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May/June 2015
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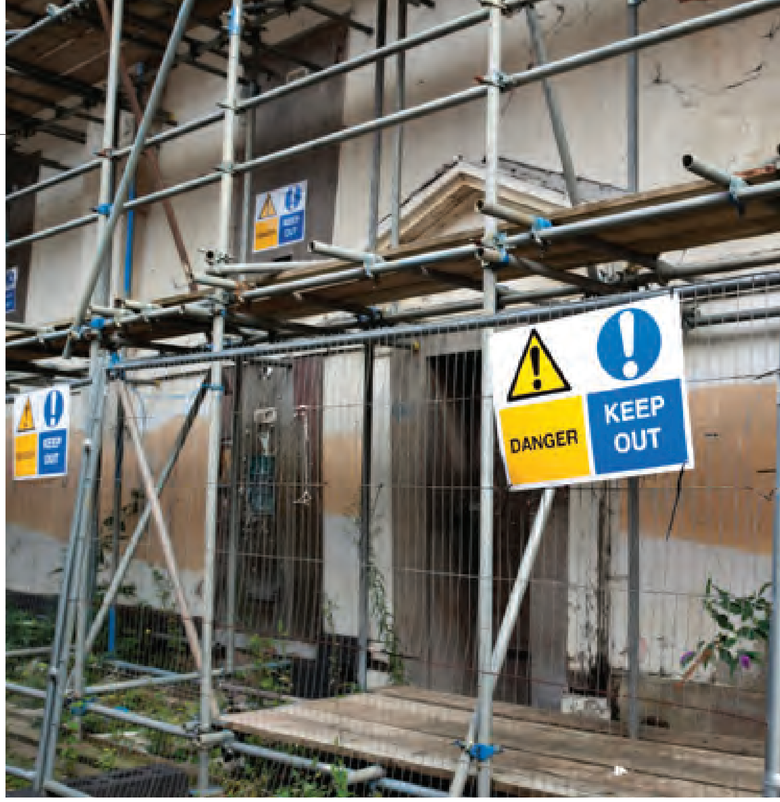


Going bust

Alistair Allison sets out the steps to be taken when a contractor runs into financial difficulty

Over recent years, the construction industry has experienced a significant lean period. This is characteristic of the cyclical, 'boom or bust' nature of the sector, due to its inflexible make up, the diverse range of stakeholders, and the timescales involved from inception to completion of projects.

Arguably, contractors are most at risk during such times, with their ability to survive being highly dependent on a number of factors they cannot control. These include their existing pipeline of work, the availability of finance or cash in the bank, the stability and depth of their supply chain and the ability of their employers to meet the payment demands.

Construction Act changes

The government's amendments to the Construction Act in 2011 could be seen as a reaction to the changing economic conditions and go some way to help manage the issues with insolvency, as well as the main contributing factors.

One of these changes is to stop the knock-on effect in the construction supply chain by prohibiting conditional or 'pay when paid' clauses in contracts, meaning the pain cannot be shared. While this is good news for subcontractors, it could be seen as adding further pressure to main contractors.

Similarly, the changes sought to address the previous 'pay now and argue later' ethos, making exceptions to the payment rules where a contractor is no longer solvent. Insolvency arising from the inability to meet payment demands benefits neither the employer or the contractor and can have a damaging knock-on effect to the wider supply chain and stakeholders.

It is important to consider not only what could/should happen if a contractor becomes insolvent, but also what can be done in advance to reduce the probability and impact of the worst happening.

Pre-contract risk

While it is almost impossible to remove the risk of insolvency affecting a project entirely, various steps can be taken to significantly reduce it.

First, when considering contractors for a tender list it is prudent to undertake checks to establish whether there are any obvious financial concerns. The extent of any checks (and who carries them out) will depend on the type of project, the duration, and supply chain reliance. All these factors contribute to the risk profile, and should identify any 'red flags' that may warrant further investigation or the removal of the contractor from the list.

The requirement for a performance bond (PB) or a parent company guarantee (PCG) as part of the contract terms can provide further protection against non-performance, enabling the employer to rely on a third party to take responsibility for completing the works, or financially compensate for an element of the subsequent costs relating to the completion of the works.

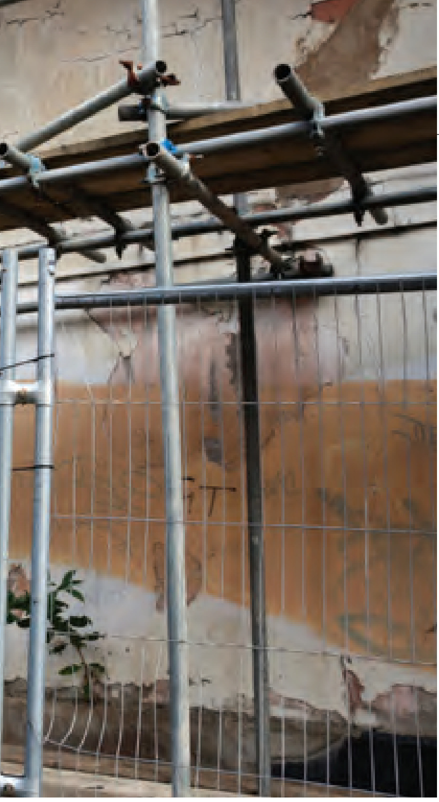
It should be borne in mind that the cost of PBs and PCGs will inevitably be passed on to the employer in the tender pricing. Typically, PB cover is also limited to 10% of the contract sum, so the added cost makes them less useful for lower value or shorter projects.

