ADDLESHAW GODDARD

THE AFTERMATH OF CARILLION – A DUAL APPROACH: FUTURE CONTRACTUAL SAFEGUARDS AND CURRENT CONTINGENCY PLANNING

- Carillion's recent collapse, and its impact on numerous construction and PFI projects, has brought the issue of main contractor insolvency (and the insolvency of other contractors or entities in the supply chain) firmly into the minds and concerns of employers and contracting authorities
- What safeguards can employers and contracting authorities include in their contracts to seek to protect themselves against the impact of contractor insolvency?
- What practical steps can employers and contracting authorities take to protect themselves against the negative impact of contractor insolvency on their live projects?

What's it about?

Carillion was a diverse group of companies operating at many levels in the construction industry, ranging from main contractors on construction projects to contracting entities in public sector and PFI projects (including as building contractor, FM contractor and (in some instances) as equity stakeholder in the SPV delivering the project). The Carillion Group's recent collapse has led many employers and contracting authorities (collectively referred to as "employers") to re-consider what contractual safeguards they can adopt in future contracts so that they are best protected should the worst happen; and also the practical steps that can be taken for current projects in order to protect against the negative impact of the collapse of another contractor or supplier.

Why does it matter?

As Carillion's demise has demonstrated, insolvency in the supply chain can be disastrous to projects, resulting in increased or wasted costs and delay in the completion of works or delivery of services, together with the potential for a knock-on effect throughout the supply chain. It also leaves employers and other affected parties without a remedy against an insolvent contractor in respect of defects in completed works.

Now what – contractual safeguards for new projects

All employers should consider the following important contractual safeguards at the outset:

Bonds and Parent Company Guarantees

For any sizeable project, the employer should consider what performance security it can (and should) ask for.

If contracting with a subsidiary contractor, a parent company guarantee should be available at little (or no) cost to the employer. The guarantee should make the parent company responsible for all of its subsidiary's liabilities arising under the contract and should be for the duration of the period of the subsidiary's liability. As such a parent company guarantee offers long term security, subject to the continued financial strength of the parent company.

A performance bond is a key document if there is any fear about contractor insolvency, and offers short term protection during the construction period (and sometimes until the end of the defects liability period). Performance bonds are provided by a third party surety (usually a bank or insurance company) on behalf of the contractor. Generally covering up to 10% of the contract sum, the surety undertakes to recompense the employer if the contractor fails to carry out its obligations under the contract. Whilst there is a cost element to a performance bond which is invariably passed on by the contractor, the cost is usually minimal weighed up against the sum it potentially covers and the protection that it gives. The cost and ability of the contractor to obtain a bond can also be a useful indicator of the market's view of the contractor's financial position.

Performance bonds have, however, given rise to a good deal of litigation over the years and there are some important drafting pitfalls to avoid.

Third Party Rights

Collateral warranties (or third party rights clauses) provide a direct contractual link between otherwise unconnected parties, for example the employer and the contractor's sub-contractors. They should include step-in rights so that if the contractor becomes insolvent, the employer has the option to "step-in" to the contractor's sub-contracts, enforce the relevant provisions and minimise delays. The step-in rights should include provisions requiring the warrantor to enter into a new contract with the beneficiary if the relevant contract is terminated prior to any step in, as termination of a main contract will usually give rise to an automatic termination of a sub-contract, raising issues as to whether it is possible to step in to such a sub-contract.

In a major project employers may wish to include provisions regulating payments to sub-contractors and enabling them to confirm that payments to sub-contractors have been made by the main contractor when they fall due. In addition to providing reassurance that sub-contractors are being paid, this minimises the risk of a party exercising step-in rights having to pay again for the same work resulting from the standard obligation to pay any monies outstanding under the relevant contract on step in.

Employers should seek to put warranties or third party rights agreements in place with key sub-contractors and consultants as early as possible. In many instances sub-contractor warranties are not provided within the time limits required by the contract (and often only just before practical completion) as a result of delays arising from negotiations with sub-contractors and a lack of impetus. Obtaining warranties (and copies of underlying contracts) in a timely way should become a higher priority for project managers so that employers can rely on them in the event of main contractor insolvency.

Retention of Title

Although construction contracts generally provide for title in goods and materials to pass when such items are paid for, the situation becomes more complicated when the employer has paid the main contractor for goods and materials supplied by a sub-contractor but the sub-contractor has not yet been paid and his sub-contract includes retention of title provisions which allow him to claim ownership in the goods and materials. Whilst the JCT form of sub-contract already covers this issue by forbidding the sub-contractor to deny that any goods have become the property of the employer where such goods have been paid for by the employer, bespoke sub-contracts may not cover this point. Therefore employers should include appropriate obligations in the main contract and may want to insist on checking and approving any retention of title provisions in sub-contracts before they are placed.

