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# The Dangers of Construction Insolvency

For many years, the construction industry has suffered more than most with insolvencies. In 2018, it was the hardest hit economic sector, with construction insolvencies representing 17% (3,001 from a total of 17,454). This trend continued into 2019, with provisional figures indicating construction insolvencies accounted for 18.6% (3,198 from a total of 17,197)<sup>1</sup>. These statistics are regularly translated through the media as there never seems to be a month that goes by without news of contractor insolvency – from high profile industry names to historic brands to specialist contractors – no one appears to be safe.

Heading into 2020, and even before the Covid-19 pandemic changed the world, many industry analysts were warning that the construction sector should prepare for distress within the supply chain as market analysis indicated a falling demand, rising input costs and lower margins.

In addition to the already precarious market, Covid-19 is having a significant impact on the construction sector at large, with pressure on the labour, supply chains and finances of all companies involved. The environment in which these organisations are having to operate is ever-changing, with regular advice from the Government and the Construction Leadership Council (CLC) about how to keep sites open, whilst ensuring that contractors comply with the Government's social distancing requirements. Notwithstanding the emergency support measures introduced by the Government, and the continued efforts of the construction industry to be open for business, it is inevitable that the financial health of all companies will be impacted, and despite best efforts, some will be fatally wounded.

Given the current climate, there is a growing need to be alert to the fragile market, with contractors displaying early warning signs of distress. The challenge is for employers to identify these early warning signs and to act quickly wherever possible.

## Pre-Insolvency – Warning Signs

**Site Issues** – these warning signs broadly relate to numbers of staff/labour, the quality and progress of workmanship and availability of materials. Examples of common issues are set out below:

1. A high turnover of staff
2. A general decrease in labour on site
3. A slowdown in the progress of the works / not achieving project timescales or milestones
4. Poor quality workmanship/increase in defects
5. Removal of plant, equipment and/or materials from site

**Commercial Issues** – these warning signs relate to steps that a distressed contractor may take to improve its cash flow and generate cash collection.

1. Requests from the contractor for changes to the payment mechanism
2. Inflated applications for payment / unsubstantiated claims

<sup>1</sup> GOV.UK Insolvency Service Official Statistics (<https://www.gov.uk/government/collections/insolvency-service-official-statistics>)

3. Complaints from subcontractors regarding payment
4. Lack of response to correspondence
5. Late filing of statutory accounts and annual returns

If any of these warning signs start to manifest themselves and the risk of insolvency for a contractor increases, it is essential that you act quickly to protect yourself. With this in mind, there are some simple “do’s and don’ts” which can be adopted to help safeguard your position and ensure that you do not fall victim to a number of pitfalls.

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### **Pre-Insolvency – Simple Do’s & Don’ts**

#### **Don’ts**

Without taking legal advice, the don’ts include:

1. Not terminating, novating or assigning contracts
2. Not appointing a new contractor to carry out relevant work
3. Not paying sub-contractors directly
4. Not making advance payments or make payments for off-site materials

If the prospect of insolvency looms, it is critical that you have a clear understanding of your contractual rights and obligations, and that you comply with all relevant provisions. Issues related to termination, the appointment of new contractors and payments at this time are fraught with danger and need careful manoeuvring so that common mistakes, such as the termination prior to formal appointment of the administrator/liquidator or termination notice not in accordance with the contract terms and/or issued to the wrong contractual party are not made, which would potentially expose the employer to considerable financial consequences.

Notwithstanding the above, there are several steps that an employer can take to ready itself for the potential insolvency of a contractor.

#### **Do’s**

1. Ensure that you have a complete set of contract documents – including warranties and guarantees – it is often the case that these documents are not conveniently stored and /or incomplete which causes problems
2. Establish a full list of the contractor’s management team
3. Identify subcontractors that are critical to the timely completion of the works, check whether you have collateral warranties in place.
4. Clarify your rights and obligations (in the event of an insolvency) – i.e. do you have step-in rights?
5. Schedule and, if possible, safeguard any plant, equipment and materials that you have paid for
6. Get your paperwork in place – instigate full monitoring of progress and determine the scope and value of the work remaining – mark up drawings, take photos, etc.
7. Prepare a contingency plan in the event of the contractor’s insolvency.

The basis of these steps is to ensure that the employer has a robust contingency plan in place in the event that the contractor becomes insolvent. In order to develop this plan, it is necessary that it has access to all relevant contractual documentation, a working knowledge of key contractual provisions and has a detailed record of the progress of the works and materials/plant that has been paid for. So, in summary, given that the market is under pressure it is vital that employers remain vigilant, know your contract, and be prepared and ready for a potential insolvency. As we have seen over the years, even the biggest can fail!

If you require any further information, please contact Paul Cacchioli at [paulcacchioli@hka.com](mailto:paulcacchioli@hka.com).