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Construction sector resilience

Weathering the storm : Part 2

6 October 2020

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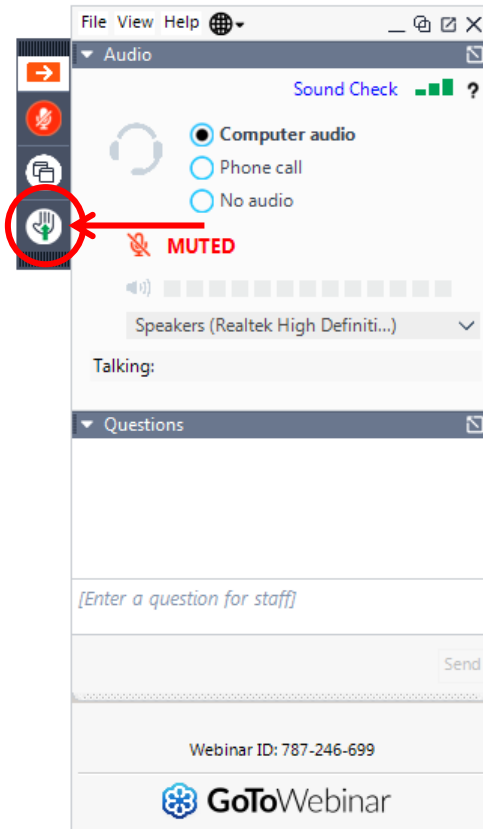
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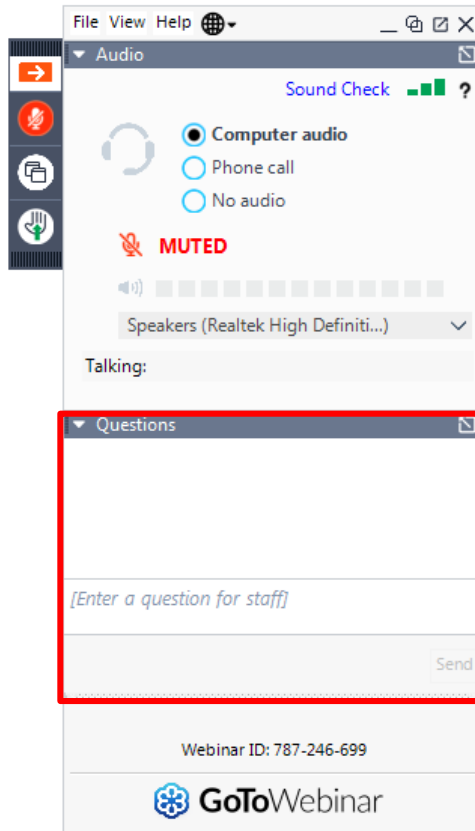


Raising an issue



If you have any issues, please select the hand button on the panel, and an organiser will contact you to help.

Asking questions



For any questions, please use the **Questions** box.

What we will cover

1

Challenges to overcome: including Brexit, tough market conditions, new ways of working and embracing modern methods of construction

