INSOLVENCY IN CONSTRUCTION: IN CONTRACT WITH AN INSOLVENT COMPANY - WHAT NOW?

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When one party to a construction contract has become insolvent, there are a number of options open to its counterparty. The best course of action will depend upon the specific circumstances. It will take into account factors such as the objectives of each party, the status of the build, the terms of the contract and the type of insolvency process involved.

In the third of our mini-series on insolvency in construction, we address some of the most commonly asked questions raised by unsecured creditors in relation to the administration, receivership or liquidation of construction counterparties.

- What an unsecured creditor needs to know about dealing with receivers, administrators, liquidators and unsecured claims
- What does insolvency mean for proceedings already underway (including adjudication)?
- What are your options?
- Ownership of materials, equipment and documents
- Retention

What an unsecured creditor needs to know about dealing with:

A receiver
The main functions of a fixed charge or Law of Property Act (LPA) receiver (a 'receiver') are to collect income from specific charged assets, manage those assets and, typically, sell those assets with a view to repaying secured liabilities. Their rights will be subject to the terms of the security under which they are appointed, and the document appointing them.

Their rights can be exercised even if they would result in the insolvent counterparty breaching a contractual obligation.

The receiver has no duties or powers to make payments to unsecured creditors of an insolvent counterparty. Accordingly, your pre-existing points of contact remain the best people to talk to about getting paid.

In addition to the general options detailed below, we recommend that you check which assets are affected by the appointment so that you can determine whether the sale of those assets will affect the ability of the insolvent counterparty to meet its contractual obligations to you.

If the insolvent counterparty owes you money, consider whether it is possible to exercise a lien over any of the charged assets if they are in your possession. In circumstances where you did not know of any restrictions that would prevent the insolvent counterparty from granting a lien to you, this remedy might enable you to retain possession of a tangible asset until the debt is paid to you.

An administrator

An administrator has a much wider range of powers and duties than a receiver (and owes their duties to the entire creditor body, rather than to the appointor or a particular secured creditor). As set out in our first article, the administrator’s objectives are to carry out one of the three purposes of an administration, which broadly speaking are:

1. to rescue the company as a going concern; or
2. to achieve a better result for the company’s creditors than would be the case if the company were wound up (without first being in administration); or
3. to realise property in order to make a distribution to one or more secured or preferential creditors.

In order to achieve its objectives, an administrator will be appointed over the whole company and will be your main point of contact instead of the directors. The administrator’s details will be included on company correspondence.

The administrator will typically have the power to do anything necessary to carry on the
business of the company and to realise company property. This can include disposing of the business and assets, undertaking litigation and investigating any potential wrongdoing by the directors. An administrator (unlike a liquidator) does not have a statutory power of disclaimer, however. An administrator can also trade the business, and may well do so, managing the build out going forward.

A liquidator

A liquidator's main aims will typically be to collect in the company's assets, realise them and share those realisations with the company's creditors before winding up the company. In order to achieve this, they are able to exercise their extensive powers to sell property, bring or defend proceedings or disclaim onerous property, although their powers to trade as a business are limited to doing so far as necessary for its beneficial winding up.

If a liquidator has been appointed as a result of a company's insolvency then that person will become your main point of contact. It is possible that directors may have retained some of their powers in a creditors' voluntary liquidation (which is an insolvent liquidation that has been commenced by the company's shareholders), but you should verify this with the liquidator. Subject to any arrangement to the contrary made by the liquidator, employees will have been dismissed if the liquidator was appointed as a result of a court order (a compulsory liquidation), but may have been retained if the liquidation is a voluntary liquidation.

If the insolvent company has had a 'provisional liquidator' appointed, this means that a petition has been presented to court for it to be wound up and placed into liquidation, but the hearing has not yet taken place. If this is the case, you should still proceed with caution. It is rare for a provisional liquidator to be appointed but for the company to successfully defend itself at the hearing. The provisional liquidator's specific powers will be set out in the court order appointing him.

As set out in our previous article, a special manager may also be appointed to exercise certain functions usually carried out by the liquidator or to carry out certain management duties. In that instance, it will often be the special manager with whom you will deal, and you should clarify early on who your point of contact will be.

