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Restructuring and insolvency in the construction industry: Q&A

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This Q&A explores the current trends in restructuring and insolvency (R&I) activity in the construction industry and considers the industry-specific issues and risks that practitioners should be aware of.

For guidance on restructuring and insolvency generally, see the Restructuring & Insolvency practice area.

Overview

1. Have you seen significant restructuring and insolvency (R&I) activity in the construction industry in the last 12 months?

Largely due to the various schemes introduced by the government in the wake of the COVID-19 pandemic, such as the Bounce Back Loan Scheme (BBLS), the Coronavirus Business Interruption Loan Scheme (CBILS) (see Practice note, COVID-19: commercial aspects tracker UK) and VAT deferrals, the construction industry has not seen significant R&I activity over the last year. The combined impact of those schemes has had the effect of postponing what most market participants expect to be a substantial uptick in R&I activity in the next 12-18 months.

In the run up to Christmas 2021, significant stress started to be observed in the industry. The main driver for this has not been the relaxation of the temporary COVID-19 measures as such (though this will start to have an effect) but the pressures on the industry caused by the substantial increase in the costs of raw materials, delays in deliveries of those raw materials and the difficulties in obtaining staff to replace European workers who have left the UK in the wake of Brexit.

2. Are current trends in R&I activity reflective of trends you have observed in the industry in the last five years or have there been any significant shifts?

The most substantial change in R&I activity over the last five years has not been in the level of activity, but in the improved ability of insolvency practitioners to recover sums owing to insolvent construction companies.

The Supreme Court's decision in *Bresco Electrical Services Ltd (in liquidation) v Michael J Lonsdale (Electrical) Ltd [2020] UKSC 25* (the *Bresco* case) clarified that the unfettered right to refer a dispute to adjudication "at any time" afforded to all parties to construction contracts continues after a company goes into insolvency proceedings.

Prior to that decision, it was less clear whether companies in administration or liquidation could bring adjudications to recover monies due to them. As a result of the *Bresco* case, insolvency practitioners have a vital additional tool to increase recoveries for the benefit of creditors.

For further discussion of the implications of the *Bresco* case, see Blog post, Supreme Court's decision in *Bresco* is ground-breaking for construction insolvencies. More generally, see Practice note, Adjudication: challenging enforcement of the adjudicator's decision: Assessing claimant's financial position.

3. The industry is facing the triple challenge of Brexit, COVID-19 and climate change. Are these factors changing the way R&I activity is being conducted in the industry?

As discussed above (see 1. Have you seen significant restructuring and insolvency (R&I) activity in the construction industry in the last 12 months?), the government's measures to assist businesses in the wake of the COVID-19 pandemic have had the effect of, temporarily, reducing R&I activity in the construction

industry. However, market participants do not view those measures as removing the R&I risk in the industry and most see those measures as temporary "band-aid" solutions, which are deferring, rather than preventing, the inevitable surge in insolvencies. Following the withdrawal of government schemes and with repayments becoming due on government-backed finance, and, crucially, when the measures restricting the ability of creditors to present winding up petitions expire (after already being replaced with more limited provisions), the picture is expected to become very different (see Legal update, COVID-19: Restrictions on use of statutory demands to be lifted but new measures introduced for winding-up petitions and restrictions to continue for smaller debts and commercial tenants until 31 March 2022). See also Practice note, COVID-19: construction and engineering FAQs.

It is also clear that in the interim the impact of Brexit has been to remove a large amount of the construction workforce from the market, leading to some otherwise viable companies collapsing into an insolvency process simply because of a lack of staff. For further information on the impact of Brexit on construction, see Practice note, Practical Law's Brexit summary: a watching brief: Construction.

As regards climate change, the "built environment" contributes substantially to carbon emissions worldwide (for example, a 2020 report from the Global Alliance for Buildings and Construction noted that emissions from building operations and construction amount to 38% of total global energy-related carbon dioxide emissions). However, we have seen little direct impact of climate change on R&I activity in the construction industry. See Global Alliance for Buildings and Construction: Building sector emissions hit record high, but low-carbon pandemic recovery can help transform sector – UN report (16 December 2020).