Termination on Insolvency

Most building contracts give an employer the right to terminate the contract in the event of contractor insolvency – such rights should be clear as to how they may be exercised to minimise the risk of an ineffective termination.

Payment Issues

Under the Housing, Grants and Regeneration Act 1996 (as amended) a paying party must pay any amount which has become a 'notified sum' no later than a final date for payment; however, the Act allows an exception in the case of payee insolvency. Employers should check that their contract includes provisions which stipulate that if the contractor becomes insolvent after the latest date for serving a pay less notice has passed, they do not have to make any further payment.

Under the JCT suite of contracts an employer must complete the works and rectify defects before he can seek to recover his additional costs of completion following termination on insolvency. We recommend an amendment to the standard form to provide for the contractor to make on-account payments in respect of such liability (linked with provisions for expert determination), which will give rise to an early entitlement to claim on any performance bond or otherwise seek recovery. Employers may also wish to consider amending the calculation of amounts payable following termination under the JCT standard form, which requires the employer to account to the contractor for any saving which he makes in completing the works, which (although unlikely) would give the contractor an undeserved windfall.

There are now growing calls in the industry for the mandatory introduction of Project Bank Accounts in longer-term contracts and PFI projects, whereby the employer or contracting authority makes upfront interim payments or unitary charge payments into a ring-fenced bank account administered by a third party. The money (or any retentions) is not held by the main contractor or SPV, which means that in the event of contractor or SPV insolvency these funds will not fall into the hands of an insolvency practitioner and risk becoming assets in the insolvency, but will be readily available to pay sub-contractors and others in the supply chain to ensure that services and works can continue to be provided.

Now what – the Present

Disaster Planning

For current projects, there are a number of practical steps that should be considered in order to mitigate against some of the issues being seen on Carillion projects. The primary one, and one surprisingly overlooked given the size of some of these projects, is to put in place and maintain a disaster management or recovery plan. An employer should not assume that funders will exercise any step-in rights that they may have and should take the initiative in order to protect its project or assets.

The first 48 to 72 hours following a main contractor or supply chain failure is a key period and a disaster management plan should include strategies intended to avoid the project grinding to a halt in this period - if momentum is lost it may be an insurmountable task to save a project from significant wasted costs and irrecoverable delays.

Any disaster management or recovery plan should cover or include:

- identification of key internal stakeholders or management within the business and their role and expectations on a contractor insolvency – effectively, who will step-in and take over in the interim
- a list of key contractors and contacts who can be reached within the first 48 hours, in order to provide information about the status of the project and potentially engaged directly to continue to perform the works or services to ensure continuity
- access to the means by which to perform the works or services – this could include agreeing now to place intellectual property, designs, O&M Manuals, BIM data, etc with third party escrow providers who would release it on the insolvency of one of the parties
- contingency funds – if payments or cash flow are trapped in an insolvent entity, has a reserve been provided for (perhaps equivalent to two to three months' worth of payments) to allow the project to continue – in this instance, as stated above, it might be that retentions or bonds are in place to be called on to support ongoing works and
- options for a "Plan B"– this could include taking works or services back in house for the long term, or utilising other contractors or suppliers with whom a relationship exists (subject to procurement regulations).

Project management review

In addition to developing or updating a disaster management or recovery plan employers should undertake a review of the contractor's compliance with relevant provisions of the contract, including checking that:

- all required security (performance or retention bonds, parent company guarantees, and retentions) are in place and valid
- all required warranties or third party rights agreements are in place and copies of associated contracts (including all technical documents) have been provided and are in accordance with (and have been executed as required by) the contract
- all insurances are in place
- (insofar as the contract permits the employer to do so) payments to sub-contractors are up to date and
- where the contract includes rights (for example in relation to termination) linked to the financial strength of a party or security provider, that the relevant tests continue to be met.

Appropriate action (including the exercise of any sanctions provided for) should then be taken to seek to enforce compliance with the contract.

Who to contact?

AMY WARD-MORT
Associate
0113 209 2324
0773 802 3364
amy.ward-mort@addleshawgoddard.com

PHILIP WITHEY
Managing Associate
0161 934 6755
0772 028 5905
philip.withey@addleshawgoddard.com