ECA
Excellence in Electrotechnical & Engineering Services

GUIDANCE Note

Debtor insolvency

This guidance is intended to inform Members of the considerations and risks surrounding circumstances in which parties owing Members money have entered into an insolvency process.

A guide setting out key considerations and explanations when your client is financially precarious or has entered insolvency:

- Why is cash flow vital to project success?
- What to look out for
- What types of insolvency are there?
- How to leverage your position

1. Cash flow

Cash flow is critical to the success of a project, specifically during the works phase.

Each participant in the supply chain is reliant on the party above it in the chain to properly (and promptly) pay for work carried out. Most construction contracts provide for interim payments meaning as a supply chain contractor you have to carry significant work in progress because you are paid in arrears.

From a project perspective, insolvency therefore causes:

- Programme disruption and delays to completion of works
- Compromised quality, workmanship and defects as the situation unfolds
- Third parties losing the benefit of any collateral warranties they may have had with the insolvent contractor and having to rely on other warranties or insurance products covering insolvent contractors

From a business perspective, insolvency therefore causes:

- Programme disruption and delays to delivery of business product and resources
- Compromised profitability and cash flow
- Compromised commercial relationships and irrecoverable debts

2. Warning signs

In monitoring your client's financial profile consider the following:

- Keep alert to their financial status – including periodic credit checks which include court and insolvency proceedings
- Removing site materials, plant and hire equipment that are re-sellable and can be recovered

- Note any redundancies or unfounded removal of staff, resource or supervision by the client
- Non-payment or late payment of other trades will also inform you of issues with the same client
- Keep in contact with; materials, plant hire and goods suppliers who have wider networks and more robust credit control abilities with those who are financially precarious
- Media, rumour and gossip is often an undervalued source of generic information about how financially precarious the client may be – this includes shareholders and stock market announcements

3. Types of insolvency

Companies in financial difficulty may be subject to the following insolvency procedures – for sole traders or partnerships there are equivalent systems under bankruptcy and liquidation, but as most businesses are companies we have outlined the fundamentals for when you are a creditor of a company:

- company voluntary arrangements (CVAs)
- administration
- liquidation/winding up (compulsory or voluntary)
- receivership

The distinguishing factor between each of these processes from a creditor's perspective is whether the process is terminal, i.e. simply involves wrapping the company's affairs up and paying the debts of the company to the extent that there are sufficient funds remaining in the company to do so, or whether the process may allow the company to trade out of insolvency back into normal trading conditions.

It is therefore vital from a creditor's perspective that you; a) establish which form of insolvency your debtor is entering, and, b) collate and confirm which company you are in contract with under which your debt has fallen due – this can often be confusing where one part of a corporate group has entered into insolvency, but other parts are not and continue to trade normally.

Administration

Administration is the most common of the insolvency procedures. A company in administration still exists legally and can continue to trade. Administration is designed to rescue and restructure a company that has become insolvent. However, as with other forms of insolvency, debts are frozen whilst the process of salvaging the company back into a solvent trading position is carried out.

An administrator may be appointed either:

- out of court, by a qualifying floating charge holder or by the company or its directors, or
- by the court, on application by the company, its directors or one or more of its creditors

The objective of administration is to:

- rescue the company as a going concern
- achieve a better result for creditors than if the company were wound up, or
- realise property for the benefit of the creditors.

As the administrator is trying to fulfil this objective, for those sub-contractors who remain unsecured creditors and require payment of some element of the debt sooner rather than later, administrators are often more amenable to commercial settlements, i.e. an offer from a creditor to settle the debt at a reduced sum over a payment plan in return for faster upfront payment.

This approach is a purely commercial one for the parties involved and should involve recognition of the risk that the company may fail to recover and move from the administration process into liquidation where it will not survive. However, such a settlement may allow an unsecured creditor to recover more monies faster, than it would otherwise fare as one of many unsecured creditors waiting months for the administration process to conclude at the risk of liquidation and recovery of 6% of the debt owed (this is the average recovery rate for unsecured creditors in construction insolvencies).

Liquidation/winding-up

Liquidation/winding up means the dissolution (death) of a company. The company will still exist legally until dissolution but will usually not continue to trade.

Under the Insolvency Act 1986, a company is insolvent if it cannot pay its debts as they fall due (cash flow test) or if its assets are worth less than its liabilities (balance sheet test) – failing to pay; an invoice as it falls due or failing to pay an amount owed under a court judgment is also proof of insolvency. Future and contingent liabilities are taken into account for these purposes.

A liquidator is appointed to act as the agent of the company. The liquidator's principal concern is to recover the assets of the company to be sold to third parties – often done at rock bottom price. During liquidation a liquidator will be appointed to gather and distribute the company's assets following a specified order of priority of creditors. This order usually involves paying the liquidation bill, fixed and floating charge holders, tax, wages and pension liabilities being treated as preferential creditors over unsecured regular creditors. Hence, unsecured creditors having waited months for the insolvency process to be carried out, often only recover under 10% of their debt if they are lucky enough to find there are sufficient funds for that amount.

