Talking Point: Insolvency risk in the construction industry

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In the difficult market conditions which have accompanied the COVID-19 pandemic, the financial health of many industries has been adversely affected. The construction industry is no exception and the insolvency of a party to a construction contract would lead to a number of challenges from both the contractor and the employer's perspectives. We discuss some key considerations and potential steps that could be taken by the employer and contractor where an insolvency event (e.g. liquidation, administration, etc.) occurs in respect of a contractor. We will refer to such events as "**Insolvency Events**".

Employer's perspective: When to terminate?

Most construction contracts would give each party the right to terminate in the event of the insolvency of the other. Termination is usually considered to be a "nuclear" option, but an employer may have little option if an Insolvency Event is looming.

Before termination

Terminating the contractor will leave the works in an unfinished state. If the contractor is in financial difficulty but an Insolvency Event has not yet occurred, the employer may be hesitant to move straight to termination. Before termination, employers should consider:

1. **Provisions of the contract:** On what grounds is the employer entitled to terminate? Does the employer need to wait until an Insolvency Event has taken place or is it sufficient for such an event to appear to be reasonably likely?

2. **Progress levels:** Try to get the most accurate information possible about the levels of completion of the works, in the form of videos, photos, drawings and any other documentation possible. This will be necessary for the employer to assess the time and cost that will be required to complete the works in the event of termination. These records will also serve the employer well if a dispute arises with the contractor or its successors later down the line.

   The employer's decision will be influenced by how progressed the works are, and it may feel more comfortable to "pull the trigger" on termination if the works are advanced. In such case, the employer may be able to exercise any step-in rights under the contract to complete any remaining work where it has the expertise to do so (though few Employers would want to do this if the remaining work is more than a *de minimis* amount). If the works are in their early stages, the employer should be concerned about who will be able to carry out the remaining work and the cost of doing so.

3. **Finding an alternative contractor and recovery of costs of completion**: If the contractor is an unincorporated joint venture between a number of companies, Employers should consider whether it is possible to require the remaining joint venture members to complete the works without the insolvent member (in most contracts, each member is jointly and severally liable for the contractor's obligations). This would be the most convenient way to ensure the completion of the works without additional cost implications. Many joint venture agreements will allow the remaining members to continue with the works even where one member is insolvent.

   However, be mindful that in challenging market conditions, the financial standing of the remaining joint venture members may be weaker than anticipated so proceeding with the remaining members may not be risk-free, especially as they would be required to take on larger commitments to perform the works than initially anticipated.

   Contractors structured as an incorporated joint venture would not be able to avail of such options as the insolvency of one of the members could trigger termination of the employment of all parties to the joint venture.

4. **Cost of completion**: The route the employer takes to reach completion of the works will also dictate how costly and time-efficient such a process will be. Appointing a replacement contractor will elongate the completion period of the works and will almost certainly increase the overall costs of the project. It will necessitate obtaining quotations or inviting tenders for the remaining works though discretion is usually advisable if termination has not yet been effected.

If termination is unavoidable

Most construction contracts will allow the employer to terminate the contract in the event of the contractor's insolvency (and some may allow termination before the Insolvency Event in question takes place if it has legitimate concerns about the contractor's financial status).

Should the employer terminate, it could take a number of steps to safeguard its position and the completion of the works. These include:

1. **Avoid making any interim payments to the contractor after the Insolvency Event has taken place (or, where relevant, where the Insolvency Event looks reasonably likely to occur).** The concern here is that the employer would want to only make payments in order for the works to progress, however if the contractor becomes insolvent, payments made to it may not be used on the project and could end up in a general pool of funds from which payments to the contractor's creditors will be made. Most contracts will allow the employer to defer making any payments post-termination until an assessment can be made of what is due from one party to the other.

2. **Consider the status of any project security available.** Many standard form contracts will grant the employer the right to engage a replacement contractor and recover any additional costs of completing the works from the contractor. This will extend to increased consultancy fees. However, where the initial contractor is insolvent, the employer will struggle to recover these costs. Employers would need to explore what project security instruments are available to ensure that it is not left with the loss of paying (a presumably, more expensive) replacement contractor and other additional

costs. Such instruments could include on-demand performance bonds and parent company guarantees.

Calling upon a performance bond gives the employer quick recourse to cash it would need to complete the works. Additionally, if the project is in delay and liquidated damages have been levied against the contractor, the employer would not be able to offset this against future progress payments to the contractor after termination. Without recourse to bond monies, the employer would be an unsecured creditor in the contractor's insolvency process and would have low prospects of recovering the full sums owed. Using on-demand bonds shifts the insolvency risk from the employer to the bank granting the bond. Check that your bond is valid notwithstanding the contractor's insolvency before attempting a call.

In respect of parent company guarantees, beware that if the parent company in question is also insolvent (e.g. in the event of a group insolvency), such guarantees would be of limited value.

