Insolvency and construction: a practical perspective

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Introduction

The construction industry, across the globe, has always been susceptible to cash-flow and solvency issues (particularly lower down the supply chain) and the on-going COVID-19 pandemic as well as the recent insolvency of Arabtec have magnified the situation.

In this article, we discuss some headline issues that key stakeholders in the highly inter-connected construction industry should consider in the context of liquidity as well as solvency and how they can potentially mitigate their exposure to such critical risks.

Key issues

Insolvency of the Owner

The insolvency of the Owner of the Project will cause very significant and obvious harm to the entire contractual chain.

Among other things, this will almost inevitably result in the Main Contractor: (i) being out of pocket (particularly as the vast majority of payments under construction contracts are typically made in arrears for works actually performed); and (ii) terminating the engagement of its supply chain (which, depending on the terms of their subcontracts, may not be fully compensated for all their out of pocket expenses).

From a Main Contractor's perspective it is therefore important that it satisfies itself as to the adequacy of the financial arrangements that the Owner has in place in order to complete the project.

Although some industry standard construction contracts (such as the FIDIC Rainbow suite) require the Owner to provide (on a continuing basis) evidence of its financial arrangements to fund the Works (and a right to terminate can even arise if the Owner fails to provide this evidence), it is customary, at least in the GCC construction market, for this clause to be deleted.

In the event of such deletion, the Main Contractor is required to perform (and essentially self-fund) substantial components of the Works at its own cost (on account of the retrospective payment mechanism) but with no real way of knowing that the Owner has the financial resources to pay for these Works. This can obviously lead to financial exposure if the Owner were to subsequently become insolvent prior to paying for completed Works.

Assuming obtaining evidence of the Owner's financial arrangements is not possible, the Main Contractor can seek to partially guard against this risk by attempting to agree frequent interim payments that are reflective of the actual works being performed, thus avoiding back-loaded payment structures.

A further pressure point is the prevalence for construction contracts to prescribe that title to plant and materials shall only pass to the Owner upon delivery to site (and not upon payment). Although it would be prudent for the Contractor to resist this risk allocation and argue title should only pass upon payment by the Owner, Owners customarily resist arguments of this nature on the basis that they fail to comply with market practice (which is also referred to in the FIDIC Rainbow Suite). In this situation, the Main Contractor should, at least, seek an advance payment to cover the cost such procurement.

Although construction contracts typically allow the Main Contractor to suspend performance in the event of failures to certify as well as on account of the non-payment of certified amounts (thereby providing the Contractor with an important 'safety valve'), it is not unusual, in the GCC, for such rights of suspension to be either deleted in their entirety or made subject to lengthy trigger periods (in respect of which 90 to 120 days is relatively common). This means that the Contractor may effectively be forced to continue to perform without payment for a significant amount of time (during which the Owner's financial health may significantly worsen) before being permitted to suspend performance (and thus 'stopping the bleeding').

This situation can, in part, be mitigated on the basis that various GCC jurisdictions allow for one party to suspend performance at law in the event of a breach by the counterparty (i.e. the Owner's failure to make due payments to the Main Contractor (or to certify)).

However, such suspension rights are not prescriptive and the question of when and to what extent a failure to make payment triggers a right to suspend is a vexed one. Indeed, it is important that a Main Contractor does not 'prematurely' or 'disproportionately' suspend and this could result in the Main Contractor being deemed to be in breach, thus casting the Main Contractor in the role of the breaching party and potentially exposing it to wide-ranging liability. In this situation, the Owner may be able to contend that it has a right to terminate the (particularly if the Owner argues that the Main Contractor has abandoned the Works) and invoke the frequently onerous consequences that apply in the event of termination by the Owner for cause.

Insolvency of the Main Contractor

The insolvency of the Main Contractor can be severely detrimental to both the Owner as well as to the Main Contractor's subcontractors and supply chain.

From the outset it is notable that a Main Contractor insolvency can, at least, partially emanate from a competitive tendering process that pressurises the Main Contractor into accepting an unrealistically low contract price. While this is the Main Contractor's commercial decision whether or not to agree to participate and ultimately win a 'race to the bottom', the Owner should bear in mind that an unduly low contract price can strangle the ability of the Main Contractor to properly perform. This non-performance can manifest itself in various forms, including in the form of poor quality work, late performance and possible insolvency, all of which are highly undesirable consequences for the Owner.

Leaving aside the issue of the adequacy or otherwise of the contract price, it is important that the Owner conducts financial due diligence on the financial standing of the Main Contractor (including by requesting recent financial statements during the tender stage as well as making enquiries in the market) before executing the Construction Contract.

Additionally, the Owner should be alert to any 'red-flag' signs, such as the Main Contractor's inability to provide a performance bond as this can indicate that the Main Contractor's banks have lost confidence in the business. For this reason, it is important that the Owner preserves the usual right to terminate is a performance bond is not provided within 28 days.