2

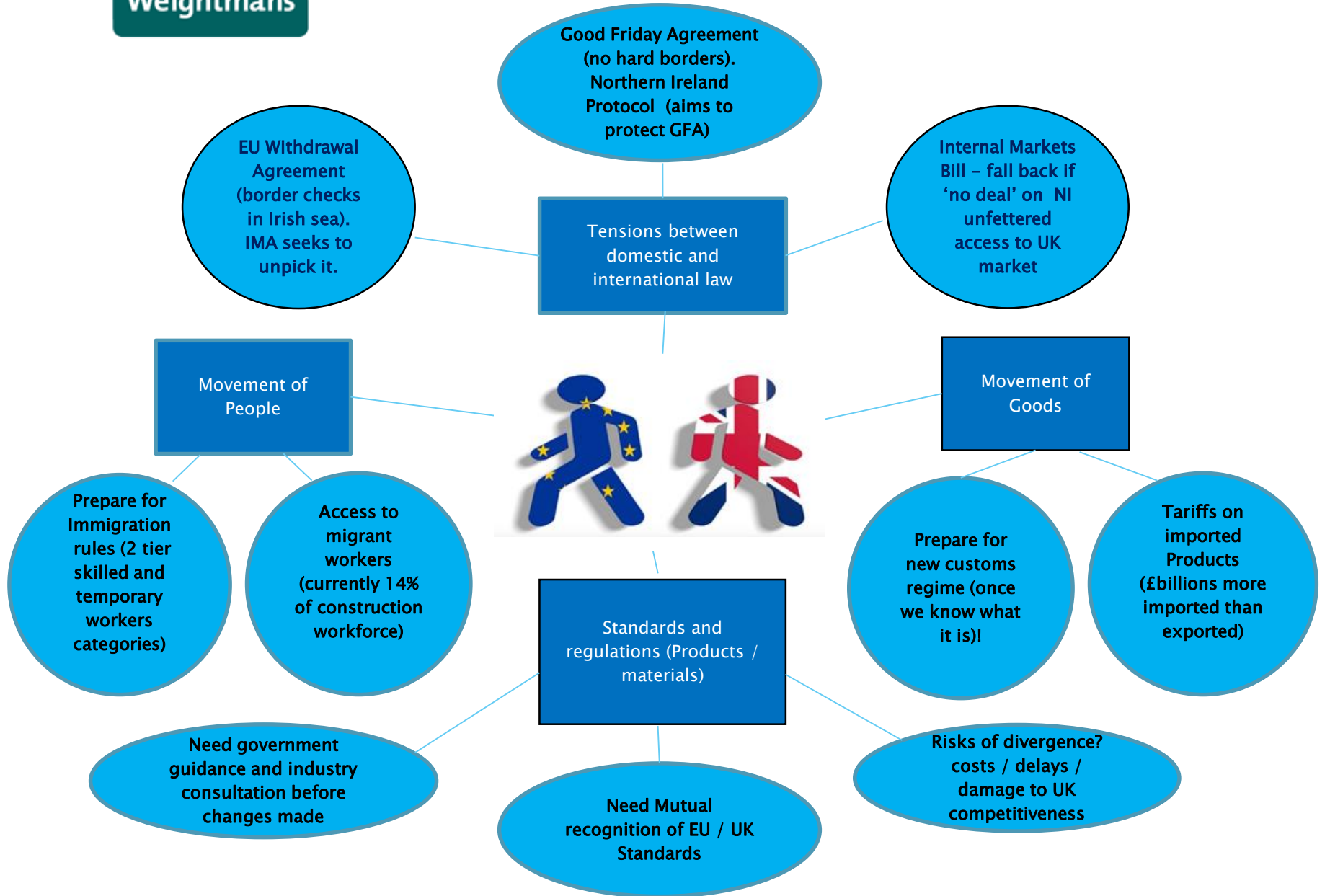
Discuss adjudication after *Bresco Electrical Services v Michael J Lonsdale (Electrical) Limited* [2020] UKSC 25

3

Provide a precis of the practical tips discussed in the last webinar. Highlight specific case studies. Discuss the common warning signs, positive early intervention measures, and the potential pitfalls / worst case scenarios

4

Provide guidance on the Corporate Insolvency and Governance Act 2020: including contractual termination clauses, the moratorium, and scheme of arrangements

