ePaper: Insolvency & Adjudications in the Construction sector

RIDGEMONT

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Introduction

The film, "A Perfect Storm", tells the true story of a commercial fishing expedition that encounters a broken ice machine, forcing them to return to shore to preserve their catch, attempting, unsuccessfully, to navigate their way through two powerful weather fronts and a hurricane. And it is in the context of a "Perfect Storm" that the construction sector, on the one hand, attempts to meet ambitious government new housing targets despite continued planning system failures, growing regulation and severe macro economic problems, culminating in increased labour and material prices.

In that context, it is of no surprise that Red Flag Alert reports that more than 6,000 construction companies could become insolvent in 2023 and perhaps 100 firms could become insolvent each week. The Construction Products Association has remarked that construction insolvencies were 27% higher in 2022 in comparison to 2019. Casualties in January 2023 have included S & I Groundworks, a £43m turnover housebuilder contractor.

That reality is played out in figures produced by the seminal Construction Adjudication in the UK Report, produced by King's College London in tandem with the Adjudication Society, that concluded that 23% of Referring Parties in adjudication proceedings are insolvent, 12% of Responding Parties are insolvent and 6% of adjudication enforcement proceedings are initiated by an insolvent party.

This "Perfect Storm" creates a battlefield, where skirmishes will be played out in the adjudication arena. Such circumstances raises questions regarding the participation of insolvent parties in the adjudication process and what parties should be doing to foresee and attempt to avoid disputes arising in circumstances where they or their counter party are insolvent.

This ePaper is our second ePaper on insolvency in the construction sector. We hope you find it a useful resource and do get in touch if you need any advice on anything contained within.

This ePaper is intended as an update on insolvency legal news that relates to the construction and real estate sectors. It should not be taken for legal advice for a specific legal issues and you are not entitled to rely on it in respect of the same. If you have a specific legal issues you ought to take independent legal advice.

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1. Snapshot: Where do Employers & Contractors stand if one of them enters administration or liquidation?

Where do I stand if a Contractor enters administration or liquidation?

Administration or liquidation is likely to be a stated ground for termination of your construction contract and hence it should be checked to that end.

An Employer should also check to see if the Contractor has provided a parent company guarantee / performance bond, and/or has obtained collateral warranties with step-in rights from any Sub-Contractors, to protect against Contractor non-performance in such an event as liquidation.

It should also check how much retention has been held back pending completion of the works.

If a project account was used, it should have assisted in safeguarding the money in that account, should it now need to be allocated to Sub-Contractors.

An Employer should take steps to secure the building site to prevent the Contractor, its creditors, or its Sub-Contractors, from removing materials.

If monies are owed to the Employer, it will likely have to prove as an unsecured creditor on the liquidation of the Contractor.

Where do I stand if a Employee enters administration or liquidation?

Administration or liquidation is likely to be a stated ground for termination under the construction contract. However the Contractor should speak to the insolvency practitioner involved, because it may be possible for it to complete the works and be paid by it if terms can be agreed.

A Contractor should also check to see if the employer has provided a guarantee or a parent company guarantee.

A valid retention of title clause in the building contract will also help the Contractor. It will allow the contractor to retain title to the goods on site and prevent the employer / its insolvency practitioner from removing them.

A good level of retention will be beneficial.

If monies are owed to the Contractor, it will likely have to prove as an unsecured creditor in a liquidation.

2. Insolvency and Adjudication: Your key concerns when a Counter-Party becomes insolvent

Tim Seal, Head of Construction at Ridgemont, explains points to consider adjudications in the context of an insolvent or potentially insolvent party.

The solvency of a party to an adjudication is not an uncommon cause of concern especially during these years of financial upheaval and so it is a topic that parties and their advisors need to keep on top of. It is a concern that can hang over Referring and Responding parties alike.

The Supreme Court decision in Bresco Electrical Services Ltd (in liquidation) v Michael J Lonsdale (Electrical) Ltd [2020] UKSC 25 held that insolvent claimants are able to pursue claims through adjudication. Although, the Technology &Construction Court would continue to have discretion in relation to the circumstances in which enforcement would be appropriate and what undertakings would be necessary. The reality is that this makes enforcement of an adjudication award more difficult for an insolvency Referring Party and may mean that the usual battlegrounds of a recession are not the scene of skirmishes post Bresco.

What is your position if your counter party is insolvent? The primary concerns that arise when a party is worried about the other's solvency, are likely to be these:

- For the **Referring Party**

- Can the Responding party afford to pay any award that I manage to secure against it and hence might it become insolvent before I get paid?

