

Contractor Insolvency Contract Risk Management



What Do I Need To Know?

The credit crunch is biting both in the UK and globally with the increased risk of Insolvency.

Construction projects are typically high risk with high value contracts, modestly capitalised contractors and relatively small margins – projects and contractors rely heavily on positive cash-flow to fund projects.

Not only is construction workload reducing (most notably in the housing sector) but also tender prices are becoming more competitive, costs continue to increase and worsening cash-flow will inevitably lead to construction insolvencies, probably at an increasing rate.

The nature of construction means that insolvency of one 'link' can potentially have an impact on the whole supply chain as well as the employer and consultants.

Insolvency

Insolvency occurs when a corporate entity is unable to pay its debts - section 132 Insolvency Act 1986.

There are four main tests:

- Failure to pay a Statutory Demand over the threshold of £750
- Where execution on a judgement is unsatisfied

- Inability to pay debts as they fall due – the cash-flow test
- Value of assets less than liabilities – balance sheet test

Insolvency is the general term applied to a number of different possible scenarios depending on the legal form of the contractor which determines the type of insolvency arrangement and practitioner – for corporate entities it is likely to be an administrator, administrative receiver, official receiver or liquidator - that will be appointed to deal with the insolvency.

On insolvency the contractor's obligation to carry out & complete the works is usually suspended.

The contractor is required to give notice of insolvency.

Warning Signs

Typical warning signs are:

- Rumours – usually from suppliers/sub-contractors
- Unexplained difficulties in securing labour and/or materials, etc
- Unexplained reductions in productivity
- Supplier/sub-contractor payment defaults
- Attempts to negotiate early valuations and payments and release of retention

It is critical to act only in the event of insolvency and not to 'jump the gun' with regard to the particular matters and actions noted below by acting on rumour.

It is important not to 'contribute' to the likelihood of insolvency by delaying or under estimating valuations or certificates, which will serve to worsen any cash-flow difficulties.



Immediate/future action

Know your particular contract wording and advise the employer with regard to:

- reasonable steps and reasonable measures to secure and protect the site, Works, materials on site and contractors' plant, etc
- withholding payments & retention
- effecting insurance of the Works, etc
- inspecting the site, Works and materials on site & recording progress and scheduling materials on site & contractors' plant, etc
- preparing a schedule of defects at the date of termination
- estimating the cost and obtaining quotations for making good defects
- formalising extension of time/liquidated damages and direct loss/expense position at date of insolvency
- keep ongoing records
- the option to terminate and options for completion of the project
- the need for expert legal & technical advice
- CDM issues
- obtaining copies of all contractor Design information
- liaising with insolvency practitioner
- administering completion of the project
- preparing the notional & completion contract final accounts

Termination

The contractor's employment under the contract, does not usually automatically terminate on insolvency (unlike with some earlier JCT editions) but may be terminated

by and at the option of the employer – see Completion Options below.

Notice in the proper form is required to avoid expensive adverse complications for the Employer and Contract Administrator/ Employer's Agent e.g. for repudiatory breach.

Payment of Contractor

The provisions requiring the employer to make further payments including releasing retention also cease to apply from the date of insolvency until accounts have been made up after the project has been completed or abandoned and the loss/ damage caused to the client as a result of the contractor's insolvency is known, identifying the balance, if any, due to the contractor

Housing Grants Construction & Regeneration Act 1996

In an insolvency situation, a withholding notice under s110 HGCRA 1996 is not required to allow withholding of payments and retentions otherwise due to a contractor **Melville Dundas Limited (in receivership) & others v George Wimpey (UK) Limited & others [2007] and Pierce Design International Limited v Johnston & Anor [2007]**.

Set-off

The 'balancing of accounts' principle allows any creditor who owes a debt to an insolvent company, no matter how long overdue, to set-off that debt in full as security against his own liquidated cross-claims in the insolvency **Bouygues (UK) Limited v Dahl-Jensen (UK) Limited [2000]**.

The Insolvency Rules give this principle statutory force. This is a valuable right for the employer, which should not be overlooked or compromised in dealings with insolvency practitioners, as the employer would otherwise rank equally with unsecured creditors.



Completion Options

The employer should consider the options in consultation with the existing project team and additional specialist legal, accounting & technical experts.