Company voluntary arrangement (CVA)

A CVA is an arrangement that a company enters into with its creditors under the supervision of an insolvency practitioner, the nominee. The aim of this is to prevent the company entering liquidation and ultimately being dissolved.

The company will still exist and usually continue to trade.

A company's directors may propose and negotiate a CVA with its creditors to agree how the company's debts will be repaid. The CVA must be consented to by at least 75% of its unsecured creditors and all of its secured creditors.

The aim of the CVA is to prevent the company entering liquidation and ultimately being dissolved. However, if the CVA confirms the debts will be treated in a specific way, those unsecured creditors disagreeing with that plan may find themselves aggrieved.

Receivership

The appointment of a receiver is a remedy for creditors and other third parties to protect their interest in a company's assets. A receiver can be appointed by court, or by a vesting document and their powers are usually limited in some way compared to other office holders such as liquidators and administrators.

There are several different types of receiver, depending on the circumstance. The most common are:

- Administrative Receivership which involves the appointment of an insolvency practitioner by a creditor who holds a floating charge over the assets of the company
- Law of Property Act Receivership whereby a receiver is appointed by a mortgagee or by the court whose role is to collect income from and protect property over which he has been appointed

As stated above in fulfilling their objectives as insolvency practitioners, , for those sub-contractors who remain unsecured creditors and require payment of some element of the debt sooner rather than later, insolvency practitioners – especially if they want to novate the sub-contract to a new main contractor or preserve the intellectual property, insurance cover and warranties - are often more amenable to commercial settlements, i.e. an offer from a creditor to settle the debt at a reduced sum over a payment plan in return for faster upfront payment.

This approach is a purely commercial one for the parties involved and should involve recognition of the risk that the company may fail to recover. However, such a settlement may allow an unsecured creditor to recover more monies faster, than it would otherwise fare as one of many unsecured creditors waiting months for the administration process to conclude at the risk of liquidation and recovery of a vastly reduced percentage of the debt owed.

4. Proactive prevention

As you under most construction contracts, get paid on a 'pay as you go' basis in 'arrears' for works as they complete, it is important to manage the cash flow cycle and minimise your financial exposure.

If the sub-contractor has not already done so, it should ensure that it has copies of all of the relevant contractual documents in relation to the project, including the sub-contract, the main building contract (assuming the sub-contractor has been provided with a copy or is entitled to request it—it may be a redacted copy), all payment applications and notices served to date, all collateral warranties/third party rights provided by the sub-contractor, and any other documents pertaining to the sub-contract and any goods/materials supplied for the project.

Impeccable record keeping is vital so that you can assess your situation and your options.

The following are factors in minimising your exposure, leveraging your position and connected issues which should be considered in the context of a material risk of your client becoming insolvent:

- **Reduced interim payment cycle**; e.g. monthly to fortnightly – this reduces your exposure to cash flow problems at any one time on the project.
- **Advanced payment**: many standard form contracts provide for a facility for advanced payment. This is commonly the case where a large portion of the contract value represents materials – hence the lifts and escalators sector require advanced payment in the ordinary course of business.

  This facility can be used to ensure you are paid in advance for the materials and plant you need to order, especially if ordered from overseas in significant volumes or on a made to order basis. You may be required to sign for the monies and in doing so, promise to insure, secure, maintain as identifiable the goods as belonging to the main contractor, should you become insolvent, but the trade-off of doing so is reasonable given the advanced payment is significantly reducing your risk.
- **Bonds and Parent Company Guarantees**: both are methods of securing performance and can be used by a sub-contractor to leverage and secure main contractor performance.

  A bond will entitle a sub-contractor who is the beneficiary to claim for all or specific loss, when a main contractor has become insolvent – this may be harder to obtain if the main contractor is financially restricted as the cost of the bond will be unaffordable whether it is an insurance product or is taken by a bank from their lending facilities.

  A PCG will allow the sub-contractor to call on the parent company of the main contractor to step-in and fulfil the monetary obligations of the main contractor, should the main contractor become insolvent
- **Project Bank Accounts**: A PBA involves a cash flow model where the sub-contractors are paid directly from the PBA – which is an account held on trust for the supply chain. As a result, if the main contractor enters into insolvency, the sums in the bank account for that month will not be caught up in the main contractor's insolvency but will be distributable directly to those supply chain contractors signed-up to the PBA.
- **Pay-when-paid on third party insolvency**: clauses removing your sub-contractor's right to get paid where your client has become insolvent are lawful – whilst questionably commercially moral, this type of clause remains a viable means of protecting your commercial position.