Unsecured Claims

A proportion of the funds realised by the administrator or liquidator from assets subject to floating charges will be set aside to be shared equally amongst creditors’ unsecured provable
debts. In addition, all realisations left over once secured creditors, preferential creditors and the administration/liquidation expenses (including the Insolvency Practitioner's fees) have been paid will be distributed to the unsecured creditors.

If a company in administration owes you money, it is essential that you contact the administrator or liquidator as soon as possible and demonstrate that you have a 'provable debt' in order that you can share in this pot of funds. A provable debt is typically one that existed prior to the commencement of the insolvency process or arose as a result of a commitment that existed prior to commencement of the insolvency process. Claims for amounts above £1000 will need to contain a prescribed set of information.

Unfortunately, notifying the liquidator or administrator does not mean that you will be paid in full as an unsecured creditor ranks near the bottom of the priority list for payments from an insolvent counterparty. Often your recovery will be a "pence in the pound" distribution, if indeed any distribution at all. It does however represent your best opportunity to recover what is owed to you.

**What does insolvency mean for proceedings already underway (including adjudication)?**

A company becoming unable to pay its debts will not have any impact on proceedings that are already underway.

However, a company that becomes subject to a formal insolvency process will be in a different position. We have covered administration, liquidation and receivership below but you need to be aware that other types of insolvency process (such as Company Voluntary Arrangements (CVA) and Administrative Receivership) will give rise to a different set of constraints and you should contact your legal advisers if these are relevant.

- **Receivership**: As proceedings underway will be against the company, rather than the asset over which the receiver is appointed, these will continue.
- **Administration**: The appointment of an administrator triggers a statutory moratorium for the insolvent counterparty that has been placed into administration. During this time creditors are prevented from exercising their rights against the insolvent counterparty in order that the objectives of administration can be achieved. This means that, for example:
  - You would not be able to commence an additional set of insolvency proceedings against the company;
  - Any existing winding up petitions will be dismissed (assuming the administrator has been appointed by a charge-holder);
Other types of legal proceedings or enforcement action, such as adjudication proceedings, the repossession of goods or exercise of forfeiture rights by a landlord, can typically only be commenced or progressed with the consent of the administrator or the court if certain conditions are satisfied; and

Taking a non-judicial step such as serving a notice to make time of the essence in a contract, is likely to be permitted.

**Liquidation:** The effect of liquidation on new or existing proceedings by creditors depends on whether the liquidator has been appointed by the court or by the company’s creditors.

- If a liquidator has been appointed or a winding up order has been made by the court (compulsory liquidation), proceedings can only be commenced or progressed with the permission of the court.
- If the liquidator has been appointed by creditors, the liquidator can apply to court for existing proceedings to be put on hold. In this situation, the other party to the proceedings should then contact the liquidator to claim for the sum to be paid out of the funds available for distribution to unsecured creditors.

**What are your options?**

In addition to the recommendations above, there are a number of things that you can do to potentially improve your position when a counterparty becomes insolvent. In outline, consider the following:

- **Contractual rights:** These are dealt with in our previous note - What does insolvency mean for your contract?
- **Parent company, insurance or bank guarantees:**
  - It is important to understand the form of guarantee provided and the nature of the guaranteed obligations. Care should be taken to ensure that there is a proper basis to call upon any such security and the manner of the call. Where an improper call is made, the opportunity to make a future call may be lost. The ability to make a call may be regulated by the underlying contracts, some of which have indemnity provisions for a wrongful call.
  - Check whether the guarantor is in fact the ultimate holding company. Does the guarantor have adequate assets to meet any liability? Does the guarantor indemnify you for any claim arising out of the works even after insolvency? Is insolvency an event of default? Does the guarantee / bond survive any material variation in the main contract?
- **Set-off:** When an insolvent company enters into administration or liquidation, any debts owed by the contractor to you may be subject to insolvency set-off against any monies that you owe to the contractor. This could significantly improve your position compared to waiting in
line for payment with other unsecured creditors.

- **Subcontractors**: Check whether the project documentation allows you to pay subcontractors direct in order to retain them and for work to continue. In general, it is not likely to, so take legal advice before making any further payments.