4. Where in the industry are you observing the most R&I activity and exposure?

Developers and employers are far more likely to have substantial cash reserves to rely upon in turbulent times and so fare better than smaller contractors and subcontractors who continue to fall into insolvency despite the government's COVID-19 measures. Many smaller construction companies may be dependent on one employer or contractor, or simply one particularly profitable contract. If that employer or contractor withholds payment (whether for genuine or disputed reasons) this can be sufficient to push a contractor or subcontractor into serious financial difficulties resulting in formal insolvency proceedings.

The introduction of the VAT reverse charge on 1 March 2021, which, broadly, now makes customers accountable for a supplier's output VAT, will also have had a short-term cashflow impact on subcontractors that might previously have used those VAT payments during the quarter to stabilise what can often be inconsistent cashflow in the industry. See Practice note, VAT reverse charge on construction services.

In addition, it is those same subcontractors, who will have entered into fixed price work and materials contracts earlier in 2021, that are now unable to complete those contracts due to the massive rise in the cost of raw materials over the past six to nine months. Unless the main contractor or employer is unusually supportive of those subcontractors, they will have no ability to continue to trade.

Industry insolvency regimes and cases

5. Please outline any industry-specific legislation and industry regimes relevant to managing insolvency or debt restructuring.

The adjudication regime referred to above (see 2. Are current trends in R&I activity reflective of trends you have observed in the industry in the last five years or have there been any significant shifts?) is critical for insolvency practitioners to be able to increase the recovery of debts owed to insolvent construction companies.

The Housing Grants, Construction and Regeneration Act 1996 (the Construction Act 1996) introduced a statutorily imposed, unfettered right for any party to a construction contract to have a dispute determined by way of adjudication (with some exceptions, such as where the employer is a residential occupier and the contract does not expressly provide for adjudication). See Practice notes, Do I have a "construction contract"? and Adjudication: section 108 and adjudication procedures.

Adjudication is an incredibly useful tool, as it provides an abridged (usually a 28-35 day) dispute resolution process to decide a "dispute" under a construction contract (see Practice note, Adjudication: has my dispute crystallised?). It can allow resolution of payment disputes, but also other matters, such as those relating to the interpretation of the contract or an award of an extension of time.

One of the other substantial advantages is that the adjudicator cannot award the payment of party costs (unless the parties expressly agree the adjudicator has this power after the appointment). Generally, so far as costs go, the adjudicator only has the power to determine which party will pay the adjudicator's

fees (usually the losing party). This works to level the playing field somewhat to enable a small contractor to issue an adjudication against a much larger and more solvent main contractor or employer, without needing potentially to pay the other side's often substantial legal costs. See Practice note, Adjudication: an adjudicator's decision: Parties' costs and adjudicator's fees.

An adjudicator's decision is valid and binding on the parties unless subsequent court or arbitration proceedings determine otherwise. The result is that most parties accept an adjudicator's decision and do not issue court or arbitration proceedings to have the dispute finally determined. This is sometimes referred to as "temporary finality" or interim-binding (see Practice note, Adjudication: section 108 and adjudication procedures: "Temporary finality" or interim-binding).

Prior to the *Bresco* case (described above), adjudication case law established that the right to adjudicate was effectively lost when a company entered insolvency proceedings (despite the lack of any such restrictions in the Construction Act 1996 itself). This was because, although an insolvent party could start an adjudication and the adjudicator issue a decision, the court was likely to order a stay of execution at the enforcement stage, resulting in the adjudicator's decision going unpaid. The Supreme Court's decision in *Bresco* made clear that the very valuable right to adjudicate is still available to companies in formal insolvency proceedings, although it is still subject to certain conditions when it comes to the enforcement of the adjudicator's decision (see Practice note, Adjudication: challenging enforcement of the adjudicator's decision: Applicable principles for court to apply to enforce an adjudicator's decision).