  Otherwise you will still be liable to continue to make payment to any sub-sub-contractors in the event of main contractor insolvency.
- **Right of suspension:** under the Construction Act, you have a right to be paid in accordance with the statutory process. If you are not paid the amount 'due' (as defined by the Construction Act), on the final date for payment, you can issue a, usually 7 day, suspension notice suspending any or all of your obligations (including the obligation to snag, rectify defects and handover completion documents – therefore still worthwhile considering at the end of the project), until you are paid.

  The sub-contract may contain an express right to suspend work upon the main contractor's insolvency pending termination, see for example JCT Standard Building Sub-Contract

Conditions 2011/2016 (JCT SBCSub/C) clause 7.10.2.2. There is no equivalent provision in the NEC suite of contracts. Carefully check the terms of the contract and adhere to all requirements as to notices and timings to avoid any argument that the sub-contractor is in breach of contract by suspending work.

- **Termination for non-payment:** it is usual for there to be a clause to allow you to serve a notice that if a significant, material or persistent breach of contract occurs (such as unlawful non-payment), the client is required to remedy the breach within a set period of time, or else you will have the option of being able to serve a notice of termination. This usually leads to disputes over whether there did in fact exist a significant, material or persistent breach of contract.

- **Termination for insolvency:** there is commonly (but you should check) a right to terminate for main contractor or client insolvency – it is best to check you have proof of insolvency, and why type of insolvency, first.

  The sub-contract is likely to provide for the sub-contractor to terminate its engagement under the sub-contract in the event the main contractor becomes insolvent, see for example JCT SBCSub/C clause 7.10.2.1, and NEC3/4 ECS clause 91.1. The sub-contractor must carefully check however that the contractor is 'insolvent' as defined by the sub-contract (e.g. the definition of insolvency in clause 7.1 of the JCT SBCSub/C and clause 91.1 of NEC3/4 ECS) and should be mindful of any requirements as to notices to be served and any time limits (e.g. under clause 7.10.2.1 of the JCT SBCSub/C 2011/2016, the sub-contractor has to wait three weeks from notification of the insolvency before it can terminate).

  Ensure that any steps following termination in the contract are strictly followed, e.g. clause 7.11.2 of the JCT SBCSub/C requires the sub-contractor to remove plant and equipment etc from the site.

  Even though the main contractor may have become insolvent, the sub-contractor should still ensure that any payment notices/applications for sums that are due are submitted in accordance with the terms of the contract. Until such time as the sub-contractor's engagement under the sub-contract is terminated, it needs to adhere to the payment process under the contract and maintain its contractual rights to payment.

- **Third party documents and step-in rights:** Sub-contractors are often required to provide collateral warranties or third-party rights in favour of numerous third parties. Before purporting to terminate its engagement under the contract or suspend carrying out the sub-contract works, the sub-contractor needs to establish whether any third parties have been granted step-in rights (usually the employer and/or funder).

  Where there are step-in rights, the sub-contractor is typically required to serve a notice on the beneficiary of the rights giving them notice that the sub-contractor intends to terminate its engagement on the project (and sometimes where it intends to suspend carrying out the sub-contract works). The sub-contractor cannot terminate/suspend until expiry of the prescribed notice period. The beneficiary may elect to step-in (itself or by way of a nominee) and assume the main contractor's place in the sub-contract. The sub-contract then continues, and the beneficiary will be liable for payments to the sub-contractor from that point and usually for any outstanding payments.

- **Direct payment by end-client**: Many construction contracts permit direct payments from the employer to sub-contractors where the main contractor has become insolvent, but this is not a sub-contractor's right, only a client's prerogative.

  The sub-contractor should also be mindful of the potential opportunity to renegotiate with other parties to assist its financial position. Assuming the project is to continue with a new main contractor, or that the employer intends to complete the project itself by engaging the sub-contractors directly, this can represent an opportunity to negotiate more favourable terms. The sub-contractor is potentially in a stronger bargaining position where its services are required to complete the project, so may be able to renegotiate prices and/or more favourable terms as to payment (e.g. shorter time-frames for payment etc).

  As the end-client may face a residual liability to pay the insolvency practitioner in addition to any direct payment, public sector clients will be reluctant to do so, because of the fear that it will be an inappropriate use of public funds. Whereas, private sector may find the value of continuing warranties, minimised disruption to completion, cost, safety, quality and insurance cover, against their potential exposure upstream for late completion of the project well worth the risk that they could pay twice for the same works.

