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Insolvency & the JCT Contract

Following on from my recent article “The Dangers of Construction Insolvency” [<https://www.hka.com/the-dangers-of-construction-insolvency/article>], which highlighted some of the warning signs to look out for in a distressed contractor, and which also set out a number of practical steps that an employer can take to protect itself from a contractor’s insolvency, this article aims to focus on the contract and what it tells us about what we can and cannot do.

Whilst there are numerous contracts under which construction projects are delivered, this article will focus on the standard form JCT 2016 (versions of the D&B, Standard without Quantities, Intermediate and Minor Works) for the scenario where the contractor has become insolvent.

In addition to the contract, in the current climate of COVID-19, it is important to be mindful of the measures set out in the Corporate Insolvency and Governance Act 2020 (“CIGA”), and to be cognisant of these recent changes to the legislation. One of the key changes introduced by this new legislation that may impact parties to a construction contract is the introduction of a permanent ban on exercising termination clauses in contracts for the supply of goods and services.

Accordingly, subject to a limited number of exemptions, this would prevent suppliers of goods and services (including contractors, subcontractors and consultants in the context of the construction industry) to an insolvent party from relying on their contractual right to terminate the contract in the event that the company that it is supplying has entered into an insolvency procedure. This will leave the supplier obligated to continue working for or supplying goods and materials to a company that it knows is insolvent. Clearly, these parties would need to explore alternative contractual mechanisms and laws to protect themselves, such as the right to suspend the works for non-payment of monies due by the final date for payment.

By contrast, the CIGA allows the party higher up the supply chain (the employer/customer) to rely on the contractual termination provisions should a supplier become insolvent.

This ban on exercising termination clauses in insolvency situations is clearly a significant change which could have a massive impact on the construction industry in the months ahead. Given the potential impact of these recent changes, it would be prudent to seek legal advice.

Notwithstanding the above and turning to the JCT form, the summary below sets out the actions open to the employer.

Terminate the contractor’s employment at any time (Subject to the provisions set out in CIGA).

In the event that the contractor becomes insolvent, the employer may at any time by notice to the contractor, terminate its employment. Accordingly, it will need to consider whether or not to terminate the contractor’s employment. It is sensible that during this period of consideration, the employer checks that any requirements which were required under the contract from the contractor (such as collateral warranties, performance bonds and parent company guarantees) are in place. It is also worth the employer verifying whether it has certain rights, such as step-in rights.

If the employer does choose to terminate, the contractor has to provide the employer with all relevant documents, such as design documents, assign sub-contracts if necessary, and remove plant and equipment when required.

However, great care must be taken if the decision to terminate the contractor's contract is implemented, as to do so before the contractor is deemed insolvent under the terms of the contract is likely to amount to a repudiatory breach of contract which could trigger significant ramifications for the employer. In my experience, this mistake is often made. Moreover, it should be noted that provisions contained in the CIGA have inserted some specific changes, such as creating a new moratorium procedure which is not currently included within the definition of "Insolvency" under the terms of the JCT contract. This will clearly complicate matters, as an employer will not be able to terminate the contractor's employment where it chooses to use the new moratorium.

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Suspension of works obligations from the date of insolvency.

Under JCT forms of contract, the contractor's obligation to carry out the works is automatically suspended.

Protect and secure the site.

Following the contractor's insolvency, it is essential that the works are adequately protected and the unfixed goods and materials are retained on site. Accordingly, the employer may take reasonable measures to secure the site and protect the works.

Payment stops, irrespective of whether or not the contract is terminated.

As with the automatic suspension of the work, the employer's obligation to pay the contractor is automatically suspended until the agreement and issue of a final account. This payment obligation comes into force regardless of whether the employer issues a notice of termination.

Choose to stop, or terminate and employ a third party to finish job.

In addition to the option to terminate noted previously, the employer can decide to just stop the works and, depending on the project status, it can postpone it to a revised date in the future.

Alternatively, the employer may choose not to terminate the contractor's employment but rather work with the contractor to agree a form of novation. This transfers the rights of the contractor to another contractor in order to minimise disruption to the works. Whilst this has obvious benefits to the employer, it is also worth noting that the continuation of the contract may be beneficial for the administrator/liquidator, as it may assist in its ability to realise any value from the contract.

Prepare a final account.

Irrespective of how the original contract is dealt with – stop the works, novate or terminate and employ others to complete the works – the employer is obliged to settle its account with the contractor.

Following the completion of the works and making good defects, the employer must prepare a statement setting out its account. This account must include the expenses that it has properly incurred in completing the

works, as well as any direct loss or damage caused to the employer for which the contractor is liable. In addition, the statement must also include the amounts already paid to the contractor and the amounts that would have been payable to the contractor had the contract not been terminated.

Any payable account balance between the parties is determined by whether the sum owed by the contractor exceeds the amounts owed by the employer or vice versa.

To conclude, the financial well-being of the construction sector is fragile at the best of times, but given the current pressures borne out by the pandemic, there is a heightened risk of contractor insolvency. Accordingly, given this increased risk and the changes to legislation, it is a good time to understand your contractual obligations.

If you require any further information, please contact Paul Cacchioli at paulcacchioli@hka.com.