If advance payments are needed to cover procurement costs or high cost/long-lead items (e.g. lifts, works of art, large items of plant, steelwork), it is vital that this is formalised with an advance PB or similar arrangement. A PB of this type essentially provides a guarantee from a surety (usually a bank or bondsman) to pay back the advance payment or properly vest the ownership to the employer in the event of the contractor failing to perform their associated duties under the contract.

Post-contract risk

Once the contract has been awarded, proactive management can be valuable in identifying early signs of a contractor running into difficulties, well before any formal insolvency proceedings are initiated. Warning signs include:

- progress slipping behind the programme
- reduction in the workforce and/or materials on site
- overzealous approach to payment applications and/or or making spurious variation claims
- rumours in the 'market'
- chasing payments before they are due.



If, as the contract administrator, you suspect there are financial difficulties, it is extremely important to keep it confidential, other than to notify the employer and raise your concerns with the contractor. Sharing the information with any other party runs the risk that the rumours will spread and drive the contractor into more serious difficulties. Subcontractors and suppliers are likely to cease work, remove materials, and/or rescind credit, thereby exacerbating the problem.

If or when you suspect financial difficulties, and having discussed with the contractor, there are various steps that can be taken to 'manage' the problems and, if workable, avoid premature termination where there is a good chance that the contract can be completed without issue. For example, it is not unreasonable, prior to agreeing a valuation, to require the contractor to prove that they have settled their subcontractor invoices due under the previous payment. This ensures that the employer is paying for the works rather than covering other debts, and that the supply chain remains engaged.

Similarly, it may be possible (subject to the employer's accounting limitations) to agree shorter payment intervals, to relieve cashflow problems. Obviously more detailed management of the programme and a contingency plan can also help.

Managing the impact

Because of the potential complexities, the RICS *Termination of contract corporate recovery and insolvency 1st edition* guidance note (*http://bit.ly/15g485q*) limits the associated advice in relation to the insolvency of a contractor. It suggests: *"If a contractor goes into administration or liquidation during the life of a building contract the contract should be checked to establish the procedures to be followed."* This is sound advice.

The various forms of JCT contracts differ slightly in their wording, but in principle a contractor is considered insolvent if they have entered into a compromise agreement in satisfaction of their debts, appointed an administrator, made a determination to be wound up or have a bankruptcy or winding up order made against them.

Under all of the main forms of the JCT suite, if the contractor becomes insolvent the employer may at any time terminate the employment under the contract.

The formalities of serving a termination notice should always be fully understood and be complied with, however the simple principles are:

- Any notification letter should be signed and sent by recorded delivery by/on behalf of the employer. The contract administrator (or solicitor) is likely to draft the wording.
- The notification letter should be served directly on the contractor at its registered address in accordance with the contract's provisions for notices and communications.
- A copy of the notice should be sent to the contractor's insolvency practitioner.

As soon as is practical following the termination of the contractor's employment, the site should be shut down and secured, with all goods, materials and plant retained. While this will inevitably create unrest and frustration for suppliers and subcontractors, the JCT contracts allow for the employer to complete the works using any temporary buildings, plant and tools, subject to obtaining any necessary third party consents.

Similarly, it is likely that even though suppliers may not have been paid for materials, they have been incorporated into the works and/or paid for by the employer. Until any proof to the contrary is provided, the assumption that all materials on site belong to the employer is reasonable and helps to limit their potential losses.

Once the site had been secured, the employer has various options for completion that should be considered fully with the project team and their legal advisers. These include:

- not completing the works
- employing another contractor to complete the works
- working with the insolvency practitioner to come to an agreement for the works to be completed
- enforcing the terms of a bond or guarantee, if the obligations are for completion of the work rather than making a proportionate payment.

There are specific timescales within which the employer must provide the contractor with a statement setting out the costs and expenses incurred in relation to the termination of the contract (and/or completion of the works where appropriate). This should include:

1. The amount of any expenses incurred by the employer (including direct loss or damage)
2. The amount of the payments already made to the contractor
3. The total amount that would have been payable for the works in accordance with the contract.

If the amounts under 1 and 2 exceed the total amount under 3, the difference will be claimable as a debt payable from the contractor to the employer. Equally, if the amounts are less than 3, then the employer must repay the associated balance to the contractor.

The process of terminating a contract is specific to the contract in place and must be carefully considered and implemented with the assistance of legal professionals, as appropriate.

The general principles described above are not without their intricacies but show the options to consider and the steps that can be taken to mitigate the impact to clients as employers under building contracts.

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