CONSTRUCTION-RELATED INSOLVENCIES

Construction focus: Insolvency in construction

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The latest official statistics on insolvency make for sobering reading, particularly for those operating in the construction industry.

According to the government's figures, the total number of company insolvencies registered in 2021 was 11.5% higher than in 2020. Though that total remained below pre-pandemic levels, there has been a constant increase in the number of insolvencies per month since February 2021 and that number now stands at more than double what it was in February 2021, and 13% more than in February 2020 (before the pandemic took hold). In Q4 2021, after seasonal adjustment, the number of company insolvencies was 18% higher than in the preceding quarter, and 51% higher than in Q4 2020 – and it is within the construction industry that insolvency is at its most rampant. The government's commentary notes that:

> *… the construction industry tends to have the highest quarterly number of insolvencies of any industrial grouping…*

with 2021 seeing a 25% increase in the number of construction insolvencies from 2020 and construction experiencing the highest number of insolvencies of any industry in 2021.

With the various factors contributing to financial strife showing little sign of let-up in the near term, this article considers the key legal aspects to consider when a main contracting company becomes insolvent, and some of the practical steps that the employer should consider taking. However, first, the ongoing challenges faced by the industry are considered.

The specific challenges

There are a number of separate but closely connected factors that are combining to make life tough for construction companies, but all are underpinned by the Covid-19 pandemic, which had an immediate yet lingering impact on a construction industry already seeking to navigate the vagaries of Brexit. The pandemic, either by way of the virus itself or the attendant rules and regulations, caused a reduction in the availability of human resources in every element of the supply chain, with manufacture, freight and transport, labour, design and management all suffering significant disruption.

At site level, this reduction in the availability of labour has placed significant bargaining power in the hands of operatives, who are able to change sites from week to week depending on who can make the best offers. That has left contractors working hard to maintain an adequate work force, which translates into to an increase in the cost of labour. On a global level, supply chains were – and remain – severely impacted by Covid-19 along with a range of other factors: the average cost of shipping a standard large container was four times higher in 2021 than in 2020, and the average door-to-door shipping time for ocean freight increased by 70%. That, along with the continued effects of Brexit and disrupted global manufacturing output meant UK firms found themselves struggling to obtain the necessary materials to execute works, even if they had the required labour. The disruption to the supply chain meant that materials were limited, which inevitably caused prices to soar. As such, even if contractors could source materials, they were forced into paying suppliers at a premium, often well in advance and largely up front, a practice which will likely continue post-pandemic. That favours larger outfits willing and able to bulk buy materials at an early stage, causing further shortages and increasing the stress on smaller firms not financially equipped to do so.

To compound matters, contractors, already grappling with the effects of the pandemic, were hit with a significant change in the way VAT was accounted for in March 2021. In order to address concerns over fraud within the construction industry, the government introduced ‘the domestic reverse charge’ which required contractors to account to HMRC for the VAT of its suppliers, rather than it being the responsibility of the supplier. This caused significant cash flow detriment for many suppliers who relied on VAT payments as working capital to fund operations. For many suppliers already under considerable strain, this change represented another challenge to overcome.

The construction industry is particularly exposed to the factors considered above, given its total dependence on labour and materials, and its top-to-bottom reliance on delicately balanced cash flow. Contractors also suffered because of the prevalence of lump sum and fixed-price contracts in the UK, which provide greater scope and leverage for holding contractors to the originally agreed price, notwithstanding the contractor’s cost increasing. While contractors were initially able to obtain extensions of time and recover loss or expense, as the pandemic wears on, the opportunity for such relief is diminishing.

All of these challenges have made construction projects more difficult and more expensive (and so, less profitable) to complete and have stretched cashflows to, or past, breaking point. In short, they have been a recipe for insolvency for many firms. Although the construction sector recovered from the pandemic more strongly than other parts of the economy, the issues discussed above do not show signs of let-up and will no doubt now be compounded by the ramifications of recent rises in the cost of fuel. As such, the spectre of insolvency is likely to continue looming large over the construction industry.

Contractual consequences

So, what happens when a main contractor enters insolvency?