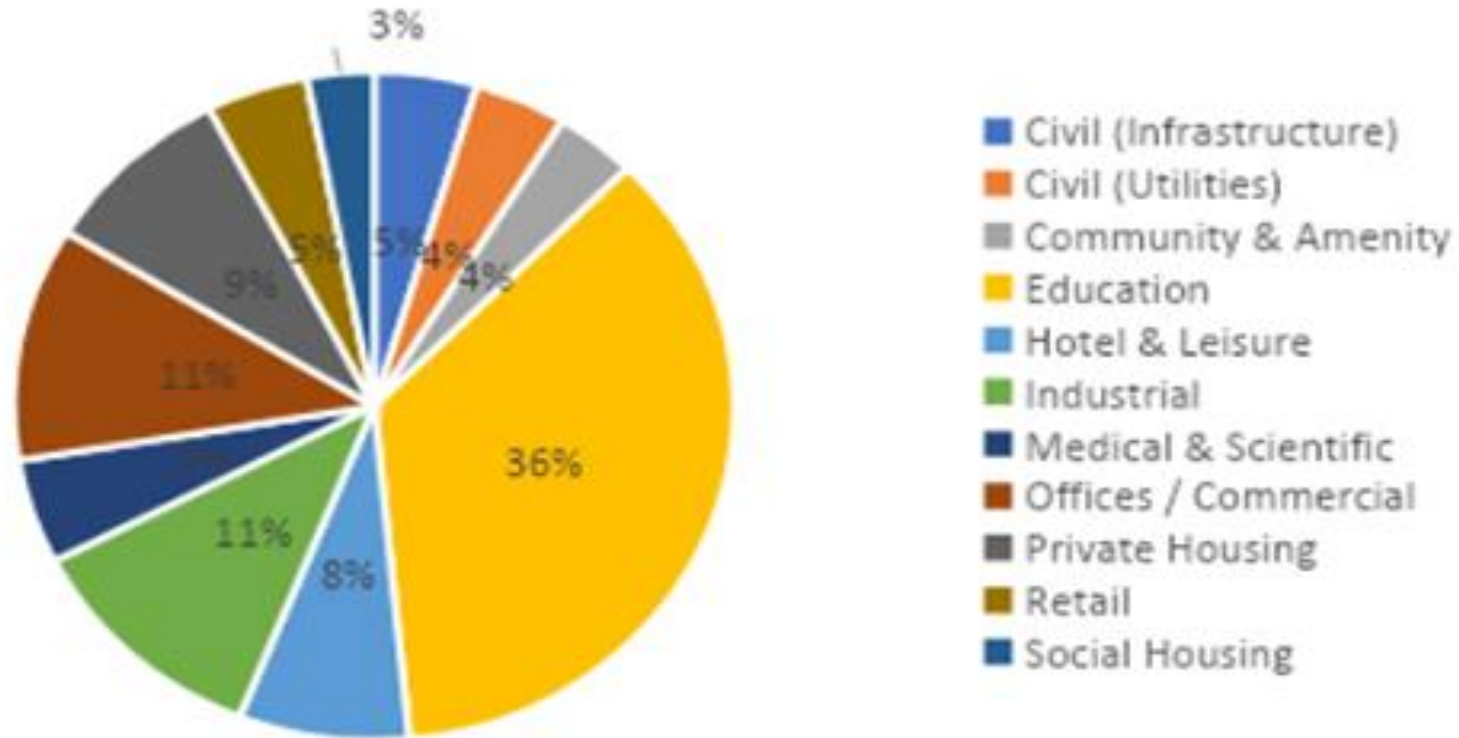


BREXIT Impact and how to manage it

- If 'no deal', UK will trade under WTO Rules under its Most Favoured Nation status.
 - Obtain specialist advice on what the tariffs under WTO rules will be for your imported goods.
- Think carefully about what contractual risks to accept, and plan and price appropriately (do not 'race to the bottom'):
 - Paying tariffs on imported goods and materials;
 - Delays at ports if goods stopped and checked;
 - Increased labour costs due to reduced migrant workers.
 - Plunging pound and rising prices on imported goods.
- Clients/Employers may draft clauses which:
 - Grant EOTs to contractors (but no additional money) if there are delays at ports.
 - Exclude contractors entitlement to additional time and money for increased costs due to less access to EU labour

- Early engagement and collaboration. Pricing. Options e.g.:
 - Standardisation / efficiencies, diversification / consolidation, restructuring.
- Modern Method of Construction (“MMC”):
 - Powerful drivers: social distancing and post Brexit world.
 - Modular (1) lower costs (20% – 40% cheaper), increased speed of delivery (20%–60% quicker), reduction in on-site labour (70% less: alleviating fears of post Brexit shortage of workers), less defects; (2) planned or constructed in last 5 years 36% in education, 11% both office and industrial.
 - MMC: Still not the norm. Seek legal advice on contractual arrangements/risks, warranties/bonds, funder issues.
- Homes England – Affordable Housing Programme (‘21 / ‘26)
 - Strategic partners to build 25% of pipeline utilising MMC.
 - £7.39bn Inc. 130,000 affordable homes outside London.
 - Aim: High-quality sustainable design/local SME house builders.