- **Suppliers**: If you are able to make arrangements for the work to continue using an alternative contractor and/or retain the necessary sub-contractors, speak to the suppliers as early as possible to explore the chance of being able to purchase materials direct on the same terms as the pre-existing project documents. Most suppliers are happy to explore this option, particularly where they have ongoing commitments to their own suppliers. Again though, you will need to check the extent to which the project documentation allows this to avoid any risk of needing to pay twice.

- **Staffing**: Are there any staff in the insolvent counterparty whose expertise is necessary for the ongoing success of the building project? If so, you should speak with the insolvency practitioner to find out how long that person is likely to be retained and in addition you may wish take employment law advice on whether it is possible to hire the relevant people as consultants for the remainder of the project. Do bear in mind that where a company is in an insolvency process, even if the Insolvency Practitioner tries to retain staff for a certain period, it is likely that those members of staff will be seeking alternative employment and will leave once it is found.

- **Insurance**: If the insolvent counterparty had insurance against the risk that has caused your loss (such as defects in design or workmanship), it may be possible to claim directly against its insurance policy and receive payment without the funds needing to first pass through the hands of the insolvent company (or its administrator). For an example of this in action, see our previous article.

### Ownership of materials, equipment and documents

Be aware that, at common law, goods and materials affixed to the land become the landowner's property. Whilst terms of a contract may not always be conclusive as to ownership of materials or equipment on site, steps should be taken to ensure that materials are not unlawfully removed by unpaid contractors or other creditors - e.g. securing the site.

Most contracts provide that payment for unfixed materials on the site will pass ownership to the employer. However, be aware that:

- title to materials from supply chain members cannot pass to the employer if the title has not passed up the chain. Contractors should check that subcontracts are "back to back" with the main contract and whether the subcontracts contain any retention of title clauses;
assets on site may be leased, rather than owned by the insolvent company and so may be recovered by the lessor as soon as it becomes aware of the insolvency.

The position may be less clear when it comes to unfixed materials off-site. Simply providing that ownership of off-site materials passes to the employer on payment will be of limited practical protection if the materials are in a supplier's or subcontractor's warehouse. A better position is found in contracts which provide that:

- the contractor must provide reasonable proof that ownership of off-site materials is vested in the contractor;
- it must be identified clearly where the materials are to be manufactured or kept that they are held to the order of the employer and that their destination is the project site.

Check who has rights over design and copyright relating to the project, and if required, obtain copies of any drawings or documents that are not already in your possession. Undertake an audit of on-site plant, equipment and materials and ensure that these are secured to the fullest extent possible.

Ensure legal protection by checking that all insurance cover required by the construction contract is in place.

**Retention**

Retentions are often lost on insolvency. Be careful what you agree at the outset, know your contract, be clear about which party owns the funds at any point in time and ensure that you get the correct amount back at the correct time. When the employer should release the retention will depend entirely on what has been agreed.

A retention deposit account ensures that the retention is held in a separate account to protect both parties. From a contractor's perspective, it increases the likelihood of recovering the retention in circumstances where the employer becomes insolvent although this is not guaranteed.

Insolvency is a complex and specialist area of law. This article has covered the most common questions raised by unsecured parties to construction contracts. If however you believe that you have any security rights against the company you should discuss this with your legal advisers.

In our final article we will be looking ahead and considering ways of managing the risk of insolvency.

If you do need advice on these or any related issues, please contact Sue Ryan or one of our
Restructuring & Insolvency experts.

Other parts in the insolvency in construction series

- Insolvency in construction: what is insolvency?
- Insolvency in construction: What does this mean for your contract?
- Insolvency in construction: Looking ahead and minimising risks

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Author(s)

Sue Ryan
Partner - London

- Email sue.ryan@gowlingwlg.com
- Phone +44 (0)370 733 0648
- vCard Sue Ryan

Catherine Phillips
PSL Principal Associate - Birmingham

- Email catherine.phillips@gowlingwlg.com
- Phone +44 (0)370 733 0605
- vCard Catherine Phillips

Lindsay Hammond
Principal Associate - Birmingham

- Email lindsay.hammond@gowlingwlg.com