Unless it is expressly provided for by the contract, insolvency will not be a ground upon which an employer can terminate the contract. In that instance, it would need to wait for the insolvent contractor to fail to perform its contractual obligations and seek to terminate for a repudiatory breach. That is a route fraught with risk for the employer, and so it is common for parties to include provisions in their contract dictating what happens in the event of insolvency. Indeed, that is the approach taken by the standard forms, such as the JCT Standard Building Contract and JCT Design and Build Contract (together referred to herein as the JCT) and the NEC4 Engineering and Construction Contract (referred to herein as the NEC4), which are considered below in the context of limited companies.

The first thing to note about the insolvency provisions in the JCT and NEC4 is the prescriptive definition of insolvency. The JCT provides that a company is insolvent either:

- when it enters administration within the meaning of Schedule B1 of the Insolvency Act 1986 (ie enters administration);
- on the appointment of an administrative receiver or a receiver or manager of its property (ie enters into receivership);
- on the passing of a resolution for voluntary winding-up without a declaration of solvency or on the making of a winding-up order (ie liquidation); and
- when it enters into an arrangement, compromise or composition in satisfaction of its debts.

The NEC4 lists the same insolvency events, although in less particular language.

The prescriptive definitions are important for parties to be aware of. Firstly, they mean that the test for insolvency under those contracts is narrower than the general tests for insolvency, such as whether a company is unable to pay its debts as they fall due or whether the value of a company's assets is less than the amount of its liabilities (as used by the Insolvency Act 1986). Rather, under the JCT and NEC4, the insolvency provisions will only come to life upon the occurrence of one of the specific events listed above. Secondly, it is doubtful whether the new restructuring and insolvency procedures introduced by the Corporate Insolvency and Governance Act 2020 (CIGA 2020) would constitute insolvency events under the JCT or NEC4.

An immediate protection that both the JCT and NEC4 affords to employers upon a contractor's insolvency is the *option* to terminate the contractor's employment upon notice at any time. Note that termination is not automatic (although under the JCT, the contractor's obligations to carry out and complete the works will be automatically suspended upon its insolvency, rather than upon termination). That is important for two reasons. Firstly, it provides scope for the employer to continue with the contract if it wishes (on which, see further below). Secondly, it means that if the employer wants out, it has to take steps to actively terminate the contractor's employment.

Additionally, each contract contains provisions that will alter the employer's payment obligations, although the triggers for those provisions differ under the JCT and NEC4. Under the JCT, upon the contractor's insolvency, no further sum shall become due to the contractor (save as prescribed by the balancing up provisions discussed below). Moreover, the employer need not pay any sum that has become due (ie, a notified sum for which the due date has passed) if the employer has served a pay less notice or, importantly, even without a pay less notice if the insolvency event occurred *after* the last day for serving a pay less notice (except in cases where the contractor has entered into an arrangement, compromise or composition in satisfaction of its debts). Note, however, that if the insolvency event occurred *before* the last day for serving a pay less notice, if the employer wishes to withhold payment, it must serve a pay less notice.

The NEC4 provides for a similar suspension of the employer's payment obligations, however, that suspension does not take effect until termination has been certified, rather than being automatic upon insolvency.

The JCT also expressly provides that, upon the occurrence of an insolvency event, the employer may take reasonable measures to ensure that the site, the works and on-site goods and materials are protected or retained, with the contractor prohibited from interfering with such processes.

In the event that the employer terminates the contractor's employment on the basis of the latter's insolvency, each contract also contains practical protections related to the completion of the works, including:

- the employer having the right to enter onto the site, employ and pay other persons to complete the works and use all plant, equipment, materials, temporary works and buildings to complete the works (even if they are the contractor's);
- an obligation on the contractor to, if required by the employer, remove its temporary works and buildings, plant, equipment and materials from the site; and
- an obligation on the contractor to, if required by the employer, assign to the employer the benefit of any agreement for the supply of goods, materials or works (the JCT expressly provides that this must be without charge and within 14 days).

The JCT also expressly stipulates that the contractor must provide the employer with copies of all the design documents relating to the works.

