and final products reflects the perfect balance between their relative scarcity and their marginal contribution to output. In this world, all market transactions are not only efficient, they are also fair. In the real world however, ‘bounded rationality’, ‘information asymmetry’ between the principal and agent and ‘opportunism’ are the norm. Transaction Cost Economics teaches us that not only does a contractor (agent) know more than a contractee (principal) about the characteristics of a good or service she or he is offering and the conditions under which it is produced but that some agents and principals will cheat by failing to honour contracts, shirk effort or otherwise do their best to ensure they get the best out of any bargain (Toner 2014 provides a summary this literature).

Research on the construction industry finds that these problems obtain with particular force in the construction industry. More intensive use of subcontracting introduces its own costs in terms of requirements for higher labour supervision and quality control. The latter is often achieved through wasteful contract disputes. In the workplace teams of self-interested subcontractors, each of whom has little interest in the final product or in assisting overall efficiency of the construction process, create an anarchic worksite. In the literature these conflicting interests and monitoring difficulties give rise to what is known as the ‘chaos of the construction worksite’ (Bosch and Philips 2003).

Intensified subcontracting and sham contracting also produces a loss of employee commitment with attendant problems for co-ordination and quality. These non-standard employment arrangements lead to high ‘employee turnover, or ‘wastage’, [and this] is an extremely important issue for construction companies’ strategic HR planning, yet a culture of mobility has emerged in the industry which has led to a workforce of corporate mercenaries that coldly drift from job to job with little sense of loyalty to their employers (Loosemore 2003: 7).

### **Increased OH&S risks and outcomes**

There is a strong association between intensified subcontracting and self-employment and adverse OH&S outcomes. Due to a range of factors such as competitive pressure to get work done quickly and cheaply and unclear lines of authority for and management of OH&S on unregulated worksites, individuals are required to make judgements about safety (versus time and payment) that should not be made. The incorrect incentive structures between payment for results/output and safety and many other such trade-offs are a daily part of life on many building sites, especially those with intensive and asymmetric sub-contracting systems. Put simply, ‘subcontracting and other aspects of work arrangements associated with supply chains have had a negative effect on work health and safety’ (Quinlan 2011: 2. See also Quinlan 2003; Quinlan et al 2002).

Loosemore (2003: 227) concludes that in ‘most OHS legislation head contractors are responsible for the OHS of the subcontractors they employ. However, recent research in Australia found that often the head contractor does not provide basic safety infrastructure, such as suitable access equipment...This leaves the provision of such equipment to trades who are only on site for a short period of time, for whom the investment of appropriate resources is not economically practicable. In many situations the OHS risk is passed down the contractual chain, to be borne by the party in the worst position to manage it effectively’.

It has also been found that the traditional sequential division of labour within the construction process excludes contractors and subcontractors from the design process which, in turn, creates many OH&S dangers. This exclusion prevents ‘consideration of OHS in design decision making, where many safety risks are created. Indeed, the Commission of the European Communities (1993) claimed that over 60 per cent of all fatal construction accidents can be attributed to decisions made before construction work commenced on site’ (Loosemore 2003: 227). The task of integrating the people doing the construction work with the design process is exacerbated with more intensive subcontracting.

Finally another consequence of the reduced role of the public sector as a financier, developer and employer in the construction industry and increased reliance on private investment is enhanced OH&S risk. ‘American research suggests that, while public-sector clients pay attention to contractors' safety performance, private-sector clients still focus primarily on the lowest bid’ (Loosemore 2003: 227).

### **Adverse effect on training**

The growth of employment in small firms and self-employment is an important factor in depressing employer investment in apprenticeship training and more general employer-funded workforce training. Growth of subcontracting contributes to a decline in average firm size in the construction industry. The propensity of a firm to train, including apprenticeship training, and the intensity of that training (expenditure on training per person) are strongly and positively associated with increasing firm size (Toner 2004). Shortages of a sufficient quantity and quality of skilled on-site labour, due to inadequate employer investment in training, contribute to rising labour costs and delays in project commencement and completion.

