IMPACT OF THE CORPORATE INSOLVENCY AND GOVERNANCE ACT ON CONSTRUCTION CONTRACTS

- The Corporate Insolvency and Governance Act (CIGA) came into force on 26 June 2020, with the intention of providing businesses in financial difficulty with flexibility and breathing space and additional assistance (such as the protection of supplies) in order to maximise their chances of survival.

- It contains a number of provisions which will impact on construction contracts and professional appointments, in particular on the rights of a supplier under a contract for the supply of goods and services (e.g. a contractor or sub-contractor) to terminate on the insolvency of its client.

- The CIGA creates 2 new insolvency events, intended to introduce flexibility and allow companies time to explore options for rescue.

- What effects are the changes likely to have on construction contract negotiations?

WHAT'S IT ABOUT?

Section 12 of CIGA inserts a new section 233B entitled "Protection of supplies of goods and services" into the Insolvency Act. The changes effected by this provision will cut across termination and other rights exercisable by a supplier of goods or services upon its client becoming subject to a defined insolvency procedure by (in summary):

- rendering ineffective contractual rights to terminate the contract or supply or do any other thing (including automatic termination or other consequences) because of the insolvency; and

- preventing the exercise of an entitlement to terminate a contract during the insolvency period where the 'termination event' and consequent right to terminate arose prior to the insolvency, but the right was not exercised.

CIGA also prohibits suppliers from making it a condition of on-going (post-insolvency) supply that pre-insolvency arrears are paid.

Termination can still take place if the relevant officer (e.g. administrative receiver or liquidator) or the client itself (depending on the type of insolvency procedure involved) consents to the termination. The court can also grant the supplier permission to terminate the contract if its continuance would cause 'supplier hardship', although CIGA does not define what supplier hardship is.

There is a **temporary exclusion** from S233B for contracts between small suppliers (as defined in CIGA) and companies that become subject to a relevant insolvency procedure between 27 June and 30 September 2020.

There is a **permanent exclusion** from S233B for certain contracts for the supply of goods and services to a company in the context of financial services under new Schedule 4ZZA of the Insolvency Act. This exclusion applies where **either** the company or the supplier is subject to the insolvency procedure and where either the client or the supplier is a type of financial institution or provider referred to in the schedule including (subject to the specific meanings set out) an insurer or a bank.

The exclusion also applies to specified "contracts involving financial services" which include financial contracts such as lending, financial leasing and the provision of guarantees and various other contracts.

CIGA also introduces two new insolvency processes that are designed to assist in rescuing companies in financial distress and maximising their chances of survival:

- a statutory moratorium process, which allows directors of companies that are in financial distress to obtain a 20 business day moratorium period to allow time to explore rescue or re-structuring options without creditor action; and

- a re-structuring plan procedure, which broadly follows, but expands upon, the existing "scheme of arrangement" regime.

WHY DOES IT MATTER?

The provisions will clearly have a significant impact on suppliers to insolvent companies, preventing them from exercising their contractual rights to terminate or cease supplies or take other action as a result of the insolvency.

The changes do not affect the rights of clients (e.g. an employer under a construction contract, or a contractor under a sub-contract) to terminate on the insolvency of their supplier.

The changes do not impact on the right of the supplier to be paid for goods or services provided during the period of the insolvency procedure or any contractual rights that it may have as a result of such non-payment. As such a supplier could exercise a contractual right to terminate for a payment default which occurs after the start of the insolvency period, although this is not provided for expressly.

A key protection for a supplier under a construction contract is the **statutory right of suspension** under s112 HGCRA, which entitles it to suspend the performance of the whole or part of its obligations on giving 7 days' notice if the client does not comply with its payment obligations. Although not expressly set out in the legislation it seems generally accepted that this right applies in relation to a failure to pay for supplies made after the insolvency. However, there is a lack of certainty as to whether this right is affected by new S223B if it is exercised after the insolvency, but in relation to a pre-insolvency payment default or in relation to supplies made before the insolvency. As the right to suspend is statutory and is exercisable because of failure to pay, rather than because of the insolvency, it seems strongly arguable that the exercise of this right should not be affected, but this is not certain. As a result we may see suppliers seeking to suspend works earlier than may otherwise have been the case.

NOW WHAT?

There is no need to amend contractual termination rights as a result of the changes effected by CIGA, as the provisions of the Act render affected contractual provisions ineffective. Longer term we may see amendments to the standard forms to reflect the changes.

Contractors, sub-contractors and other suppliers (**suppliers**) will no doubt start to become increasingly focussed on payment periods and failures to pay within the required period. They may seek to operate termination provisions earlier to avoid losing the entitlement to terminate on their client becoming insolvent, or start to utilise the statutory right to suspend for non-payment sooner or more readily.

Many sub-contracts provide for automatic termination on the termination of the main contract and indeed it is a requirement of the JCT main contracts that a sub-contractor's employment under its sub-contract terminates automatically on the termination of the employment of the main contractor for any reason. This automatic termination of the sub-contract seems likely to continue to operate and this will mean that the sub-contractor will not be obliged to continue to supply an insolvent main contractor. It is arguable that the automatic termination provision is rendered ineffective when the cause of the termination of the main contract is main contractor insolvency, but the argument to the contrary seems stronger as it is the termination of the main contract by the employer (not the insolvency directly) which causes automatic termination of the sub-contract. On a practical level there seems no rationale for tying in a sub-contractor when the contractor no longer requires the sub-contractor's supplies or services as its employer has terminated the main contract.

From a drafting perspective, those advising suppliers may wish to consider:

- undertaking additional due diligence on the financial strength of their client;

- checking that any contractual right to suspend work on non-payment is not subject to a longer notice period than the statutory 7 day period. It is not certain that a longer contractual notice period would be effective anyway, but this removes the potential for a dispute in relation to this matter;

- trying to negotiate shorter payment periods and shorter notice periods for termination (especially in respect of payment defaults during the period of client insolvency) to reduce exposure, although these changes are likely to be strongly resisted;

- ways to minimise the risk of client insolvency including advance payments (subject to appropriate security for the client against supplier insolvency), payment guarantees and project bank accounts;

- in a sub-contract (or professional appointment in a D&B project) making sure that the contract or appointment terminates automatically on termination of the main contract; and

- whether risk can be minimised by using contractual structures such as a framework agreement for long term supply arrangements under which each call-off is a separate contract, and the supplier can elect whether to enter into an individual call-off in its absolute discretion.

However, insofar as these changes would require a change to the normal contractual risk profile they are likely to be resisted by employers and by contractors in their sub-contracts.

Turning to the new insolvency events, it remains to be seen whether employers will seek to extend the current list of insolvency events to include them or will take the view that this is not appropriate given that the policy behind CIGA 2020 is aimed at ensuring businesses can maximise their chance of survival.

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