

INSOLVENCY IN THE CONSTRUCTION INDUSTRY

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The Problem (1)

- Very cyclical industry
- Collect early and pay late culture
- The domino effect – over exposure at any one time to individual clients and many parties in any project
- Overwhelming contract claims

The Problem (2)

- Insolvency is a big risk in construction due to business model
- Participants have low profit margin, low fixed assets and low capital but high cash flow and high return on capital employed
- No financial barriers for entry into the industry: lots of small firms with little management expertise
- Financing generated on cash flow meaning vulnerability in the absence of this
- True of contractors but also developers and consultants

CONSTRUCTION INSOLVENCY PART 1

Sarah Cook

The Importance of Paper

- Contractual certainty
- Network of contractual relationships
 - Step-in rights
- Requirement of writing
 - Guarantee provisions (Statute of Frauds Act 1677)

Step-in Rights

- What are they?
- Who receives them?
 - E.g. fund, employer
- How do they operate?
 - Breach of funding arrangements
 - Employer's breach of primary contract
- Problems with priority
 - Employer over fund etc

Who Are You Contracting With?

- Covenant Strength
 - Dun & Bradstreet
- Security of performance
 - On-demand bond/default bond
 - Parent company guarantee
 - Retention

On-demand bond

- Guarantee to pay sum of money on first demand
- Contract of indemnity
- Primary rather than secondary liability
- Exists independently of liability between contractor and employer
- 10% of contract sum
- Expiry on practical completion
- Cost
- “Bonds should not be on-demand and unconditional but should have clearly defined circumstances set out in them for being called”

Default bond

- Undertaking to recompense up to a certain level
- Contract of suretyship
- A answers for liability of B to C
- Depends upon primary liability in the construction contract and a default under that contract
- Payment conditional on proving
 - Breach of the underlying contract
 - Amount of loss caused by the breach
- Amount, expiry and cost
- ABI Bond – is insolvency a breach of the primary contract?

Parent Company Guarantee

- When required?
- Guarantee the duration of the contractor's liability under the contract
- Practical if contractor is not performing
 - Employer can call upon directors of parent company to ensure the obligations under the principal contract are performed BUT
- Not as good as bond?

Retention

- Retention from regular payments under contract until satisfactory completion
- Standard retention – 5% or 3%, half released at practical completion and half released at making good defects
- Trust relationship
- Requirement to place in separate bank account

Consultants' Appointments

- Payment schedules
 - Only pay for work done
 - Make sure you get paid for work done
 - Statutory right to suspend services on appropriate notice
- Right to determine
 - At will
 - Material breach of the client
- Copyright

“Fair Payment” practices

- Project Bank Account
 - Held in trust on behalf of the whole of the supply chain
 - Client pays money into account as and when due
 - Monies separate and distinct and clearly identifiable and on trust in the amounts owing
 - New sub-contractors etc sign a deed of adherence and join the arrangements

CONSTRUCTION INSOLVENCY PART 2

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Indicators of Insolvency

- Slow down on site/of service delivery
- Late payment
- Requests for advance payment and/or early payments
- Withholding of payment on the grounds of “dispute”
- Unexpected claims/claim building
- Sub-contractor contact re non-payment

First Actions

- Do not ignore issues
- Ensure all contract documents are in place so that terms are clear. Get documents in order
- Get advice if unclear
- Ensure you comply with your contractual obligations (set off and termination)

The Options to Procure Project Delivery prior to Insolvency

- Act on the assumption that insolvency will follow
- Replacement
- Assistance
- Step-in/Direct payment
- Contract security (performance bonds/parent company guarantees)
- Securing the site/design information

Replacement – Issues to Consider

- Does the appointment/contract allow termination at will
- If not has there been a breach
- JCT termination provisions – “failure to regularly and diligently proceed with the works”
- Secure all information
- Procure alternative suppliers
- Consider third party obligations (agreements for lease, funding agreements etc)

Assistance (1)

- Will often be a request from party in difficulties – natural reaction is to assist to procure delivery
- Document fully to ensure the position is protected
- If making advance payments consider security
- Consider renegotiation of terms and conditions (e.g. alternative security, rights to step-in, outstanding information etc that may previously not have been agreed). Document this

Assistance (2)

- Step-in/direct payment. Ensure that step-in rights are enforceable/check with any other parties (funders) with such rights
- If making direct payment ensure contractual discharge for that direct payment
- Retention of title
- Warranties/guarantees from sub-contractors paid direct
- Check sub-contractor contractual obligations

Contract Security

- Check terms of bonds and guarantees
- Do nothing that will allow avoidance of liability (e.g. determination of liabilities under the main contract)
- Comply with procedures set out in security documentation
- Make the claim early

Securing the Site/Possession of Information

- Consider whether taking possession is sensible – insurance obligations, release of liability with regards to performance etc
- Enforcement of rights with regards to design information – tie payments to performance

Formal Insolvency Proceedings

- Options less open as administrators and liquidators have greater power to avoid liabilities. (More to follow)
- Contact the insolvency practitioners and other creditors
- Disputes issues re adjudication