The self-employed and small firms also have a much higher apprentice non-completion rate than larger firms (Karmel and Roberts 2012). This is another contributor to chronic skill shortages in the construction industry. The factors giving rise to high non-completion rates by small entities are well established (Bednarz 2014). Compared to larger firms small firms and the self-employed have a higher chance of going out of business, poorer recruitment practices, lower wages and conditions, less chance of career progression and also less opportunity to relocate an apprentice within the organisation if they do not get on with a fellow worker. There is also a significant difference between the propensity of apprentices to complete between public and private employers, even controlling for the obvious differences

in firm size between the two sectors. The average completion rate for apprentices employed in the private sector is just 49% compared to 78% in government entities (Karmel and Roberts 2012). The large decline in employment in public sector construction has had a material effect on the quantity and quality of tradespeople. In the past the public sector also accounted for a disproportionate share of apprentice training. In the mid-1980s government accounted for well over 10 per cent of all construction apprentices; it now accounts for only 1-2 per cent (Toner 2005). A similar decline occurred in the employment and training of construction professionals, such as engineers and architects by government.

### **Adverse effects on innovation and productivity**

The construction industry has long been recognised as having significant constraints to investment in innovation and productivity. For example, ‘at just 1.2 per cent per annum, average productivity growth in the construction industry since 1990 to 2005 has been below the average of Australian industry (1.7 per cent)’. (Melbourne Institute of Applied Economic and Social Research 2007: 11). The construction industry also has the ‘lowest proportion of innovation activity’ of 17 industries (Department of Industry, Innovation, Science, Research and Tertiary Education 2012:52). Innovation is defined as the introduction of new products, services, production methods, marketing approaches, work organisation and R&D. The construction industry also has one of the lowest R&D intensities of any industry in Australia. R&D intensity is spending on R&D as a proportion of the industry’s value added. In 2006 the industry’s R&D intensity was just 06% compared to over 10% in high tech industries (Barlow 2012: 17).

This low innovation propensity and intensity and low productivity growth is a function of many characteristics of the industry (Gann 1998; Malley 2006; Loosemore 2014) such as:

- many construction projects are one off designs and this prevents cumulative learning by doing and optimisation of designs, which arises in the repetition of production processes. Often construction clients will undertake only one substantial project in their lives, such as house construction, and this also restricts cumulative learning by the consumer
- there is often little interaction between designers and head contractors and this restricts the scope for constructors to impart knowledge regarding efficient constructible designs gained from years of experience. ‘This separation of design and construction as distinct phases of activity is one of the main defining characteristics of the traditional procurement process...[as a consequence] the lack of participation creates divisions, misunderstanding, suspicion, a lack of trust and the potential for conflict within the project team (Loosemore 2003: 70).
- adversarial relations between head contractors, contractors, subcontractors and the self employed reduces the incentive for parties to invest in productivity improvements. Intense competition results in parties further up the contractual chain absorbing any productivity induced improvements in margins gained by a subcontractor
- the predominance of self-employed and very small firms constrains productivity and innovation within the industry. The self-employed and very small firms have a much lower propensity and intensity of investment in R&D and innovation (Toner 2011). This

constrains productivity growth in the construction industry. The structure of the construction industry is a major factor in explaining why, despite accounting for over 10 per cent of total employment, it accounts for less than 2 per cent of total capital stock. The capital stock is the total value of productive equipment, and buildings used for production. The construction industry capital-labour ratio is less than 20% of that the economy wide ratio.<sup>3</sup>

- Pursuit of labour market flexibility on the one hand and product and process innovation on the other are alternative and, largely, mutually exclusive, strategies for firms seeking to improve their competitiveness. Within the UK construction industry for example, it has been argued that ‘employers have chosen a very limited way of increasing productivity - work intensification - over more thorough-going investments in improving work organisation through capital investment and rationalization of the production process’ (Winch 1998: 540). A similar strategy applies to the Australian construction industry
- Given the structure of economic incentives within the industry many self-employed and subcontractors have little interest in quality or assisting head contractors to improve efficiency. The system of payments by results, such as fixed payments for the number of bricks laid, walls painted or colourbond roofing installed means subcontractors and the self employed must give absolute priority to completing tasks as quickly as possible and then moving onto the next job, even if this means creating problems for the next contractor in the production sequence. This is a major factor in the well-known problem of the ‘chaos of the construction site’ or absence of co-operation between the multiple subcontractors and trades to be fund on a construction site.
- low wages promote labour intensive production methods at the expense of more efficient capital intensive methods.