6. What impact is the Corporate Insolvency and Governance Act 2020 expected to have on the industry?

It was the temporary COVID-19-related measures contained in the Corporate Insolvency and Governance Act 2020 (CIGA 2020) that had the most impact in construction, as they did in many industries. We have seen no impact of other measures, such as the new prohibition on suppliers terminating supply contracts due to the customer's insolvency. The main reason for this is because the new protection against termination of supply contracts only protects a construction company's contracts with its own suppliers (its downstream contracts). It does not prevent the company's main employers from terminating its upstream contracts shortly before or upon its insolvency. This will have a greater impact on the insolvency process and the recoveries for the construction company's creditors than the situation with its downstream contracts.

See Practice note, Corporate Insolvency and Governance Act 2020: construction aspects.

7. Please describe up to two important insolvency and/or restructuring cases in the industry and what their impact is.

The *Bresco* case is significant for R&I in the industry (see 2. Are current trends in R&I activity reflective of trends you have observed in the industry in the last five years or have there been any significant shifts?).

Another relevant recent case is *Meadowside Building Developments Ltd (In Liquidation) v 12-18 Hill Street Management Company Ltd [2019] EWHC 2651 (TCC)*. While *Bresco* considered whether a company in liquidation could adjudicate at all, *Meadowside* considered whether and in what circumstances an insolvent company could enforce an adjudicator's decision by way of summary judgment. Although *Meadowside* was decided before the Supreme Court's judgment in *Bresco* was handed down, in *Bresco* Lord Briggs referred to the conditions that Adam Constable QC, sitting as a deputy High Court judge in *Meadowside*, had identified.

The *Meadowside* case enshrines the key considerations to be taken into account by a liquidator (and their litigation funder, if applicable) when seeking summary judgment to enforce an adjudicator's decision (see, in particular, paragraph 87 of the judgment).

For more information, see Legal update, Insolvency prohibition in *Bresco* is not absolute (TCC) and Practice note, Adjudication: challenging enforcement of the adjudicator's decision: What are "exceptional circumstances"?.

It is clear that since the *Bresco* case, while the adjudication path may be clearer for insolvent companies, the outcome remains uncertain and there are no guarantees that an adjudicator's decision will be enforced (see Practice note, Adjudication: challenging enforcement of the adjudicator's decision: Exceptional circumstances in practice and Legal update, Applicable principles for court if company in liquidation applies to enforce an adjudicator's decision (TCC)).

Supply chain risk

8. Where in the supply chain are you seeing the biggest areas of financial distress and insolvency risk? How is this impacting business continuity and operations in the industry?

See above, 4. Where in the industry are you observing the most R&I activity and exposure?. Inevitably it is at

the sub- or sub-sub-contractor level where financial distress first begins to bite. However, this does not have a significant upward impact, as there is always another subcontractor available to complete the works if the initial subcontractor goes into insolvency proceedings.

9. How should industry participants seek to protect themselves against this risk to maintain supply chain continuity and resilience?

The timings of payments due under construction contracts mean that there is often a lag of 28 to 35 days between a contractor submitting an application for payment for work done and being paid for that work.

As a consequence, if a contractor or subcontractor goes into insolvency proceedings, the employer or contractor is usually entitled to withhold any further payments until the construction works are complete and defects in those works are remedied (see Practice note, Payment in construction contracts: Construction Act 1996: Insolvency and section 111). Also, under the JCT standard forms of contract, the employer is entitled to terminate the contractor's employment (see Practice note, Terminating a JCT building contract: Termination by Employer if Contractor Insolvent).

While there is often an additional cost associated with bringing on a new contractor or subcontractor to complete those works, the employer or contractor can use the money that it did not pay the insolvent contractor or subcontractor to mitigate its loss.

Acquisition opportunities

10. Please describe trends you are seeing in distressed M&A in the industry. What areas of opportunity are there for prospective buyers of distressed or insolvent companies?

We do not see a huge amount of distressed M&A in the construction industry. One of the key reasons is that often the loss (or decrease in financial value) of one key contract is sufficient to cause substantial financial stress to a construction company. Cashflow is notoriously tight in the construction industry and if a main contractor or employer issues a substantial pay less notice against the contractor, it can have a disproportionate impact on the contractor (see Practice note, Payment in construction contracts: Construction Act 1996: Section 111: requirement to pay notified sum and pay less notices).