Consideration should also be given to requesting a parent company guarantee if the Main Contractor is part of a larger group, although such an instrument will be of limited value if the Main Contractor's entire group is the subject of a corporate failure.

From the perspective of the Owner, the insolvency of the Main Contractor will obviously mean that it will need to engage a replacement of the Main Contractor.

Given that an insolvent Main Contractor cannot realistically be held responsible for the inadequate works that it may have performed, it will be the Owner's preference that the incoming contractor agrees to assume 'single point responsibility' so that it is responsible for the Works performed by the insolvent Main Contractor. However, this can be a complicated and expensive proposition for various reasons, including as an incoming contractor may be reluctant to take over (and assume the risk of) a half completed project and may well seek to charge a premium to reflect this added risk (especially if it has not been possible to adequately interrogate the adequacy of the works performed as at the date of termination).

It is therefore important that the Owner ensures that it has sufficient cash security (i.e. in the form of retention and a performance bond) under the terminated construction contract to mitigate the cost and expense that will almost inevitably be incurred when engaging a replacement contractor.

A further and related point is that it is likely to be more efficient for the replacement contractor to engage some (or all) of the insolvent Main Contractor's supply chain in order to complete the Project (and this will also be the case if the Owner elects to engage the supply chain itself and, subject to licensing requirements being satisfied, to complete the project without a main contractor in place).

In this regard, an insolvent Main Contractor will almost certainly have outstanding payments due to the supply chain as, even if the Owner has continuously made prompt and complete payments to the Main Contractor, there is no certainty that the supply chain will have been paid their dues (i.e. as the Main Contractor may have diverted funds, that should have rightfully been paid to the supply chain, to pay off other urgent liabilities). In any event, payment entitlements of the supply chain will need to be verified (which is seldom a straightforward task) and paid (at least partially) before the supply chain is willing to be reengaged on the Project. As such, security that the Owner holds under the construction contract of the insolvent Main Contractor will therefore also be highly relevant in this context.

As with regard to the supply chain, it is prudent for the Owner to insert a clause in the Main Construction Contract that allows it to make direct payments to the supply chain if it considers that sums are due to members of the supply chain from the Main Contractor and to deduct such direct payments from sums that would have otherwise have been paid to the Main Contractor. As related points, the Owner may also wish to: (i) ensure that it obtains collateral warranties from key subcontractors and suppliers that contain step-in rights (enabling the Owner to cure the Main Contractor's breaches (including in respect of non-payment) and thus eradicating the subcontractor's possible right of termination); and (ii) ensure that it has transparency (i.e. in the form of a right to audit) over the use of the funds that it pays to the Contractor to ensure that they are being used for the Project (and not for other purposes).

A final remark is that the insolvency of the Main Contractor will also almost certainly delay the completion of the Project (and therefore the date upon which the Project becomes a revenue generating asset). Amongst other things, this may have an impact on the Owner's financing arrangement and, as such, the Owner may wish to consider the availability of insurance to address this risk (as well as building flexibility into its financing documents to reflect such a delay).

Insolvency of supply chain

The insolvency of a critical member of the supply chain (such as the subcontractor the responsible for a major package (i.e. MEP) or the provider of a long-lead item) can cause significant delays to the Project. Further, as the Main Contractor is fully responsible for the performance of its supply chain, this can expose the Main Contractor to liability under the Main Contract, including in the form of delay damages.

It is therefore important that the Main Contractor carefully manages and keeps a close eye on the financial standing of its supply chain and is ready to take pragmatic preventative action if it appears that a key member of its supply chain is in financial difficulty.

Notwithstanding the critically important role it plays, the supply chain is typically engaged under conditional payment arrangements, which provide that a subcontractor is only entitled to payment provided that the Main Contractor has received payment for the Subcontractor's works under the Main Contract. This can be particularly problematic if non-payment to the supply chain is caused by disagreements between the Owner and the Main Contractor that have nothing to do with the works or services performed by the supply chain.

Payment arrangements of this nature have been prohibited by law in various jurisdictions on account of the fact of the financial stress to which they can expose the supply chain as well as on account of their susceptibility to abuse. While is can be very difficult for conditional payment regimes to be resisted in their entirety, subcontractors may consider seeking to negotiate mitigants to lessen the harshness of an undiluted conditional payment mechanism.

Such mitigants may include: (i) conferring transparency upon the subcontractor to determine when payment from the Owner is received by the Main Contractor; (ii) specifying that the conditional payment mechanism is not indefinite (but is expressly subject to a definitive long-stop date); and (iii) providing that the conditional payment regime is subject to prescribed thresholds.

Finally, the points made above in relation to steps that the Main Contractor can take in respect of its arrangements with the Owner are generally applicable to the supply chain and should therefore be carefully considered by the supply chain.

Conclusion

The construction sector has always been highly susceptible to liquidity and payment issues and this has been amplified by the on-going Covid-19 pandemic: all stakeholders should therefore acknowledge that insolvency is a real and increasing risk in the industry and take all practical and legal measures that are viable to properly protect it should an insolvency event occur.

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