

# Construction Law

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## A guide to surviving main contractor insolvency – for employers

When a main contractor becomes insolvent mid-project, the impact is far reaching. A crucial link in the contractual chain required for successful completion of building projects falls away. The employer faces the disruption of replacing the main contractor, retention of title claims from sub-contractors, an inability to recover over-payments, the loss of skilled workers with specific knowledge of the project and a delay to completion. Sub-contractors face non-payment and uncertainty as to their continued involvement in the project. This guide suggests methods of risk management for employers. A subsequent bulletin will provide guidance for sub-contractors.

### Definitions of insolvency

A company is deemed to be insolvent when it satisfies one of the two tests under s123 of the Insolvency Act:

- Section 123(1)'s "cash flow" test is met if there is an unsatisfied statutory demand, an unsatisfied execution of a judgment, decree or order of any court or it is otherwise proved to the satisfaction of the court that the company is "unable to pay its debts as they fall due".
- Section 123(2)'s "balance sheet" test is met if it can be proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its continued and prospective liabilities.

Section 123 defines insolvency more widely than most standard form contracts.

### JCT definition

"8.1 For the purposes of these Conditions, a Party is insolvent if:

1. he enters into an arrangement, compromise or composition in satisfaction of his debts (excluding a

*scheme of arrangements as a solvent company for the purposes of amalgamation or reconstruction); or*

2. *without a declaration of solvency, he passes a resolution or makes a determination that he would be wound up; or*
3. *he has a winding up order or bankruptcy order made against him; or*
4. *he has appointed to him an administrator or administrative receiver; or*
5. *he is the subject of any analogous arrangement, event or proceedings in any other jurisdiction; or*
6. *(additionally, in the case of a partnership) each partner is the subject of an individual arrangement or any other event or proceedings referred to in clauses 8.1.1 to 8.1.5"*

### Termination

Termination of an insolvent contractor's employment and suspension of payment obligations may be automatic under the contract if the contractual test for insolvency is satisfied. However, the fact that a company might arguably be deemed insolvent under Section 123 does not necessarily mean that an insolvency practitioner will be appointed. Statutory demands and judgment debts are frequently satisfied or set aside without the contractor

concerned entering into a formal insolvency arrangement as required to activate most standard form termination provisions.

An employer would therefore be wise to obtain proof of entitlement to terminate, such as a letter confirming appointment from the administrator or liquidator of the main contractor, or confirmation from the Companies Register before serving any notice of termination. Purporting to terminate on the basis of rumour alone or other inadequate grounds will probably amount to breach of contract. If the correct procedures are not followed the 'terminator' may face a substantial claim e.g. for loss of profit. For an example of a construction contract in which entry into administration did not lead to a finding of insolvency, see *William Hare v Shepherd Construction* [2010].

Conversely, if termination is brought about in accordance with the terms of contract, then the employer may be able to set off any costs arising out of the termination such as the cost of appointing a replacement contractor, rectification of defects and duplication of effort.

If the contractual test for determination on the basis of insolvency is not satisfied, it may be possible to terminate on other grounds

such as “failure to proceed regularly and diligently with the works”, although the consequences of determination might differ.

#### Typical JCT insolvency provisions

A typical JCT main contract clause provides that if the contractor is insolvent:

- the contractor is obliged immediately to inform the employer in writing;
- the employer may by notice to the contractor terminate the contractor’s employment;
- whether or not the employer has given notice of termination, the contractor’s obligations to carry out and to complete the works are suspended;
- the employer’s payment obligation is suspended until after completion of the works and making good of defects;
- the employer is obliged to take reasonable measures to ensure that the site, works and site materials are adequately protected; and
- the contractor is prohibited from hindering or delaying those measures.

If the contractor’s employment has been terminated correctly, the employer is at liberty to employ and pay others to carry out and complete the works and use all temporary buildings, plant, tools, equipment and site materials for those purposes.

After completion of the works and making good of defects the contract administrator prepares a final account. This sets out any sum due to the insolvent main contractor after deduction of the employer’s expenses incurred as a result of the termination.

#### Advance measures - employers

The most effective method of avoiding main contractor insolvency is to employ the right main contractor. Employers should not be tempted to accept the lowest tender submission on principle. The trading history and financial position of those submitting tenders should be carefully reviewed and a financial risk assessment made.

Be alert to warning signs such as requests for payment in respect of large cost items before they arrive on site, disgruntled sub-contractors complaining about non-payment or disappearing from site, slow progress and strategies such as requesting additional information to allocate blame elsewhere.

Employers can improve their legal protection against main contractor insolvency by obtaining subcontractor warranties at the outset, obtaining performance bonds and / or parent company guarantees and carefully managing the transfer of title to materials included in interim certificates.

If you are relying on a parent company guarantee or performance bond for protection against main contractor insolvency, check:

- Is the guarantor the ultimate holding company?
- Does the guarantor have adequate assets to meet any liability?
- Does the guarantee indemnify you for any claim arising out of the main contractor’s works even after insolvency?
- Is insolvency an event of default?

- Does the guarantee/bond survive any material variation in the main contract?
- Will the parent company /bondsman satisfy and discharge any adjudicator’s decision?

#### Conclusion

“The collapse of mid-sized contractors has become a motif of the recession.” – Building Magazine 23 July 2007. By taking preventive steps, the rest of the project team can reduce the knock on effect of main contractor insolvency.

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*This “reliable group of highly skilled construction lawyers” draws praise for “its ability to break down complicated legal issues and convey them in a readily understandable way”.*

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