### **Tax avoidance and evasion**

The use of sham contracting and self employment within the construction industry imposes large costs on taxpayers as these forms of employment can exploit a variety of tax deductions such as income splitting with spouses, extensive work related expenses not available to employees and tax evasion through non-declaration of work income. An investigation by the Australian Taxation Office (2011) into these forms of employment found extensive avoidance.

‘In our field reviews with employers we capture details of amounts paid to contractors (whether sham or legitimate) and use the Australian business number to match these with our records to check whether contractors are correctly reporting their contract income. Over 10% of invoices we have collected did not contain an Australian

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<sup>3</sup> The ABS adjusts capital stock estimates to include financial leases so that ownership is in effect transferred from the lessor (say a finance company) to the lessee (the construction firm or self-employed construction worker). Many builders will acquire capital goods like cars or earth moving equipment under a financial lease. The ABS regards ownership of ‘operating leases’ or short term hiring of equipment as remaining with the lessor, so this is not included in estimates of construction industry capital stock. Calculations by the author reveal that in real terms capital stock per hour worked in construction was just \$23 compared to an average of \$131 for the total economy.

business number or contained an invalid number. We have been able to match income details of over 22,000 contractors. Of these, 31% of individual contractors appear not to have lodged a tax return and a further 20% have lodged but do not appear to have declared their contract income. We are following these up to ensure that they properly report their contract income.

We will continue with the level-playing-field work in 2011-12, to ensure that workers are properly engaged in the taxation, superannuation and welfare systems and correctly reporting their income and that employers are meeting their obligations to their employees and not unfairly undercutting their competitors’.

However despite these initial measures by the ATO to gauge the scale of the problem a recent study by the Australian National Audit Office found that the ATO has been largely ineffective at reducing the tax revenue losses. The chief measure to reign in these losses is the *Alienation of Personal Services Income*’ (APSI) tax rules introduced by the Treasurer Peter Costello in 2000. In 2011 the CFMEU estimated that almost \$2.5b pa was being lost to the public coffers in the construction industry alone to the practice of sham sub-contracting.

The ANAO found that even though the ATO regarded the APSI area as an ‘endemic (compliance) risk’, there have been inadequate to estimate the size of the non-compliant APSI population since 2004-05. It also found that the ATO has no methodology to assess the magnitude of the tax revenue at risk through non-compliance. The official figures show that over 70% of those who declare any personal services income at all assess themselves as being exempt from the reach of the laws. The number of those who simply do not declare is unknown.

The number of compliance audits by the ATO in this area has also declined sharply, from over 800 cases in 2003-04, to 441 cases in 2012-13. The average number of ATO staff administering the APSI rules has fallen from 120 in July 2000 when the laws commenced, to an average of just over six people in 2012-13.

### **Significance of taxation for sham contracting**

It is self-evident that the taxation treatment of income will have a bearing on the way that individuals seek to structure their working arrangements.

Taxation laws are currently acting as an important incentive to the use and abuse of contracting arrangements. In order to ensure taxation equity as between individual taxpayers, to staunch the flow of lost public revenue and to ensure that illegitimate tax advantage does not encourage and promote the practice of sham subcontracting, it is necessary to make a number of key changes to the existing taxation regime as it relates to the alienation of personal services income (APSI).

It is clear that the existing legislative regime has not been effective in meeting the policy objective of reigning in revenue lost through the alienation of personal services income. The APSI provisions which have applied to the construction industry for almost ten years now have manifestly failed to ensure that the personal services income of those who are not in substance and reality working as contractors on their own account, receives comparable taxation treatment to the income of employees who are subject to the PAYG system.

**Are the current provisions in the Fair Work Act sufficient to discourage sham contracting?**

The Fair Work Act provisions relating to sham contracting (and the predecessor provisions under the Workplace Relations Act 1996) have proved wholly ineffective in dealing with the issue of sham contracting. Firstly, there is nothing in the current legislation that prohibits sham contracting per se. The existing provisions are confined to circumstances involving misrepresentation, dismissal and inducements relating to sham arrangements.

Whether the sham arrangement involves a concerted and conscious effort to disguise the relationship and/or to avoid industrial regulation or merely wilful indifference to the consequences of the means by which a person is engaged, the Fair Work Act should recognise that the fact that a sham contracting exists is, in itself, enough to warrant a serious sanction. The absence of this type of provision allows the entire regulatory regime established by the Fair Work Act to be subverted by the single device of sham contracting.