- Therefore, is it worth me pursuing it, bearing in mind that I may recover nothing, and if that happened, along the way I would incur my legal costs in the adjudication and in any court enforcement that's required, plus the adjudicator's fees and the court fees, all of which I could end up having to bear myself?

- For the **Responding Party**

- If I lose the adjudication and have to pay any award against me, plus bear my own legal costs and the adjudicator's fees, and also perhaps the costs of losing court enforcement proceedings that I have had to defend, will the Referring Party still be solvent by the time, later on, when I try to get that money back, by way of a second adjudication and/or court or arbitration proceedings?

- If not, then I risk paying out the adjudication award and incurring lots of costs, that I will never be able to get back.

The risk in any adjudication of either scenario playing out for the party asking itself one of these questions, is often not easy to assess, not least because that party will only have limited information about the other party's solvency, ie what it can obtain from Companies House and any online searches that it carries out or instructs from a 3rd party.

Mixed in with actual solvency issues, may also be the concern that the other party may seek to cease trading simply to try and avoid the liability it is facing. Ultimately these insolvency / trading issues are for the expertise of an insolvency lawyer or insolvency practitioner, not a construction lawyer, and therefore Ridgemont involves those specialists when they are needed in an adjudication.
Another complex situation arises when an insolvent party seeks to start adjudication proceedings. Is it allowed to do so? Will it be entitled to enforce?

In the situations referred to in this paper, construction law and insolvency law sometimes seem to compete against each other, trying to protect different parties and interests, trying to reconcile things that can't always be reconciled. For example, the right to adjudicate at any time and the pay now argue later aspect of adjudication, versus the circumspect protections of debtors and creditors within insolvency law.

Finally, of course, it serves to remember that these solvency issues are within the adjudication context: ie a form of dispute resolution that is so highly unpredictable as to outcome, given not least its rapid timescale, the corners that it cuts on fair procedure and high quality decision-makers, and the scope for argument and evidence to twist and turn from start to finish.

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3. Piercing the corporate veil: How directors can be personally liable for an insolvent company's debts

I was instructed by a company that had suffered at the hands of a dishonourable director. The director's barrister asserted to the High Court Judge that his client could not be held liable as he was only a director for a particular reason and "wasn't really intended to be a director for any other purpose". More on this later.

2023 is set to be a challenging year for construction businesses, regardless as to where they sit in the supply chain. The damaging impact of labour shortages, material price inflation and shortages and increased interest rates will be amplified in a receding economy. The inevitable outcome is that many more construction businesses will become insolvent.

The business activities of insolvent companies will be examined by insolvency practitioners, who often turn to directors when a company has insufficient funds to pay its creditors. Creditors, too, may pursue the directions of insolvent debtor companies, looking to mitigate their losses when a trading partner goes under leaving them holding the baby. This will be seen, for example, where a Main Contractor suffers loss as a result of the wrongful trading of an insolvent Sub-Contractor and the Main Contractor pursues the Sub-Contractor's directors' assets in the absence of any assets in the name of the insolvent company.

The are an alarming number of ways whereby a director can be held personally liable for a company's debts. As an example, a director that allows a company to continue to trading notwithstanding there is no reasonable prospect of the company avoiding insolvent liquidation or administration. Such circumstances would enable an insolvency practitioner to bring a claim against a director or de factor or shadow directors for "wrongful trading". A director could be Ordered to contribute their personal assets to those of the insolvent company to enable the creditors to be paid. The director may also be disqualified from being a director of a company in the future for up to 15 years.

Any director found to have continued to allow a company to trade with the intent to defraud creditors (or for another fraudulent purpose) not only commits a civil offence, but also a criminal act.

A director in that situation could be imprisoned for up to 10 years and fined.

Alternatively, or in parallel, a civil Court may declare, on the application of an insolvency practitioner, that anyone "knowingly party" to the fraudulent trading must contribute to the assets of the company.

A director found to have committed misfeasance or a breach of fiduciary duty may be required to contribute such amount as the Court considers "just" to the company's assets. Additionally, directors could also face prison time and fines if they allow a company to continue trading in the intent to defraud creditors or other parties.

You need to manage your business carefully to ensure that you are not liable for the following:

1. **Wrongful Trading** is an action brought by an insolvency practitioner against a director allowing an insolvent company to continue to trade where there is no "reasonable prospect" of avoiding insolvent liquidation or administration (contrary to section 214 Insolvency Act 1986). A Court may make an Order that a director, including any de facto or shadow director, who is found to have "wrongfully traded", make such contribution to the company's assets as it considers "proper". The director may also be the subject of a disqualification Order.

