Constructive criticism

A disturbing new scenario which should be of interest to all banks, funders, factors, directors, creditors, stake-holders, insolvency practitioners and recovery professionals

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In the last few years, we here in the construction industry have seen a lot of changes. First there was a new Arbitration Act in 1996 which, as an art-form, was, and is, a brilliant piece of legislation and one of the clearest and most sensible ever written. Why is this relevant? Because the construction contracting industry is historically and singularly the biggest user of arbitration around. Why? Because it is belligerent, argumentative and stubborn of course, but also because it simply is not allowed to make enough money by doing what it is supposed to do, i.e. build buildings for people who want them, so it uses the most complex of contract conditions to try, quite successfully, to trip other bits of the same industry up over the odd comma, full-stop and semi-colon.

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So off to arbitration it is – there's no choice in the matter – the dispute 'will' be referred to arbitration, not 'may', where the participants have the pleasure of paying for the room, and the arbitrator too, as opposed to the rest of civilised society who get a nice judge free of charge and a courtroom thrown in for the duration. Of course, the participants – or shall we call them 'belligerents' – do get a nice arbitrator from the industry who professes to know a spade from a shovel and a batt from a butt. So what does he know? Well, apparently everything about the facts and nothing about the law, and that's the law, so it's off to the proper court at the end of the day to get the nice judge to sort out those law bits, but without questioning any of the facts as seen by the arbitrator. Never mind that he fixed the facts to fit the law. Urgh. '…and that arbitration we won was just soooo expensive – nearly sent us bust…'

Following the serious injury incurred in the aftermath of the property price crash in 1989/90, the industry had an intense navel-gazing session and came up with The Housing Grants, Construction and Regeneration Act 1996 – and very wonderful it is too! Eight years later the great and the good are still discussing and dissecting every inch of it, and the plethora of case law that has followed. It gives all sorts of new rights to…well, just about everyone in the industry. The right to a quick fix adjudication in just 28 days (in which the poor old adjudicator only has time to use a combination of coin tossing, dice throwing, and pulling petals off flowers to decide immensely complicated issues; new, improved payment terms apparently spirited into the construction contract as of right; the right to suspend performance and go home, and so on.

Of course, the industry being what it is, the great masters of belligerence (by and large the main contractors and the larger of the specialist subcontractors) have long since ensured that their self-penned contract conditions bring the balance right back in their favour and generally against the subcontractor – 'we can determine your employment with two days' notice, but you have to give us 30 days' notice if you want to suspend performance because we haven't paid you'. A sort of nah-nah-ni-nah-nah-nah approach to contract drafting. It's all there, written in the 18-inch thick bible calling itself 'contract document'. The evident fact is that the most devious of these 'special' clauses are never noticed by the subcontractor – desperate for the next job – let alone understood, and the majority of rank and file local contractors have still never heard of the Housing Grants, Construction and Regeneration Act. Then again, with a title like that, why should the local bricklaying subcontractor with a £250k overdraft and a Mercedes pick-up truck know or care about such things – he's got a business to run.

The same masterful piece of good intent – good enough to shave 30% off the cost of construction – or so it was thought at the time, inevitably ended up with a string of see-saw judgements by the proper judges that really make the whole deal look far worse than ever, and still the belligerents continue to knock seven bells out of each other with increasing vengeance, keeping an army of construction lawyers in very gainful employment.

Another wonderful attempt in the Housing Grants, Construction and Regeneration Act to bring some fairness to the industry was the outlawing of so-called 'pay-when-paid' (a.k.a. pay-if-paid) clauses except in the circumstances of the employer or end-client insolvency. The effect of this did no more than to encourage all main contractors to put a pay-when-paid clause into their subcontracts explaining away that it was not effective until they got stitched up by their client. What earthly use was that? It's apparent that the poor subbie now needs to gamble not only on the ongoing solvency of the main contractor he's jumping into his contractual bed of nails with, but also the main contractor's client, 'New Building Owner No 2987 Ltd' in case he does a runner with the last instalment. Why on earth anyone thought it right and proper that pay-when-paid could justifiably apply when things go horribly wrong for the main contractor (nothing to do with the subcontractor remember), and not in the ordinary course of regular dealings is frankly beyond my understanding. Nevertheless, that's what we got in the act in the pursuit of fairness.