Where it can be demonstrated that a sham arrangement has been put in place by an employer this should be sufficient to attract a penalty under the Fair Work Act.

The Fair Work Act should be amended to include such a provision. A proposed amendment is set out below:

***DIVISION 6 – SHAM ARRANGEMENTS***

***[Clause] Engaging an employee as an independent contractor***

*(1) A person (the **employer**) must not engage, or propose to engage, another person (the **employee**), whether through an interposed entity or otherwise, as an independent contractor where the true character of the engagement, or proposed engagement, is that of **employment**.*

***Note:*** *This subsection is a civil remedy provision (see Part 4-1).*

*(2) For the purposes of sub-section (1) ‘interposed entity’ includes a corporation, partnership or trust.*

### **s. 357 - Misrepresenting Employment as Independent Contracting Arrangement**

An employer who engages an employee as an independent contractor avoids statutory obligations like superannuation payments, annual leave, sick leave, leave loading etc., which the employer is otherwise obliged to provide to an employee. The FWO targeted sham contracting in 2011 and identified the cleaning services, hair and beauty, and call centre industries<sup>4</sup> as those in which sham contracting is most prevalent. These are industries with some of the lowest paid and most vulnerable employees in Australia.

Section 357(1) does not prohibit employers engaging employees as independent contractors, only the making of representations to an individual who is, or should be an employee, that they are an independent contractor. However, a defence to s. 357(1) is available to an employer who makes such a representation but:

- a. did not know; and*
- b. was not reckless as to whether;*

the individual was an employee and not an independent contractor.<sup>5</sup> There are three distinct problems we have identified with the defence in s. 357(2) of the FW Act that invariably provide employers a valid legislative defence in all but the most blatant and egregious breaches:

- There is no clear definition of the term “reckless”,
- Once the employer relies on the subjective defence, the onus of proving the employer knew or was reckless, rests with the person alleging the breach, and
- The defences are made out on purely subjective grounds.

#### **Definition of the term “reckless”**

The sham contracting provisions of the FW Act are intended to broadly mirror those that existed in the WR Act,<sup>6</sup> in which the government stipulated that: ‘Recklessness will take its common law meaning as the Commonwealth Criminal Code does not apply to the civil

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<sup>4</sup> *Sham contracting and the misclassification of workers in the cleaning services, hair and beauty and call centre industries: Report on the preliminary outcomes of the Fair Work Ombudsman Sham Contracting Operational Intervention*, November 2011

<sup>5</sup> FW Act, s. 357(2)

<sup>6</sup> Explanatory Memorandum to the Fair Work Bill 2008, item 1447

remedy provisions in the WR Act'.<sup>7</sup> As the term “reckless” is not defined in the FW Act, a relevant court must rely on the common law for guidance.

However, the term “reckless” has a number of different definitions across civil law, depending on the cause of action<sup>8</sup> and while the meaning is settled in the context of the criminal law, that settled meaning cannot apply to a breach of the sham contracting provisions because it is not an offence.<sup>9</sup>

It is yet to be settled which, if any, of the civil law definitions of the term “reckless” should apply to s. 357. In *CFMEU v Nubrick Pty Ltd*,<sup>10</sup> the union relied on an existing definition that applies in the context of insurance policies, while the employer did not rely on a particular definition but referred to observations made by the High Court in *Banditt v R*<sup>11</sup> but the court did not ultimately decide what definition should apply as it found the employer was not reckless under any definitions.

It is essential that the obligations imposed on employers be clear, particularly because s. 357(1) is a civil penalty provision.<sup>12</sup>

### ***Onus of proving the defence***

The onus of proving the defence in s. 357(2) rests with the employer. In practice, however, the person alleging the breach will likely be required to provide evidence that the employer actually knew.

Following the principles outlined in the High Court decision in *Barclay*,<sup>13</sup> an employer may give evidence that they simply did not know they made misrepresentations and, if that evidence is accepted by the court, the employer will be taken to have discharged the onus of proof.