2. **Fraudulent Trading** is an action brought by an insolvency practitioner under section 213 Insolvency Act 1986 against a director where an insolvent company continues trades with the intent to defraud creditors or for another fraudulent purpose – this is both a criminal (section 993 Companies Act 2006) and a civil offence. It is worth noting that a single transaction can amount to "continuing to trade". A person guilty of fraudulent trading in the criminal court may be imprisoned for up to 10 years and fined. In civil proceedings, an insolvency practitioner can seek a declaration that anyone knowingly part to the fraudulent trading must contribute to the company's assets as the Court thinks proper.

3. **Misfeasance or breach of fiduciary duty** could mean that a director is liable, in the course of a winding up, where they have misapplied or retained, or become accountable for, any money or other property of the company, or they have been guilty of breach of a fiduciary or other duty.

The Court may make an Order that the director repay, restore or account for the money or property, with interest or contribute to the company's assets as the Court considers just (section 212 Insolvency Act 1986). In addition, a director found guilty in such circumstances may be disqualified from being a director for up to 15 years.

Here are the **four key steps you need to take** to help you avoid personal liability for your company's debts:

1. Consultant lawyers and accountants on your contingency plans at an early stage in anticipation of the company's inability to continue to trade.

2. Hold weekly board meetings at which all decisions are made on the basis of up-to-date legal advice and final information. Record decisions in formal resolutions and minutes.

3. Scrutinise carefully any extension of credit or loan arrangements.

4. Ensure that your board only approves "antecedent transactions" if the board believes in good faith that they bring advantage to the company.

The board must not ratify any antecedent transactions unless the board believes in good faith that the transaction would benefit the company. Antecedent transactions are transactions that:

a) Put a particular creditor in a better position than it would have been at the point the company is insolvent;

b) Transferring assets to another party for no consideration or for significantly less consideration than the asset's true value; or

c) Transactions seeking to put assets out of the reach of creditors.

Key Learning Points

- Seek expert legal and accounting advice as soon as the risk of insolvency raises its ugly head.
- Directors should ensure that board meetings are held on a weekly basis, with board decisions, made on the basis of up-to-date financial and legal information, recorded in formal resolutions and minutes.
- The board should be cautious and should scrutinise any extension of funding facilities or additional facilities, before entering into them.
- Directors must ensure that contingency plans are put in place and discussed with their legal and accounting teams in preparation for the inability of the company to trade out of its precarious positions.

Conclusion

Directors of construction companies must be fully aware of their obligations as directors, the consequences of not complying with those obligations and the best practice required to avoid personal liability. This is something that clearly has greater importance in a receding economy, where participants in the construction sector are notoriously more litigious.

Back to the High Court, where the Judge had little time for the First Defendant barrister's assertion that the director was only a director in name, remarking that "you can't be half married". You are either a director or not. Of course, the reason why the First Defendant's barrister was denying his existence as a director was to avoid the serious obligations that directors must meet and which many do not.

4. Bonus content: How to ensure your business is ready for an Adjudication

Adjudication is a process by which the Referring Party (the party bringing the claim) has as long as it requires to put together its claim and the Responding Party (the defendant to the claim) must submit its Response normally within 7days of receipt of the Referral. It is an uneven playing field.

This article attempts to identify how parties should prepare for an adjudication, the prospect of which they may not be aware of and the factors that they should consider in bringing or defending an adjudication claim.

Maintain detailed records relating to the dispute

It is good practice to ensure that you maintain thematic electronic folders containing all contracts, correspondence, documents, photographs, videos, WhatsApp messages and so on, organised into appropriate sub-folders. Ensure that detailed telephone and meeting notes are maintained for all meetings, setting out when (date and time) the meeting took place, who was there, where it took place and what was discussed and/or decided. You may curse having to do this, but each time you do, imagine you have received a Referral and the evidence you need to defend the adjudication is totally disorganised or cannot be found.

You must consider who are the key individuals who would need to provide instructions or give witness statements in any adjudication. Ensure that those individuals maintain comprehensive contemporaneous notes relating to this dispute. This ought to include a site diary that is updated on a daily basis. Giving them training on what an adjudication is and how it works will encourage compliance by providing them with some context in respect of what you are asking them to do.

It is sensible to ensure that there are provisions in key individuals' employment contracts ensuring that they are obliged to assist with an adjudication or other form of dispute resolution even if they have left your employment. However, by requiring that they maintain meticulous records, all of the knowledge will not leave your business if the individuals goes on to pastures new. Consider amending your Staff Handbook to ensure that key individuals do not go on holiday immediately before or after an adjudication has commenced.