Once the dust has settled, each contract then provides for a balancing up exercise to take place, pursuant to which, in summary, (a) the total amount the contractor would have been paid had it completed the works is deducted from (b) the employer's total costs of completing the works. To the extent that (b) exceeds (a), that sum shall be due to the employer; to the extent that (a) exceeds (b), that sum shall be due to the contractor.

However, there is a significant difference between the two contracts regarding when that process takes place and when the payment becomes due. The NEC4 requires that the assessment of the final balance and certification of the final payment take place no later than thirteen weeks after termination. Hence, as part of its calculation of (b), the NEC4 requires the employer to account for:

> *… the* <u>*forecast*</u> *of additional cost to the [employer] of completing the whole of the works.*

In contrast, under the JCT, the employer has until three months after the completion of the works and the making good of defects to provide the contractor with its statement of account setting out sums (a) and (b), which may be quite some time after insolvency. That will likely be a significantly longer period than is allowed under the NEC4 and means that the employer may deduct its *actual*

> *… direct loss and/or damage…for which the Contractor is liable, whether arising as a result of termination or otherwise…*

rather than its costs as estimated 13 weeks after termination.

The insolvency provisions of the JCT were recently considered by the High Court in the case of *Levi Solicitors LLP v David Frederick Wilson, JKR Property Development Limited* [2022]. While the case considered the JCT Minor Works Contract 2011 (MWC), the relevant provisions are precisely the same in the JCT contracts discussed in this article, and so the useful clarification and guidance given in the judgement will no-doubt apply thereto.

In *Levi*, the three-month time limit within which the employer must serve the statement of account required by the MWC (and the JCT as discussed herein) was, for various reasons, not met by the employer. However, Fancourt J found that the three-month time limit was not intended to be a strict one and that submission of the statement of account within that time limit was not a condition precedent to payment to the employer. The judge noted that:

> *… it is not beyond reasonable contemplation that [the employer] might have been unable, even within the generous period of 3 months, to put a figure on any direct loss or damage suffered.*

and held that an employer:

> *… would be entitled to provide a statement of the account and claim the balance at any time before the expiry of the limitation period.*

(although in practice, it is advisable to take that step as early as possible).

Fancourt J also found that, unless the parties agree an ad hoc variation to the JCT to the contrary, upon an event of insolvency, the regular payment provisions governing stage payments and the final payment will fall away and be substituted by the balancing up provisions in the termination clause, under which, per the express terms of the JCT, the sum calculated in the statement of account becomes due as a debt to the payee.

Practical steps

Upon insolvency, given the potential risks associated with paying an insolvent party, consideration should first be given to whether the employer has the right (as in the JCT) to withhold payment to the contractor, and whether it should exercise that right, even if only while deciding what to do next.

As explained above, the JCT and NEC4 grant the employer the *opportunity* to terminate; termination does not happen automatically and so there is the possibility of the parties continuing the contract. As such, another early step is for an employer to consider whether it wishes to try and continue the project with the existing contractor or terminate the contractor's employment.

Continuation

Administration and receivership do not necessarily spell the end of the road for a company and so, while there will be increased risks, (save where the contractor is in liquidation) it may be the lesser of two evils to stay the course with the existing contractor.

When making this decision, various factors will need to be considered, including, *inter alia*:

- the stage the works had reached when the contractor became insolvent and the complexity of any remaining works;
- the contractor's ability to survive the insolvency procedure and complete the works;
- obligations owed to third parties, including with respect to timing of completion of the works and the procurement strategy;
- whether there is a parent company guarantee in place which requires the parent company to guarantee or step in and perform the contractor's outstanding obligations?; and/or
- how difficult and costly it would be to find a replacement contractor who is willing to take over and complete the works.