3. **Consider what effect the contractor's insolvency would have on subcontractors.** It may be that the employer requires subcontractors to continue work in order complete the project. But how does the employer do this when the contractor falls out of the picture due to insolvency? Some contracts allow the employer to exercise "step in" rights where they can directly perform duties that the contractor would have performed or provide for novation rights in respect of subcontracts when a contractor is terminated for default.

   The employer will invariably avoid making payments to the contractor after the Insolvency Event has taken place. However the prevalence of "pay-when-paid" clauses in some jurisdictions would mean that subcontractors are starved of cashflow which will ultimately threaten progress. Compounding matters, any payments actually paid by the employer to the contractor for the subcontractors may not have been passed down to the subcontractor before the Insolvency Event took place. Some contracts permit the employer to make direct payments in certain circumstances. Going forward, the party liable to make payments to the subcontractor has fallen out of the picture leaving the subcontractor with no contractual recourse to payment.

   The downside of this is that the employer would end up in numerous direct contracts until a replacement contractor is found, which many employers may not have the resource or expertise to manage on an ongoing basis. From an administrative perspective this would mean that the engineer or contract administrator has to spread its time across a number of contracts instead of one.

Contractor's perspective

From the contractor's perspective, dealing with a likely or actual Insolvency Event would naturally bring some difficulties to the ongoing performance of the project. Before an Insolvency Event occurs, if cashflow issues will have slowed down the progress of the works on site and depending on the extent of delays, the contractor may have begun to incur liquidated damages. In distressed projects, the employer may already have been contemplating termination and the contractor will be unable to prevent this when the Insolvency Event takes place.

If the employer decides to call on the performance bond, it is unlikely that this can be stopped by the contractor and any attempt to do so must be based in a legitimate claim that the bond has been called wrongfully. It would be an uphill struggle to demonstrate this in insolvency, however the contractor should investigate its position under local laws if it believes that it has grounds to stop a bond call. In common law jurisdictions such as England and Wales, Singapore and Hong Kong, this will be difficult however in countries such as the UAE, some parties have had success in obtaining injunctions from the local courts to prevent a bond call.

Contractors should beware of making payments to subcontractors in the same group of companies close to the time of an Insolvency Event taking place. Such payments could be challenged by the liquidator or administrator as a preference transaction and can be reversed if a court sees fit to do so in the interest of achieving fair treatment of all creditors.

A major concern from the contractor's perspective is if it is a member of an unincorporated joint venture and one of its joint venture partners becomes insolvent. Many joint venture agreements will have provisions where the contractor would be automatically excluded from the joint venture upon the occurrence of an Insolvency Event, allowing the remaining members to complete the works though this may be subject to the employer's consent.

The consequences of exclusion from a joint venture can be wide-ranging and will be dependent on the provisions of a joint venture agreement. Under some agreements, any number of the following events can take place:

1. The insolvent contractor could be denied access to the site and any plant or machinery belonging to the insolvent member would be forfeited to the remaining joint venture members

2. The remaining joint venture members may try to retain some of the insolvent member's staff working on the project. Any transfer of labour from one entity to the other would of course require the agreement of the staff member in question and could be structured as a secondment of staff from one joint venture member to the other. This would mean that the insolvent entity may still be liable to pay for a proportion of its labour cost even after exclusion from the joint venture.

3. The insolvent member may lose access to any joint bank account held by the joint venture members and even if this is not provided for expressly in the joint venture agreement, the remaining parties will inevitably seek to restrict the insolvent member's access to the joint venture's finances.

4. The insolvent party will still be liable for its share of any losses that the joint venture occurs prior to its exclusion from the joint venture.

Of most pressing concern to a contractor whose joint venture partner has become insolvent are the implications for it, vis-à-vis the employer. It may ultimately be terminated due to no failings on its part. The likely joint and several obligations it has agreed to make it a more attractive target for an employer seeking recovery for the joint venture's entire liability (and a similar obligation may also extend to subcontractors). A "Sword of Damocles" may be dangling over the solvent contracting party as to whether the employer will exercise any right of termination. Such a contractor will also face uncertainty over whether the employer decides to make a bond call which will affect it as it will need to bear its share of the burden of any bond call.

Alternatively, the solvent contractor may be compelled to complete the works and it may consider this to be a more appealing prospect than termination. Achieving its commercial objectives will require careful and nuanced navigation in its discussions with the employer to ensure it is not unduly prejudiced by its partner's insolvency.

Conclusion

As explored, the insolvency of a contractor can present a number of difficult issues which may not always have simple solutions given the number of competing objectives which may need to be balanced. Before taking any action, both parties must first check the provisions of the relevant contracts before acting and must at all times keep detailed records of the reasons for any decisions made in the event that disputes arise later down the line. Both the contractor and employer would be advised to seek legal advice on the implications of insolvency regimes in the relevant jurisdiction as this will impact on how they decide to proceed in mitigating the impact of such an unfortunate event.

Authors

Nabeel Ikram
Partner, Dubai
T +971 4 377 9303
nabeel.ikram@hoganlovells.com

Jodie Reindorf
Associate, Dubai
T +971 4 377 9310
jodie.reindorf@hoganlovells.com