Therefore, there is often a very quick acceleration between non-payment (see 9. How should industry participants seek to protect themselves against this risk to maintain supply chain continuity and resilience? which explains the timing of payments in the construction industry generally) and the company being unable to return to its sites to complete the works it had contracted to do. If the company is unable to pay its staff on a Friday, its staff will not attend site the following Monday, and the company's decline rapidly accelerates. Pre-pack administrations are far more likely to save part or all of the distressed business than the intervention of distressed M&A prior to a formal insolvency process. See Practice note, Pre-packs in administration: overview.

11. Are there any industry-specific risks prospective buyers should be aware of? What actions can they take to mitigate these risks?

See answer to 10. Please describe trends you are seeing in distressed M&A in the industry. What areas of opportunity are there for prospective buyers of distressed or insolvent companies?.

12. How are sales of insolvent businesses generally structured in the industry?

See answer to 10. Please describe trends you are seeing in distressed M&A in the industry. What areas of opportunity are there for prospective buyers of distressed or insolvent companies?.

Approaching a restructuring or insolvency process in the industry

Restructuring

13. Can you outline any industry-specific considerations and risks in a restructuring process in this industry, from the perspective of both (i) a financially distressed entity in the industry and (ii) a creditor of this type of entity?

Large scale restructurings and insolvencies in the construction industry are rare in the UK, with the exception of the very high profile (and very unusual) compulsory liquidation of companies in the Carillion group in 2018.

The vast majority of insolvencies that occur are on a smaller scale and, as such, the creditor base tends to be a single secured lender, trade creditors and potentially the Pension Protection Fund (if the company

had a defined benefit pension scheme). Control of any restructuring or of any insolvency appointment tends to rest with the secured lender (which may sometimes be a bank or in some cases a factoring company, given the difficulties with obtaining more conventional secured bank finance in an industry where much of the value resides in traditional floating charge assets).

The key risk with trying to negotiate a restructuring (whether avoiding an insolvency process or using a pre-pack to save some or all of the company's business) relates to the loss of ongoing contracts that the insolvent company has. Often the main contractors or employers have lost faith in the management of the insolvent company by the time it reaches the restructuring stage and are not prepared to entertain a novation of the company's valuable contracts to a new entity controlled by existing management. Without those contracts, there is often not much of a business to save for an insolvent construction company. See Practice note, Assignment and novation of construction documents and Standard document, Novation of building contract by contractor's administrator.

Insolvency

14. Are there any industry-specific considerations and risks to be aware of when advising (i) an entity in this industry that is going through a formal insolvency process and (ii) third parties dealing with such an insolvent entity in this industry?

If there is a prospect of saving the business of an insolvent construction company, administration is generally the preferred route. Liquidation will be appropriate if there is, by that stage, no business with potential to save. While company voluntary arrangements (CVAs) are occasionally approved by creditors for construction companies, insolvent construction companies have traditionally had substantial debts owed to HMRC, who are often unwilling to support a CVA and may hold a controlling proportion of the company's debts and therefore creditor votes. Most CVAs that are approved in the construction industry do usually fail in any event, with the result of immediate administration or liquidation. One of the main reasons for the failure of CVAs is that they usually rely on recoveries being made on the debts owed to the insolvent construction company. However, the timing of debtor recoveries is often very protracted in construction insolvencies (if recoveries are ever made at all), which usually causes the company in CVA to breach its payment obligations, resulting in administration or liquidation.

Third parties dealing with an insolvent entity (particularly where main contractors or employers are dealing with a contractor in financial stress) have traditionally taken the approach of stopping payment to the contractor and replacing them on site with a new contractor, or directly retaining that contractor's subcontractors to complete the works. However, at a time when the cost of raw materials has spiralled so substantially, it is difficult to see how that approach continues to make economic sense. If a main contractor or employer is otherwise comfortable with the performance of the contractor, it might make more sense to seek to support the contractor and vary the contract sum to reflect the rising cost of raw materials rather than allowing that contractor to fall into insolvency and incur even more costs bringing a new contractor on site.

For further information on insolvency procedures, see Practice Notes:

- Company voluntary arrangements (CVAs).
- Administration.
- Liquidation: overview.
- Overview of company insolvency procedures.