Ensure you are connected with appropriate advisers

When an adjudication arises, you may need legal or other experts to assist you. On claims with substantial value, you need to take advice from specialist construction solicitors.

Broadly speaking construction solicitors, amongst other things, advise you on the law and legal procedure as it applies to your transaction or dispute; advise you on procurement methods, and the right contracts and amendments for your transaction; advise you on dispute resolution methods and navigate with you any that you participate in (including adjudications); advise you on how best to deal with your contract partners or dispute opponents, and liaise with their advisors on your behalf; appoint experts to provide technical advice and evidence for you; liaise with organisations such as HM Courts & Tribunals Service and the Land Registry as needs be; and ensure that your exposure to cost and other forms of risk are appropriately managed throughout.

Where the value of the claim is relatively low, you need to ensure you keep your costs proportionate to the dispute, as adjudications are not adverse cost environments i.e. you cannot recover your legal costs. So if your dispute is sufficiently complex for you to need advice, but does not warrant instructing solicitors, you could turn to unregulated advisers, such as Claims Consultants or direct access barristers (that is barristers that will take instruction from your directly, rather than via a firm of solicitors).

Understand & follow your contracts and have an understanding of construction law

We believe that it is important that all our clients are educated on the contracts that they regularly sign up to. This is to ensure that our clients' teams are operating in a way that is consistent with those contracts and because it means that when a legal issue arises, we are starting from a more advanced position than we would be if we are having to explain the mechanics fo the contract from scratch. That is not to say that you need to be contract experts, but having a basic understanding of the contracts you operate under and a broad understanding of construction law across your business will reap benefits.

Recognise when a dispute arises

Due to the inevitable contracted timeline of an adjudication, the time to prepare for an adjudication is before it has commenced. The first step is to recognise where there is a dispute between the parties and to prepare evidence on that dispute as though you have lifted the door of your Delorean, fired up the flux capacitor, sped up to 88 miles an hour and found yourself sitting in your office, three months later, dealing with an adjudication of the dispute.

If you are a Referring Party, you need to ensure that a dispute has crystalised before you start an adjudication. An adjudicator does not have jurisdiction to make a decision where a dispute has not yet crystalised. You need to ensure that your position has been set out in detail in writing to the Responding Party and that there is unequivocal evidence that they have rejected your assertions.

Unless allowed for under your contract or otherwise agreed between the parties, an adjudicator may only consider a single dispute in an adjudication.

Ensure that the dispute relates to a "Construction Contract"

Section 104 of the Housing Grants Construction and Regeneration Act defines a *"Construction Contract"* as an agreement with a person for the *"carrying out of construction operations", "arranging for the carrying out of construction operations by others, whether under sub-contract to him or otherwise"* or *"providing his own labour, or the labour of others, for the carrying out of construction operations".* This includes an agreement to do architectural, design, or surveying work or to provide advice on building, engineering, interior or exterior decoration or on the laying-out of landscape.

If the dispute does not relate to a Construction Contract, then the claimant party may not adjudicate unless allowed for under the contract. In which case, any dispute would need be to resolved via Court or Arbitration proceedings, if it cannot be resolved through alternative dispute resolution, such as mediation.

Consider the value of the claim, prospects of success & the opposing party's ability to pay

When consider whether to commence or defend an adjudication it is worth giving consideration to whether it makes financial sense to participate in the adjudication at all.

If the value of the claim is low, it may be less expensive for you to settle the dispute rather than taking part in the adjudication. Think about the man hours involved in putting together the evidence to bring or resist a claim, the irrecoverable cost of taking external advice and the distraction from your core business.

Assuming that the value of the claim makes it sensible to engage with it, you should also consider your prospects of success. That is the chance you have of succeeding with your claim or of defending the other party's claim. Try to look at the evidence objectively. What would a third party think of the evidence if they saw it in isolation?

Finally, when bringing an adjudication claim, you need to do some due diligence on your counter party and consider whether they would have the ability to pay any award. If you succeed at adjudication but the Responding Party cannot afford to pay the award, you will be a net loser when considering the internal and external costs that you have incurred.

Maintain dialogue with the opposing party

Maintaining a dialogue with your counter party provides ongoing hope that a settlement can be reached that is acceptable to both parties. Given the legal and expert costs associated with construction disputes, the loss of management time and the litigation risk (i.e. the risk that you do not succeed), often disputes can be resolved prior to an adjudication being commenced.

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