Therefore, unless the employer makes admissions, it is up to the person alleging that the employer knew or was reckless in making the misrepresentations (“the Applicant”), to adduce evidence of the employer’s knowledge. This is highlighted by the recent decision in *Director of the Fair Work Building Industry Inspectorate v Bavco Pty Ltd & Ors (No.2)* in which the Federal Circuit Court listed the three potentially relevant classes of evidence from which a person’s knowledge may be inferred:

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<sup>7</sup> Supplementary Explanatory Memorandum, Workplace Relations Legislation Amendment (Independent Contractors) Bill 2006, p 4

<sup>8</sup> See commentary of Justices Gummow, Hayne and Heydon in *Banditt v R* (2005) 224 CLR 262 at [1]–[2]

<sup>9</sup> FW Act, S. 549

<sup>10</sup> [\[2009\] FMCA 981](#)

<sup>11</sup> (2005) 224 CLR 262 at [1]–[2]

<sup>12</sup> Fair Work Act 2009, s. 539

<sup>13</sup> *Board of Bendigo Regional Institute of Technical and Further Education v Barclay* [2012] HCA 32.

- *One is the conduct or behaviour of the person who is alleged to have knowledge. A generalisation that is applied to such evidence is that the manner in which a person acts is a reflection of a person's state of mind. At least in some circumstances, then, it is possible to rationally infer from a persons' behaviour the state of mind that has produced it.*
- *A second class of evidence is external circumstances; that is, circumstances that are likely to bring to the persons' mind the matters about which it is alleged the person has knowledge. Examples include evidence of direct exposure to the fact, the making of a communication to the person about the fact, and reputation about the existence of a fact.*
- *And a third class of evidence is that which shows a person had knowledge of a fact at a time before or after the time at which it is necessary to prove that person had that knowledge. Knowing a fact at one point in time may be a basis for inferring knowledge of the fact at a later or earlier time.<sup>14</sup>*

These elements put the onus back on the Applicant to adduce evidence of the employer's likely knowledge of particular facts, such that a court may determine that the employer knew or was reckless in making the representations.

This is a particularly difficult hurdle to overcome for an Applicant and provides an employer with an almost assured defence, except in the most flagrant of breaches.

### ***The subjective nature of the defence***

The defence in s. 357(2) has two limbs, both of which apply subjective tests. In deciding whether a defence to a breach of s. 357(1) exists, the court must only consider what the employer knew, not what a reasonable person should know.

The subjective nature of this defence encourages an employer to be ignorant of the law surrounding independent contractors and/or covert when proposing changes in the workplace, rather than including and consulting employees. The less an employer knows (or can be proven to know) about the operation and existence of laws relating to independent contractors, the less likely they will be found to have breached the provisions of the Act.

The concept of reasonableness would introduce an objective element to the test for recklessness in the sham contracting provisions. This objective test is well understood by the courts and is the test for recklessness for the common law tort of negligence,<sup>15</sup> as well as a director's duty to not trade whilst insolvent.<sup>16</sup>

As such, we propose the following amendment of subclause 357(2):

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<sup>14</sup> [2014] FCCA 2712 at [71]

<sup>15</sup> *Banditt v R* (2005) 224 CLR 262 at [1]–[2]

<sup>16</sup> *Corporations Act 2001* (Cth) s 588G.

*Subsection (1) does not apply if the employer proves that, when the representation was made, the employer:*

- a. did not know;*
- b. could not reasonably be expected to know; and*
- c. was not reckless as to whether;*

*the contract was a contract of employment rather than a contract for services.*

This amendment would provide clarity as to the definition of the term “reckless” in the context of the sham contracting provisions, as it would be possible for the courts to adopt a fixed common law definition. Thus, it would clarify the obligations imposed on employers by these provisions. Further, the amendment would put the evidential burden back on the employer to prove the reasonableness of their belief, which we submit is fairer than requiring an Applicant to provide evidence of surrounding circumstances from which a court may infer an employer’s knowledge.

It is true that the Act applies the subjective test for recklessness on employers in other provisions,<sup>17</sup> but we believe that clarity and practicality must take precedence over legislative consistency. Further, the concept of reasonableness already exists in the Act,<sup>18</sup> which is evidence that an objective standard can be effectively used.

In the context of striking a balance between the protection of employee interests (particularly low-paid, vulnerable employees) and not punishing employers who have made a legitimate attempt to engage independent contractors under the law, an objective standard of the reasonableness of an employer’s level of knowledge, is appropriate.