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In the meantime, the subbie owner is each week reading the 'New Tenders' pages of *Building Magazine*, eyes glazed at the thought of all those

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new contracts, when just a few years ago he was struggling to get the job of the high street hairdresser's new shop-front. His estimating department is churning out tenders at an alarming rate, doing what it does best – deciding the meticulous virtues of a pile of drawings which touch the ceiling (or more likely nowadays fill the hard-drive) and whether the rate for the left-handed oogimaflip in the duplegromet thingummy is £7.28 or £7.29, and, according to the probably out-of-date drawings, there's 14,687 of them.

So in all the haste, the clauses which set out the rules of the game get overlooked, the tender goes in and before you know it, he's at a pre-contract meeting (after making sure that he parks the Merc out of sight), saying 'yes' to just about anything through his salivating mouth, with a promise that he can start the design work tomorrow…and he finds himself in the biggest pile of contractual dog poo imaginable, and doesn't even know it. In fact, in many cases he never ever will.

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Ah well, I suppose that ignorance is bliss and when his company fails, he can blame the bank, blame the architect, blame those horrid main contractors, tell himself it was just one bad job out of a hundred good ones, put in an offer for a few vans and a computer full to overflowing with e-mails to 'Fred' the site manager (mostly about nothing), plus 9,000 revised drawings, get some white paint to blot out the sign-writing and the digital equivalent for the hard disk and start again. And over to you, Mr and Mrs Insolvency Professional. Never mind that he's left the bank with a £250,000 overdraft, plus 50 18-inch piles of contract documents and 500 lever-arch files of correspondence, mostly about the left-handed oogimaflip in the duplegromet thingummy.

Now then, we all know how difficult it is to recover those nasty contract debts. No matter whether they are so-called book debts (actually quite rare in contracting), those old fashioned retentions (which I assure you will never go out of fashion), final accounts and the supposed contractual claims, they always take forever to collect and inevitably get a severe pounding from the effect of defects ('the oogimaflip's fallen off'), the cost of the remedials ('it costs £728 to replace each oogimaflip and there's 14,687 of them'), additional completion costs ('no-one would tender just for the oogimaflips so we had to have 16 men on daywork for three months putting them right'), and of course delays ('we, of course had to supervise the oogimaflip replacement operation, which meant us having the whole site set-up on site, including the canteen, for another three months at a cost of £20,000 per week – its health and safety y'know'), and the so called 'penalty clauses' ('the client has charged us three months delay at a rate of £50,000 per week'). And not forgetting the other 10 subbies on site who nobody particularly has ever cared about but, in this spectacular instance, each of whom was held up by three months and submitted their own claim for whatever it could think of.

So what's new?

As if it wasn't all bad enough, what is new is the introduction by at least one large main contractor of a 12 year suspension of payments clause in the event of its subcontractor entering an insolvency procedure and having its employment 'determined' or terminated under the subcontract. Yes, you heard it right! 12 years – on the basis that this is the duration of the main contractor's liability for the (as yet non-existent) defects under his contract. So…that's 12 years before you can advise the debtor about the seven changes of practitioner since, start the recovery and get down to those gripping discussions about the as yet unagreed final account and, of course, those oogimaflips.

Never mind the difficulties you had before in squeezing blood out of the stone. Even if you've got in an expert in oogimaflips on your side and got around alleged delays and the rest of the cross-claims (you might even have had a nice adjudicator smile on you, or an even nicer arbitrator write his lovely award entirely in your favour, or even have had a judge or two sort it out in eloquent excellence), unless you're prepared to wait for 12 years from the date the building was complete before you even knock on the main contractors door for the cheque, there'll be no recovery at all. The main contractor, with this nifty little wheeze, will profit…well…however much it happens to hold in the pot at the time. £50 or £5m – it makes no difference. It doesn't even make a difference if the work was completed perfectly and handed over to a delighted end-user client – the effect is the same – no more money, save as a sort of perverse long-term investment, but with even worse prospects than your endowment policy. And no cause of action until the 12 years is up means no interest either. Brilliant!

What thought was given to the likely recovery if it all went horribly wrong when the subbie dashed off to lunch with his bank manager, showed him all the lovely artist's impressions of the new job; told him how the main contractor was his best customer and that he had another 20 jobs for the same firm and that they always – well, nearly always – paid on time; showed him how the price of £7.28 per oogimaflip left him with at least £1.82 profit – a dead cert? Never mind that every contract contained this nasty little clause. Never mind that there was a contractual right of set-off between them all.

