Insolvency in The Construction Industry

Over the last five years, the construction industry has seen insolvency rates rise the quickest out of any other industries across the UK. We consider the common factors of insolvency in construction and look at how to protect your position if insolvency occurs.

Insolvency is defined as a state of financial distress; this can often mean that a company is unable to pay debts as and when they fall due, or, from a balance sheet perspective, that the value of a company's liabilities being greater than the value of its assets. Each can result in a company being placed into liquidation or administration. The aim of these processes is to recover all available assets, enabling them to be disposed of to generate proceeds which can be distributed to creditors to satisfy their debts.

Records are understood to show that in the 12 months to the end of September 2018, out of a total of 17,439 insolvencies, 2,954 of these were in construction, representative of 12% increase. As you will be aware a major contractor falling into insolvency was the construction firm Carillion, whereby we saw their dramatic collapse in 2018.

One of the key reasons for Construction Insolvency is the delay between works being performed/completed and payment being received (the progress since the publication of the Latham report in this regard is questionable!). Most contracts provide interim payments in arrears. This delay in funds being made available can result in the business suffering cash flow issues as some contracts have in excess of 90-day term set for invoices to be paid, or in some cases, not being paid at all. Late payments coupled with bad debt are usually the main triggers of insolvency.

In addition, heavy competition can drive down margins resulting in a lack of profitability on projects which affect the Construction Industry (as well as businesses) of all sizes. The Construction Industry understood to be contributing approx. 7% of GDP means it is a large industry, but it is also a highly competitive one. With tenders often decided on a price metric, the lowest price tender is often the most successful, so any unexpected delays or increase in material cost, currency fluctuations and rising labour costs (from submission of the tender) results in the contractor working to an even smaller margin. With the pressure to ensure job profitability coupled with a cash flow issue, should a dispute arise regarding payment and valuations could leave the business at risk of insolvency.

Lastly, we have the all-important domino effect occurring when a party higher up the chain becomes insolvent, for example a main or sub-contractor. The failure of one business can have major repercussions for others in the chain reliant on the income from the project to continue their works.

The Courts' interpretation of 'insolvency'

The Courts, when determining insolvency view it in strict accordance with its definition in the contract, even when the contract refers to an out of date non-exhaustive list of insolvency processes.

In Case Law (or Common Law), insolvency by itself is not a breach of contract. Its effect, however, can result in a repudiatory breach of contract meaning the contract could be ended regardless of whether the contract contains any termination provisions or not.

The Insolvency Act 1986 says a company is “insolvent” when it cannot pay its debts as and when they fall due, yet under clause 8.1 of the JCT Standard Building Contact a party, (which is a company), is taken to be insolvent for the purposes of the contract where a recognised

insolvency procedure has been invoked, for example a company has passed a winding up resolution or has entered into an arrangement or compromise of its debts with any creditors. As a result under the JCT contract, the fact the company is unable to pay their debts when due, is not sufficient enough for it to be insolvent contractually, although this may lead to a formal insolvency procedure being invoked to make the company insolvent for the purposes of the contract. The status of the insolvency needs to be carefully considered; in addition, it must be ensured that all parties follow the correct contractual formalities to avoid any claim of wrongful termination IF insolvency is relied upon to terminate a contract.

Warning signs of insolvency

There are many significant early warning signs that a "party" (employer, contractor/sub-contractor) may be having financial difficulties which may include any of the following

1. Late/non-payment of supply chain invoices/employees' wages
2. Persistent rumours within the industry about their financial position
3. Late filing of accounts or annual returns at Companies House
4. Unsatisfied court judgements, County Court Judgements or High Court Writs being issued against them
5. Creditors issuing winding up petitions
6. Cash flow issues
7. Personnel removed from the project unexpectedly.

Reduce the risk of Insolvency

When negotiating contracts, parties should consider all of the below, which is not an exhaustive list;

1. Obtain references/credit checks.
2. Auditing of the contracting party's financial status at the time of contract negotiation can be a good indicator of future performance.
3. Third Party (Rights Against Insurers) Act 2010. This legislation enables claimants to bring proceedings against the insurers of defaulting insolvent companies, it may also assist an employer if latent defects arise after practical completion at a time when the contractor has become insolvent as the defects may be covered by the insurance policy.
4. Retention of title clauses can enable an unpaid party to get back goods/materials belonging to them prior to full payment being made. These clauses however need to be properly drafted, and title to goods often passes to the buyer when the goods have been incorporated into the building / attached to the land even if the supplier is unpaid.
5. Having collateral warranties create a direct contractual relationship between the contractor and all parties, i.e. consultants, subcontractors and the employer - by which the consultant or subcontractor warrants to the employer that it has complied

with its appointment/subcontract. This enables the employer to pursue them for defects despite not directly appointing them.

6. Communication is an important factor, as a creditor, any debtor must consider your interests when experiencing cash flow issues. Arranging agreements with debtors that spread payments can help avoid insolvency occurring. If insolvency occurs, parties can negotiate with Insolvency Practitioners to reach mutually agreeable solutions such as ensuring works are completed, and the site is secured.

7. Maintaining records which demonstrate the losses arising out of the insolvency to include the recording of materials and equipment that are on site, items/materials already paid for being especially important; this can help safeguard a party's interests should insolvency occur.

8. Initiating adjudication prior to the other party becoming insolvent can mean the difference between securing payment should insolvency occur and avoid being at the end of the queue of unsecured creditors. You should always consider formal dispute resolution options prior to impending insolvency as adjudication cannot be pursued against a company in liquidation/administration.