### **s. 358 - Dismissing to Engage as Independent Contractor**

This clause, like the current section under the FW Act, provides that an employer must not dismiss an employee in order to re-engage that employee for the ‘same or substantially the same’ work under a contract for services. The amendments are aimed at extending the current section 358 to situations in which individuals are dismissed and re-engaged as a contractor under a labour hire arrangement, as well as where individuals are dismissed to be re-engaged by a related entity, in order to avoid employment obligations and entitlements.

#### ***358 Dismissing to engage as independent contractor***

*An employer must not dismiss, or threaten to dismiss, a person who:*

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<sup>17</sup> *Fair Work Act 2009*, ss. 345 and 348

<sup>18</sup> *Fair Work Act 2009*, ss. 707, 708, 711, 715, 716 and 718

*(a) is an employee of the employer;*

*(b) performs particular work for the employer;*

*in order to engage the person as an independent contractor, or through a labour hire arrangement, to perform the same, or substantially the same, work under a contract for services, whether with the employer, a related employer or labour hire firm.*

*Note: This subsection is a civil remedy provision (see Part 4-1).*

A determination of whether an individual is an employee or an independent contractor is not a simple matter, it involves complex considerations about, among others, the nature of the relationship between the parties, the work performed and any agreement made between the parties. A state of the law governing the determination of whether an individual is an employee or an independent contractor can be found in *Hollis v Vabu*.<sup>19</sup>

This High Court decision shows that it may not be clear, even to experienced members of the court, whether or not a particular individual is an employee or an independent contractor.

Nevertheless, an employee who is dismissed and re-engaged as an independent contractor performing the same or similar work has only 21 days from the date of the dismissal to make an application seeking remedy.<sup>20</sup> Such a timeframe for making an application is inappropriate for sham contracting. It may take weeks before a worker realises that by becoming an independent contractor they are in a substantially less beneficial position than they were as an employee, by which time, they will no longer be eligible to make an application.

Further, the term “dismissal” is defined in the Act as a situation where:

- *a person’s employment has been terminated at the employer’s initiative, or*
- *a person was forced to resign because of the conduct or course of conduct engaged in by the employer.*<sup>21</sup>

However, this definition does not encompass situations where an employee has been pressured to “agree” to resign in order to be engaged as an independent contractor. For example, an employer may apply undue pressure on an employee seeking flexibility in their working arrangements in order to care for their family to resign and be reengaged as an independent contractor performing the same or similar work. An employee who agrees to be terminated or resigns would not be eligible for relief under s. 358, as there is no dismissal.

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<sup>19</sup> [2001] HCA 44; 207 CLR 21

<sup>20</sup> Fair Work Act 2009, s. 366

<sup>21</sup> Fair Work Act 2009, s. 386. NOTE: While this definition is used only for determining whether an applicant is eligible for protection under the unfair dismissal provisions of the Act, it is likely to provide guidance for a court in an application made under s. 358.

To remedy these anomalies, we recommend the ss. 358 be amended to allow relief in circumstances where an employer has unduly influenced or applied undue pressure on an employee to agree to termination or resignation.

Further, we recommend an extension of the 21-day limit in which to make an application for relief, due to the complex nature of the determination of whether an employee has in fact been improperly engaged as an independent contractor.

### **s. 359: Misrepresentations to engage as Independent Contractor**

Section 359 adopts an even stricter test than s 357 in that the misrepresentation to persuade or influence an employee to perform the same work as an independent contractor must be one that the *employer knows is false*. This imposes an almost insurmountable evidentiary burden on those seeking to rely on the section.

In order to be in breach of this provision, the employer must actually know that the representations they made were false. This is a purely subjective test and does not even include an element of recklessness. Like s. 357(2), this provision also encourages ignorance of the law. Further, after the decision in *Barclay*<sup>22</sup> (also discussed above), unless the employer makes admissions, the practical onus of proving the employer knew, rests with the Applicant.

Section 357 of the *Fair Work Act* prohibits an employer from misrepresenting that an employment contract under which an employee is or would be employed is a contract for services. However sub-section (2) provides that if the employer can prove that they '*did not know or were not reckless as to whether*' the contract was a contract of employment, the prohibition does not apply. Under this provision proof as to the employer's state of mind becomes a critical factor in determining whether a breach has occurred'

The scope of this defence and its significance was exposed in a case taken by the CFMEU under the equivalent provisions of the *Workplace Relations Act*. Although the wording has altered slightly under the FW Act, the decision in that matter made it clear that the exception in the FW Act is so wide as to make the provisions almost worthless. In *CFMEU v Nubrick Pty Ltd*<sup>43</sup> the employer, a large and well-resourced corporation, successfully relied on the defence by showing that at the time of the representations they did not know or were not reckless as to whether the contracts in question were contracts of employment.