Did the subbie owner even look at the determination clause? Did he heck? That was never an option. This clause is the last clause he would ever look at. It wasn't going to happen to him, and even if it did, it was the bank's problem, not his. Did he really think that this little clause, hidden away out of sight, would matter when he gave his personal guarantee to the bank? Did he realise that no recovery for 12 years means that the bank will take his house? They might give it back in 12 years if anyone is around long enough to remember to ask the main contractor for the cheque, less of course costs of the receivership, and not forgetting interest.

Did the brick supplier realise that when he delivered the bricks? No – why should he, but then again, he was covered with his bad debt insurance wasn't he? Quite a reasonable premium, he thought, until the insurer got wind of the new fangled clauses and decided to quadruple the premium.

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Did the creditors know about this when they forced the subbie into the insolvency corner? Was that the purpose of the winding-up petition? Surely we only meant to frighten him? But now, just by the issue of the petition, nobody will get a bean, except the main contractor, who's propping up his own appalling cashflow figures on the proceeds and getting nicely into the new-fangled PFI jobs and smoochy partnering (a.k.a. 'of course I'll love you in the morning').

Of course, from the main contractor's point of view, it would be unreasonable to expect him to hold the money separately in any sort of 'cordon sanitaire', and anyway, why should he? He might as well use it in the meantime, and you can't keep a liability rolling over for 12 years, can you? So what will happen when the diligent liquidator does remember and does go back for his money? Better still, what happens when the subject building burns

down next week, thereby taking the supposed 12-year liability for defects up in smoke with it, and bring about a right to immediate payment of the pocketed (and now spent) millions?

Did the bank know? Well of course not – the subbie had a 15-year-long 'personal relationship' and was always there in the end. Besides, it had its debenture, and the lending ratio was only 50 pence in the pound of the book, wasn't it? Never mind the non-event final accounts and 'claims of fancy'; enough would come back from the contracts, wouldn't it? Well, not any more Mr Bank Manager. Nil, zilch, nought, at least not until you've retired to Eastbourne. The Friday golf and the 'personal relationship' won't be quite so good when Mr Subbie is homeless and living with his mother-in-law in the holiday chalet in Great Yarmouth he bought her five years ago when business was good.

Did the investigating accountant know when the whizz-kid did his last lending review? Well, unless during his day on site he rifled through 20 piles of 18-inch thick contract documents that everyone's forgotten about since the day they were put in the rented storage container, no. But at the time the cashflow looked just fine, the contracts were nearly always profitable, and this was a regular customer who always – well nearly always – paid on time. But did the bank ever care about cashflow anyway? Did it need to care about the profit? I suppose it thought it did, whereas what it should have been interested in was what happens 'if' it decided to pull the plug, not whether it should or not.

Even Mr Subbie himself, taking the best possible advice and seeing through to an administration in order to 'best preserve the asset for the benefit of the creditors' had no comprehension that, on the same day the administrator got appointed, the 12-year clock came into play. The insolvency lawyer charged with getting the admin order has only had two days to put through the paperwork and in any case, he's taken the view of the company and the whizz-kid regarding the estimated realisable value, even with more than a dash of salt. Did he account for the column of zeros in this particular scenario?

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Then there's the very positive CVA. 'Let's keep it all together and trade through this'. It makes no difference. Under the 'rules of the game' contained in the 18-inch thick pile of dog poo, the 'convening of a meeting of creditors', 'appointment of a provisional liquidator', 'has winding-up procedures commenced against it', 'makes a composition or arrangement…', let alone your ordinary liquidation, administration or receivership and so on and so forth, all bring in the 12-year wait…and wait…and wait…

So what future does such a kamikaze industry have? One thing you can bet on is that before you know it, all main contractors will add the same mañana clauses into their subcontracts, of course cunningly disguised in the boring bit as clause 134.5.6.7 (j) (ii), and no-one will ever spot it until the recovery professional asks the main contractor to write a cheque so, quite apparently none. How can an industry survive such an ordeal? How can it even deserve to survive such self inflicted harm? The latest and craziest contractual gymnastics make it appear darn right foolhardy to lend to a subcontractor on the receiving end of such iniquitous clauses, unless you happen to go in for long-term, interest free loans, of less than certain security, and the potential knock-on effect across the entire industry is clear to see.

You have been warned.

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