- **Intellectual Property Rights:** Check the copyright provisions of the sub-contract and any collateral warranties/third party rights. Where a sub-contractor has provided a copyright licence granting other parties the right to use its material/designs produced for the project, that licence may allow the sub-contractor to suspend such licence in the event that it has not been paid by the main contractor. If this is the case, it puts the sub-contractor in a stronger position when negotiating with the employer in relation to payment and continuation of the project.
- **Retention of title to goods**: without a suitably and clearly drafted retention of title clause retaining ownership to goods and materials, many of the standard form contracts provide that ownership in goods and materials passes on delivery despite payment not having been made. Some bespoke contracts go as far as to pass ownership in equipment and tools at the same time allowing the main contractor to sell them and apply the proceeds of sale towards funding the completion of the project.
- A retention of title clause will only work where:
  - the clause is sufficiently clearly and robustly drafted Included in the contract
  - the goods remain readily identifiable and adequately protected from theft, vandalism and damage
  - the goods in question have not been incorporated into the fabric of the works
  - you have a right of access to recover the goods in question

  ECA has a separate guidance note on Retention of Title.

5. Letters of comfort

Unless the insolvency practitioner issues a statement that you "will be paid for the work you do during the liquidation." You will not get paid for this work. If such a letter is issued by the insolvency practitioner, payment for work undertaken by Members during the liquidation is considered an expense of the liquidation process and is therefore guaranteed, payment for work undertaken prior to the date on which the business entered into liquidation will, in the vast majority of cases, be considered unsecured debt.

Again, due to the scale of the insolvency process and therefore the costs involved in administering it, most liquidations do not generate sufficient funds to make any payment (a "dividend") to unsecured creditors. Payments of this nature tend only to be a small proportion of what is owed and even then, not paid for a considerable period of time.

If the letter of comfort: (a) contains statements which can reasonably be construed as a contractual promise arising; (b) after the date of liquidation, this is likely to evidence a binding contract between the liquidator and the party within the scope set out by the terms of the letter – as opposed to a letter containing statements of fact which are meaningless.

Much like letters of intent, whether letters of comfort give rise to a contractually binding relationship, depends on the substance and scope of the letter.

Your team at ECA is here to help with this issue.

6. Joint ventures

Most joint ventures relate to projects, on which there are commonly partners who are jointly and severally liable. Subject to checking the specific provisions of these agreements, these contracts will often continue under the terms of the JV with the remaining partners.

7. Summary

Market Research

- What is the financial position of both your customer and the overall project employer?
- Verify who is actually funding the project: government, banks, self-financed, grants etc?
- Are financial accounts available? Be concerned if they are late in publishing them.
- Keep abreast of 'local' news. Try to understand what are influencing events in the area.

- The first line of defence is a robust credit control system
- Try to have your terms and conditions be the basis on which you carry out the work
- Where appropriate, ask for a; shorter payment cycle, bank reference, performance bond or a Parent Company Guarantee
- Is there sufficient time for everyone to price the work and the risk?
- Are project risks identified and placed with the party best able to manage them?
- Is the size of job appropriate to the 'named' contractors and suppliers? Will they cope?
- Vet any 'named' contractor or supplier. Ask for trade or bank references, if these prove unacceptable, you can ask that an alternative company is chosen.
- Check, that your 'key' supplier's 'retention of title' terms and conditions are communicated to your customer. Comply with any stipulations regarding the labelling, for identification purposes, of this equipment and/ or plant.
- Site based intelligence and media can provide a valuable source of information – delegate, to one person, the responsibility for gathering this information.
- Be wary of any sudden change in the management of your account. Unexpected claims for payment should be investigated and used as an opportunity to negotiate.
- Ensure that any retention fund or performance bond adequately protects you against your suppliers' insolvency.
- Sizeable contractors will be capable of producing a company cash flow forecast. You may be asked for yours and you should ask key sub-subcontractors for theirs.
- Check the contract to see if the retention can be placed into a trust fund. This protects against customer insolvency.
- Debt recovery agencies should be instructed to chase bad debts.
- If payment stops (take advice), then issue a notice suspending work and consider making a statutory demand before a winding up petition.
- Assess your working capital requirements in light of the reassessing your cash flow forecast and act to secure additional sources of finance.
- Review contract documents to see whether the Section 113 rights to withhold payment in light of an upstream insolvency are present, which could thwart any attempts to claims for payment of retention.
- Be alert to signs of financial distress on any other contracts and act to safeguard your exposure. See whether retention can be secured or whether payment guarantees can be provided, or better terms offered as goods are delivered to site.
- Consider the retention of title position both up and down stream.
- Look to formalise any rights of set-off you may wish to impose. Ensure your pay-less notices are issued in accordance with either the Scheme for Construction Contracts or your bespoke contract terms.
- Look to your existing contracts and, if necessary, divert resources to ensure measurement and applications for variations, changes and disturbance of the regular flow of work are formally communicated and applied for.
- Cash is king – be alert to the opportunity for 'deals'.
- Talk to the insolvency practitioner – register your debt even if unsecured alongside many, including your:

    a. copy of trading terms

    b. statement of account as proof of contractual performance

    c. copy invoice

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