Burges Salmon Construction and Engineering Group News ▪ April 2009

QUAYSTONE

CREDIT CRUNCH SPECIAL

Further information

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Introduction

These are some of the most difficult economic conditions for the construction industry in living memory. The press is full of stories of stagnation in the commercial sector resulting in developer and contractor insolvency. This special bulletin from Burges Salmon's Engineering and Construction Group, expanding on a series of articles in our regular quarterly bulletins, looks at ways in which players in the industry can organise themselves to better weather the storm. It also considers the impact of the government's plans to stimulate the economy by investing in infrastructure.

Investment led recovery: Too little too late?

The government has indicated that part of its economic stimulus package will be to fund an investment led recovery by bringing forward £3 billion of infrastructure projects. The tactic is unsurprising given that the construction industry accounts for around 10% of UK GDP.

So which projects will benefit? Those with immoveable end dates such as the Olympics and those required to comply with EU commitments are obvious choices. Long term rail investment is also a government commitment. Major projects already underway include Thameslink and Crossrail in London, the latter with an overall project value equivalent to 1% of GDP. Away from the capital there are long term plans to redevelop Birmingham New Street station and electrify parts of the intercity network.

Nuclear new build is also very much on the agenda. Development land is currently being auctioned off on existing nuclear sites but spend here is to a longer timetable. EU targets to reduce landfill use is the driver behind waste managment schemes such as the £3 billion Greater Manchester Waste PFI.

Funding will be crucial of course. Major public schemes have until recently relied on private finance through the PFI scheme. In the credit crunch, when banks are simply not lending, private money has dried up. This has produced a log jam of stalled projects. To get things moving the government has recently announced its intention to provide £2 billion to bridge

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Employer friendly payment provisions

Contractor insolvency is an unfortunate possibility in these challenging times. A prudent employer would consider covering the following issues in express contract conditions:

- no obligation on the employer to make any further payment that would otherwise be due following contractor insolvency (see the *Melville Dundas* House of Lords case for an example of this type of clause operating in JCT DB 2005);
- employer allowed to complete the project with another contractor and recover the (additional) cost of doing so from the insolvent contractor (or set off this cost against amounts due to the insolvent contractor);
- employer allowed to make direct payments to sub-contractors/consultants. This will require careful drafting to mitigate the risks of contravening insolvency rules and of "double liability" to the insolvent contractor and the sub-contractor/consultant.

Consideration should also be given to including the following in the contract:

- **a project bank account**: historically, these have not been very popular but they can safeguard money which could then be used to pay sub-contractors and consultants which, otherwise, would be subsumed into the insolvent contractor's bank account. The employer and contractor will set up the PBA and hold the monies on trust for each of the contractor and the key subcontractors. The sums to be deposited by the employer are determined in accordance with the main contract. The contractor informs the subcontractors of the sums to be paid to them from the PBA. Payments are then made direct from the PBA to the contractor and the subcontractors.
- **"back-loaded" stage payments** so that larger amounts become payable only as the project nears completion;
- **an escrow account:** the escrow agreement should specify that funds will return to the employer in the event of the contractor's insolvency (or other default) and that any accrued interest also goes to the employer.

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Step-in Rights: Some practical issues

Step-in rights allow funders to take the place of employers in consultant appointments or building contracts to complete projects and realise their value. Step-in can be difficult and may increase risk. This article highlights issues to be considered before step-in.

- **A last resort** – Step-in is a drastic remedy and generally a last resort. Step-in will disrupt the works and may increase cost. Consider other options first.
- **Investigate liability** – Funders should obtain details of the remaining works and timescale for completion. As funders will be liable to pay outstanding and future fees, details of the fees should be obtained. Claims against the borrower by its consultants and contractor, should be investigated. Funders may be liable for such claims and they may increase the difficulty of achieving completion. Claims may however be confidential.
- **Use a nominee** – This would provide a single point of responsibility and allow the funder to avoid becoming directly involved. A funder should enter into a contract with its nominee. Funders should consider appointing a project monitor to undertake an enhanced monitoring role.
- **Pragmatic approach** - Funders should consider liaising with the borrower/contractor/consultants to obtain their views on the funder stepping-in and how this may affect the project. It should be remembered that it will be in a contractor/consultant's interest to have a funder step-in, so that they get paid.