Adjudication

- Mandatory dispute feature in all construction contracts. Intention is allow speedy resolution of construction disputes on an interim basis
- Section 108(c) provides an adjudicator's decision is binding on the parties until their dispute is finally determined in court/arbitration, even if erroneous
- “It is inherent in this scheme that injustices will occur because from time to time adjudicators will make mistakes...the victims of mistakes will usually be able to recoup their losses by subsequent arbitration or litigation sometimes they will not be able to do so, where, for example there is an intervening insolvency, either of the victim or of the fortunate beneficiary of the mistake”. (Bouygues -v- Dahl-Jenson [2000 B.L.R])

Stays of Execution

- Case law provides that a stay will be granted where there is sufficient evidence to demonstrate there is a “real likelihood” of non-payment in the event of a successful challenge or “credible evidence” of insolvency
- The threshold for stay appears to be high – all reported cases have involved formal insolvency proceedings rather than informal insolvency

How to use Adjudication

- If concerned about solvency bring claims early and do bring claims to get an enforceable decision
- If facing a claim take it seriously – the right to subsequently challenge in court may become irrelevant as an unsecured creditor

Adjudication & Formal Administration/Insolvency

- A claimant in administration or liquidation has the best of both worlds, protection against claims and a relatively low cost and quick procedure for collecting its debts
- This is because the claimant require the permission of the court to bring a claim against a company in administration and liquidation
- The case of *Straume -v- Bradlor* (2T.C.L.R) illustrates this
- The claimant (in administration) brought proceedings for non payment due to a failure to serve withholding notices
- Rights of set off were lost due to that failure
- Once the payment was made in the claim to recover sums the employer was an unsecured creditor
- The interchange of adjudication and insolvency is an area yet to be fully clarified. Not been in place during a major recession

CONSTRUCTION INSOLVENCY PART 3

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Overview

- Outline of UK insolvency procedures which may affect employers and contractors
 - which parties can initiate them and
 - concerns for affected parties
- How these procedures affect the parties' rights as outlined in previous talks
- Risks arising from inaction
- Risk mitigation

Insolvency Procedures - The Main Options for Insolvent Business

- Consensual informal rescue
- Formal insolvency
 - receivership
 - administration
 - voluntary arrangement
 - liquidation (voluntary or compulsory)

Receivership

- Remedy by secured creditors
- Receiver's principal duties are to the bank that appointed him (but some duties to other interested parties)
- Quick, inexpensive for simple jobs (often don't need an insolvency practitioner)
- No restriction on enforcing contractual rights but if unsecured may be worthless (so trust or secured claims valued)
- Difficulty with floating charge assets - don't inadvertently appoint an admin receiver (but NB a.r permitted for ppp, urban regeneration, project finance)

Administration

- Breathing space for business rescue and orderly realisation through administrator's chosen strategy - so best to be involved
- Out of court for floating chargeholders and directors or otherwise on court application
- Moratorium on creditor action (enforcement of security, repossession under HP agreement, landlord's forfeiture, court proceedings)

Voluntary Arrangements

- Deal between debtor and creditors/shareholders which binds all when approved by 75% of debts and 50% of shares
- Moratorium for negotiations for small companies and individuals
- Challenge for unfair prejudice and material irregularity within 28 days

Liquidation 1 - Compulsory

- Court petition on inability to pay debts (stat demand etc) or other grounds (e.g. just and equitable)
- Official receiver appointed on order but may bring in private IP
- Freezes business from issue of petition

Liquidation 2 - Voluntary

- Start by shareholders resolution (can be on short notice or in writing)
- IP approved by creditors (so exercise vote)

Parties Contractual Rights On Insolvency 1 - Employers

- Option to determine and
 - make account of sums due for work done and if necessary seize retention
 - appoint other contractors
 - take possession of materials for which contractor has been paid
 - use of plant etc

Parties Rights 2 - Contractors

- Option to determine and
 - stop work
 - account of sums due including materials ordered for project (and if necessary claim from retention)
 - remove plant and equipment

How Are These Rights Affected by Insolvency - Termination

- Does the right survive administration or va moratorium ? Probably - *Olympia and York, Amex v Adamson [1993]* not a legal process (but is it enforcing security?)
- Does the right survive liquidation ? Probably but arguments that it offends statutory order of priority

Effect of Insolvency on Parties Rights 2 - The Account

- The value of an unsecured claim
- Set off: liquidation and admin/receivership
- Retention - is it in trust? Is the trust valid?

Effect of Insolvency on Parties Rights 3 - Materials

- If title resides in contractor at date of insolvency clause should be effective but
 - problems with non-standard drafting - eg property passing on delivery
 - Supplier's retention of title
 - Competition with bank charge

Risks Arising From Inaction - Directors' Exposure

- Monetary loss but also...
- Wrongful trading/Directors' duties
- Disqualifications (and bankruptcy restriction orders)
- Transactions at undervalue and preferences

Risk Mitigation - Early Preparation

- Documentation: guarantees, security, enforceability and triggers
- Information: rights, collect and monitor
- Look for early signs: late payment, legal actions, repossessions
- Act early to assess options, take advice, exert your influence

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