It seems that on the basis of this decision and the current wording of the FW Act, if an employer can prove for example that they did not turn their mind to the legal distinction between a contractor and employee, they cannot be found to be in breach of the sections. This means that the less knowledge of the legal distinctions between contractor

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<sup>22</sup> *Board of Bendigo Regional Institute of Technical and Further Education v Barclay* [2012] HCA 32.

and employee and the less attention given to the issue, the more likely the employer is to be able to raise a successful defence.

We recommend the addition of an objective test for the determination of whether a statement was false. The inclusion of a test for reasonableness would encourage employers to seek advice or do their own research before making such statements to employees, and would encourage an appropriate level of prudence in their dealing with employees.

As such, we recommend s. 359 be amended to:

*A person (the employer) that employs, or has at any time employed, an individual to perform particular work must not make a statement that the employer knows, or ought reasonably know, is false in order to persuade or influence the individual to enter into a contract for services under which the individual will perform, as an independent contractor, the same, or substantially the same, work for the employer.*

*Note: This section is a civil remedy provision (see Part 4-1).*

### **Other Laws Dealing with Misrepresentations**

The provisions of the *Fair Work Act* relating to misrepresentation may be contrasted with the provisions of the former *Trade Practices Act* 1974 and now the *Competition and Consumer Act* 2010 (CC Act). Under both s 53 of the TPA and now s 29 of Schedule 2 of the CC Act, corporations (now persons), are prohibited from making false representations in relation to the supply of goods and services. In neither case is the intent of the party making the representation relevant. Section 151 of CCA (Schedule 2) also creates an offence of strict liability in relation to misrepresentations.

When such provisions are considered it is evident that there is a clear anomaly at present in that companies dealing with each other (and consumers dealing with companies and other business entities) are subject to stronger protections from false representations than workers dealing with employers about their employment status. This is so because it is the accuracy of the representation that is the focus of the inquiry and not the state of knowledge of the person making it. This anomaly could be addressed by deleting the exception in s 357(2) of the FW Act.

#### ***Misrepresenting employment as independent contracting arrangement***

*(1) A person (the **employer** ) that employs, or proposes to employ, another person (the **employee**) must not represent to the employee that the contract of employment under which the employee is, or would be, employed by the employer is a contract for services under which the employee performs, or would perform, work as an independent contractor.*

*Note: This subsection is a civil remedy provision (see Part 4-1).*

The former sections 53B and 75AZE of the *Trade Practices Act* also dealt with the issue of misrepresentations in relation to employment. Those provisions are now reproduced as s 31 and s 153 of Schedule 2 to the CC Act which contains the civil and criminal sanctions for employment-related misrepresentations. Section 31 provides:

***31 Misleading conduct relating to employment***

*A person must not, in relation to employment that is to be, or may be, offered by the person or by another person, engage in conduct that is liable to mislead persons seeking the employment as to:*

- (a) the availability, nature, terms or conditions of the employment; or*
- (b) any other matter relating to the employment.*

*Note: A pecuniary penalty may be imposed for a contravention of this section.*

A similar but amended provision should be included in the FW Act to deal with the problem of misrepresenting that holding an ABN is a condition of obtaining employment, a practice that is widespread in the industry. Trade unions would then be able to institute proceedings on behalf of persons affected by the misleading behaviour.

***357A Misleading conduct relating to employment***

*(1) A person must not, in relation to employment that is to be, or may be, offered by the person or by another person, engage in conduct that is liable to mislead persons seeking the employment as to:*

- (a) the availability, nature, terms or conditions of the employment, terms or conditions upon which the employment may lawfully be offered ; or*
- (b) any other matter relating to the employment.*

*Note: A pecuniary penalty may be imposed for a contravention of this section.*

## References

ABS (1996) *Labour Force, Australia, 1978-95*, Cat. No. 6204.0

(2013a) *Wage and Salary Earners, Public Sector, Australia*,  
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