It should also be borne in mind that, as a consequence of section 233B of the Insolvency Act 1986 (introduced by CIGA 2020), notwithstanding a contractor's insolvency, its subcontractors or suppliers will remain bound to perform their subcontracts or supply agreements. Section 233B affords considerable protections to customers (such as main contractors) who entered insolvency proceedings on or after 26 June 2020 (when CIGA 2020 came into force) by preventing suppliers (such as subcontractors) from:

- exercising any right they have to terminate that is based on the customer's insolvency, even if there are express contractual provisions allowing termination on that basis (s233B(3));
- doing 'any other thing' or allowing 'any other thing' to take place because of the customer entering insolvency procedures (which could include a change in the payment terms, for example) (s233B(3));
- relying on an event which occurred before the customer entered insolvency proceedings as a reason for termination post-insolvency (s233B(4)); and
- making it a term of continued supply that they be paid any outstanding sums relating to the supply pre-insolvency, (s233B(7)).

In short, a main contractor's supply chain must continue as normal which, while potentially unpalatable to the subcontractors and suppliers, improves the opportunities for project continuation, provided sufficient cashflow can be established and maintained.

A final point to note in relation to the JCT is that, as a result of the JCT suspending the contractor's obligation to complete the works upon insolvency, the employer has no contractual right to unilaterally compel the contractor to complete the works. As such, to continue a JCT, the contractor must be willing to complete the works, in which case, as noted in *Levi*, the parties would need to agree to vary the contract in order to reverse the suspension of the contractor's obligations (and also reactivate the payment provisions).

Termination

If termination of the building contract is the preferred course of action, then the requisite contractual notices should be served, and immediate steps should be taken to secure the site, especially if site security is the contractor's responsibility. This will prevent trespassers, the contractor or subcontractors from removing materials, or even works, from the site, possibly as leverage for payment for any unpaid works (note that under the JCT, it is possible to take this step upon insolvency rather than waiting for termination).

Next, the employer must consider whether insurance is required to be taken out to ensure the works are being protected and that third-party duties have been discharged (under the JCT and NEC4, a contractor's obligation to insure falls away on termination of the contract).

In assessing how best to complete the remaining works, the employer should assess how the works have progressed, what remains outstanding for completion, whether it wishes to engage any of the existing subcontractors or suppliers and what procurement route would be most suitable. From there, the professional team should be instructed to ascertain all information required to enable completion, which may include procuring contact details for all subcontractors and suppliers, and obtaining copies of any contracts, drawings, specifications or other documents relating to the works. The contractor should also be requested to assign the benefit of any supply agreements or subcontracts, which the JCT and NEC4 obliges it to do upon request.

Prior to recommencement of the works, the employer must consider whether any third parties need to be notified; it is not unusual for the approval of any bank or fund to be required for the recommencement and completion of the works.

Finally, the employer must take steps to protect its position in respect of any losses incurred as a result of the termination. The employer will need to prepare for the accounting process by which the final payment under the contract is established, and as part of that exercise, the employer will need to establish its losses arising from the termination. Under the JCT, this process takes place once all defects are rectified, and so a detailed record of all of the employer's actual costs incurred as a result of the contractor's termination must be kept. That would include any direct loss or damage for which the contractor is liable, whether arising as a result of termination or otherwise. However, under the NEC4, the employer must submit its account within 13 weeks of the termination, which may be some time before the completion of the works and quantification of the employer's actual costs. As such, it will need to prepare substantiated estimates of its costs which should provide for adequate contingencies.

The employer should also check what documentation, such as proofs of debt, it must submit as part of the contractor's insolvency procedure, and what the deadlines are for doing so, in order that its claim against the contractor is properly registered.

Conclusion

The challenges faced by the industry show little sign of let up. As recently as 21 March 2021, Mace's Group Chairman and Chief Executive, Mark Reynolds, told the BBC's Today Programme that the industry continues to face cost pressures across the range of fundamental materials, such as steel, concrete, cladding, aluminium, M&E components and plasterboard, as well as wage inflation. As a result, it seems that the trend of rising insolvencies in the construction industry may well continue throughout 2022. It is therefore imperative that employers properly understand the legal position upon a contractor's insolvency and remain aware of any further legislative or judicial developments in the law surrounding construction insolvency.

Cases Referenced

- Levi Solicitors LLP v David Frederick Wilson, JKR Property Development Limited [2022] EWHC 24 (Ch)

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