Insolvency in the Construction and Engineering Sector

The UK construction and engineering sector is recognised as one of the most contractually complex in which Insolvency Practitioners ("IP") can find themselves. As a consequence of these complexities, its adversarial nature, very low margins and strained cash-flow, it is one of the most fertile for the IP. Over 1,000 construction companies became formally insolvent in the last quarter and the sector is expected to continue to suffer over the next 12 months with a "double-dip" recession and a significant increase in insolvencies.

Apart from physical assets, such a plant, machinery and any real estate, the assets of a contractor are in its contracts comprising a mixture of outstanding Invoices, Applications for Payment, Work in Progress (including contractual claims) and Retentions. However, the IP's ability to protect and realise these assets can be dramatically affected by specific contractual provisions and the parties' compliance with such provisions.

So what difficulties and pitfalls should the IP be aware of and how can they be avoided?

Pitfalls to watch out for and how to avoid them

It is recognised that there numerous pitfalls however, it is worth considering the following key issues.

1. Applications for Payment

   A contractor's entitlement to be paid is governed by whether it and its client have complied properly with the payment provisions. This can come down to as simple a matter as sending the Application to the correct address, or giving a Notice at the correct time. Disappointingly for the IP, in the case of *Melville Dundas Ltd (in receivership) v George Wimpey UK Ltd (2007)* the House of Lords held that the client had a better right to unpaid monies than an insolvent contractor. As a result, the likelihood of clients withholding payment without a withholding notice on the suspicion of insolvency is increased, but appropriate and prompt action prior to formal insolvency can circumvent the client's action. Action taken at this stage this will dramatically affect realisations and potentially change the entire outcome of the case.

2. Retention and Defects

   Most construction contracts entitle the client to withhold a percentage of the certified sum, usually 3-5%, for a period of time after the Works have been completed; known as the Defects Liability Period ("DLP"). Whilst the retention is an asset of the contractor, it must survive the DLP before it can be realised. This duration is most commonly 12 months, but on housing and public highway contracts the DLP is generally 24 months and elsewhere 3 to 5 years is becoming more prevalent.

   The ramifications of these timescales are frequently misunderstood by IP's and creditors and will significantly delay realisations. Even then, payment is subjected to clients' attempts to diminish or extinguish sums due to the contractor which will undoubtedly have a major impact on realisations.

Defects claims are frequently exaggerated and often do not survive scrutiny. Even so, for the cost of a defect to be rightfully deducted by a client it must first properly notify the contractor of such a defect, provide it the opportunity to inspect and rectify the defect. Should it fail to do so, it is not entitled to deduct the cost it has incurred rather the cost it would have cost the contractor which given its own subcontract terms or warranties could very well be nominal if not nil.

3. Termination Clauses and Repudiation

The most commonly used standard form of contract is the JCT contract, in its many forms. These contracts state that if a contractor enters formal insolvency then the client is entitled to withhold all monies until the Works have been completed, the Defects Liability Period expired, all defects rectified and the client has produced a final account. Such provisions will prevent the contractor from recovering any monies for a substantial length of time. There are contractual methods to avoid this "manana" clause, but precise planning pre-insolvency is required. The contracts oblige each party to comply with certain provisions and it is the failings of the client in this regard which may provide an opportunity for the contractor to retain its right to payment, despite a forthcoming insolvency.

Therefore, in summary the avoidance of these and other pitfalls is largely dependent on a timely review of the contracts prior to entering a formal insolvency procedure. Prior to insolvency, the contractor has a number of rights, remedies and devices at his disposal. Following insolvency, very few.