Completion by:

1. Contractor, usually in the person of the insolvency practitioner, but a liquidator may disclaim. The employer's contractual termination rights are waived. Probably only practical where little work remains to be done and a payment to contractor will result otherwise not attractive to an insolvency practitioner. Future defects liability remaining with an insolvent contractor are a risk.
2. Guarantor e.g. where an effective parent company guarantee exists with a 'see to it' obligation.
3. Bondsman e.g. under performance bond (rare in UK) usual position is that a payment is made under the bond either 'on-demand' or the after works are completed and proper procedure followed.
4. Novation to a 3rd party – an agreement between the employer, the insolvency practitioner, the insolvent contractor and the new (3rd party) contractor – that transfers all rights and obligations (past & future) to the new contractor. These agreements need careful drafting to be effective in transferring pre-existing obligations especially where design is involved. Novation is attractive to an insolvency practitioner as it achieves a 'clean break' but the new contractor may want a premium to take on the risk of latent defects, etc.
5. Completion contract with new contractor selected after tender/ negotiation but:
 - EU procurement rules may still apply

- Delay may result
- Liability for pre-existing defects, delay and additional cost in excess of available retention and withheld payments remains with original (insolvent) contractor

6. Sub-contractor(s) under direct agreement(s). This is safest where original agreements contain step-in rights and provisions/ indemnities with regard to pre-existing and future payments otherwise employer may have to pay a premium and find such payments are held to be void under the Insolvency Rules. The employer is then left as an unsecured creditor having effectively paid twice!

For the same reasons, care should be taken not to compromise legitimate withholding or set-off between the contractor and suppliers/ sub-contractors **British Eagle v Air France (1975)**.

The employer may decide to complete the works himself.

Materials on site

Once incorporated into or affixed to the works these become the property of the employer.

The position with unfixed materials should be clarified as the general principle that the employer has a lien over or that title vests in the employer on inclusion in a certificate or on payment may be displaced by retention of title clauses in supply/sub-contract terms **Dawber Williamson v Humberside (1979)**.

If title has not transferred to the employer the owner may repossess good/materials and in the event of wrongful use or interference a claim against the employer in tort for conversion may result.



Materials off site!

If materials off site are eligible for inclusion in certificates care must be taken to ensure that all the contract requirements are complied with to effectively vest or transfer ownership to the employer. Advance payment bonds should be considered.

In the event of insolvency, steps should be taken to ensure that these are safeguarded.

Contractors' plant

The contract provides that the employer may use all temporary buildings, plant, tools & equipment to complete the works and the contractor removes from site only when instructed to do so.

However 3rd party ownership and/or vesting issues may arise where plant, etc is hired requiring delivery up of plant or direct hire agreements.

Dealings with insolvency practitioners

Beware agreeing settlements without expert technical and/or legal advice to avoid compromising pre-existing rights and/or set off principles.

Pre-insolvency and post-insolvency debts cannot be set off against each other *Asphaltic Limestone Concrete Co v Glasgow Corporation (1907)*.

Latent defects insurance

As an employer would be merely an unsecured creditor with regard to latent defects, the availability & cost of latent defects insurance should be considered; the premium for which could be a legitimate cost to the employer that could be set off against amounts otherwise due to the contractor.

Accounts

Within a reasonable time after completion of the Works and making good defects, accounts are to be taken of:

1. Amount of expenses properly incurred by the employer completing the Works
2. Amount of payments made to insolvent contractor
3. Amount which would have been certified if insolvent contractor had completed the Works

If the total of 1 and 2 is greater than 3 then this will be the balance/debt due to the employer against which the employer may set-off withheld payments & retention. If there is a shortfall this becomes a claim in the insolvency so the employer should register as a potential creditor early in the insolvency. The employer has a duty to mitigate their loss.

Contract Services

- Intelligent Procurement
- Contract Drafting
- Contract Risk Management
- Claims Management
- Case Management
- Expert Opinion

Free Advice

Call the Contract Services Helpdesk and we will give you a hour of expert advice on any contractual problem

+44 (0) 20 7544 3999

csfreeadvice@turntown.com

This article is not intended as a statement of law and should not be taken as such. This newsletter is for information purposes only. Its contents do not constitute legal advice and should not be regarded as a substitute for detailed advice in individual cases.