After step-in it may be advisable to have a short period (e.g. two weeks) where the contractor stops work so a funder has time to consider how to proceed. This may however cause costs to rise and the contractor may not agree.

Step-in can be an invaluable tool for funders provided that the risks are considered before the option is exercised.

Contractor insolvency: Is termination the answer?

When faced with the insolvency of a contractor, termination can be used as an effective tool by the employer to take control of a project and secure its completion. Before pushing the button employers should consider the following issues:

Basis of right to terminate

Most standard form contracts contain express provisions for termination in the event of insolvency. A common law right to terminate, unless expressly excluded, also exists although insolvency itself may not entitle a party to terminate. More often than not a party will have to rely on other breaches, such as a failure to complete the works which tends to occur when a contractor becomes insolvent, as opposed to the insolvency itself.

Impact of termination on other rights

The performance and quality of the work are commonly secured by bonds, guarantees, insurances or warranties. Terminating the contract may have an impact on these securities and consequently their benefit needs to be considered when assessing whether termination is the right course of action.

What process must be followed?

Having established that termination under the contract is the right course of action, the employer must have regard to any process and time limits set out in the contract. It is vital that these are strictly followed as even minor breaches can result in the termination being unlawful.

Check the contract for other rights

Most standard form contracts provide the employer with additional rights not available under common law. More often than not, an employer has the right to use plant and material on site or request the assignment of subcontracts. These provisions can make the completion of the work much easier for the employer.

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Investment led recovery: Too little too late? *(continued from page 1)*

the funding gap. This debt will then be sold to the private sector when liquidity returns. Critics hail this as the death of PFI whereas pragmatists claim it is simply the government stepping in to underwrite some of the risks that the private sector cannot bear in these exceptional times. Either way it should mean that more projects get started soon.

Another boost to the industry in the longer term is the new Planning Act 2008. It provides a fast track planning mechanism for nationally significant infrastructure projects and replaces the previous system which was notoriously slow. It won't make much difference in the short term but could bring projects on line before the recession is over.

While any good news is to be welcomed, it remains to be seen whether these announcements have come soon enough to help those being squeezed now.

Litigation against an insolvent company

The impact and availability of litigation remedies changes when a company is insolvent.

Administration

Once an administrator has been appointed a moratorium is imposed preventing or halting any proceedings against the company unless a court order is obtained. Nevertheless, if the court would clearly grant leave, the administrator should consent to the action without the need to apply to court.

The case of *Re Atlantic Computer Systems plc [1990]* sets out guidelines that the court will apply when considering whether to allow claims against a company in administration. The court will weigh up the interests of the applicant and the other creditors. The underlying principle is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights. The applicant should ideally have a proprietary interest rather than a simple claim for monetary relief (e.g. a claim for damages). The latter ranks alongside claims of other unsecured creditors and permission to litigate is therefore far less likely.

A moratorium suspends rights rather than extinguishes them – so, subject to the expiry of any relevant limitation period, litigation can be commenced either when the administration ends or the company goes into liquidation.

Liquidation

In compulsory or provisional liquidation, where a moratorium is imposed, the court may apply the *Re Atlantic* principles. The court will seek to do what is right and fair in all the circumstances *(New Cap Reinsurance Corporation Ltd v HIH Casualty & General Insurance Ltd [2002])*.

There is no automatic stay of legal proceedings where:

- A winding up petition has been presented but not yet been the subject of an order; or
- The company is in a voluntary liquidation

Should proceedings be commenced?

The key issue is whether the applicant has a proprietary right or security over assets. Without it the claim will rank equally with those of all the other unsecured creditors. Even if a favourable judgment is obtained the applicant will not be entitled to recover its debt ahead of other unsecured creditors. Incurring litigation costs for solely financial relief could be a futile exercise.

Details of whether a company is insolvent and the name of any relevant office holder can be obtained from Companies House online WebCheck service:

http://wck2.companieshouse.gov.uk

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