Modular Projects by Sector: 2014 - 2020



Source: **G Glenigan**

Interaction between Insolvency Rules (England & Wales) 2016 and Adjudication

- The Insolvency Rule 14.25 mandatory set off. Net balancing exercise of mutual dealings.

- Housing Grants, Construction and Regeneration Act 1996 (as amended) adjudicate “*at any time*”

- **Bresco Electrical v Michael Lonsdale** Court of Appeal 2019 – (i) Insolvency and Adjudication are incompatible; (ii) Cross claims = “*exercise in futility*” (unenforceable); (iii) adjudication would deprive a responding party of benefit of Rule 14.25 by making him pay adjudicator’s award then have to prove all claims in the liquidation.

- (iv) risk = responding party puts more in then he gets out;

- (v) Adjudication only in “*exceptional circumstances*”.

- **Meadowside v Hill Street** – TP funders fee can be no more than 50% of sum recovered

Effect of SCUK decision?

(i) greater flexibility for adjudication in administration of insolvencies to realise greater value for creditors; (ii) increased use of third party funding by liquidators seeking to protect against the risk of unfavourable adjudication decisions.

Meadowside V Hill Street (TP funders fee can be no more than 50% of recovery). (Damages-Based Agreement Regs 2013)

- **Bresco SCUK 2020** – (i) allowed Bresco’s appeal; (ii) neither incompatible nor an “*exercise in futility*” (iii) if cross claims exist, adjudication can determine the net balance owing to insolvent co; (iv) “*exceptional circumstances*” e.g. security for costs (inc. ring fence adjudicator’s award in case responding party challenges it in future court/arbitration proceedings within set timeframe).

- In **Balfour Beatty v Astec**, the TCC reached a similar decision shortly before SCUK. Astec had ATE insurance and gave £750k security for costs. Adjudication(s) allowed to continue.

- Section 14 of inserts new provisions into the Insolvency Act 1986 relating to contracts for the supply of goods and services. Ban on termination clauses upstream due to an “*relevant insolvency procedure*” (moratorium, administration, restructuring plan, or CVA) (“Insolvency”).
- Suppliers inc. contractors and subcontractors – **cannot, due to employer/customer insolvency:**
 - Terminate (or to do “*any other thing*”) because of customer Insolvency, even where he had a right to terminate **before** the Insolvency, but did not take action.
 - Stop providing services under the contract.
 - Change payment terms/demand payment of outstanding pre-Insolvency charges a condition of continuing contract.
- Exceptions:
 - 1. Insolvency officer consents to termination;
 - 2. Insolvent company consents to termination;
 - 3. Court permission (to prevent supplier hardship)

- **Standard Form Contracts:** e.g.
 - NEC cl. 91.1: ineffective insofar as upstream concerned.
 - JCT D&B 2016: cl. 8.5 downstream still applies. cl 8.11 upstream now ineffective.
 - Publishers may decide amendments not currently necessary as (clauses remain effective save for ones banned by CIGA).
- **Existing Contracts:**
 - Any contractual right to terminate due to customer insolvency is **now ineffective** (right falls away).
 - Left too late, options may be unavailable or higher risk.
 - May still have **statutory right** to suspend works for non payment (s112 HGRG Act 1996 (as amended)).
- **Negotiating new contracts:**
 - Include clauses to take the CIGA effects into account (i.e. supplier's rights severely restricted on customer Insolvency).
- **Main contractor:** is supplier to employer and customer to sub-contractor (downstream termination possible subject to contract).



Construction Sector Resilience Weathering the Storm – Part Two

6 October 2020

DUFF & PHELPS

Summary of Key Points from July 2020 Presentation

Construction Sector Resilience – Weathering the Storm (Part two)



“Construction companies are notoriously difficult to restructure through an insolvency, or immediately prior, through a formal restructure such as an Administration and a Company Voluntary Arrangement (CVA)”

Restructuring Issues

Construction companies are difficult to restructure through an insolvency process due to the insolvency clauses in the JCT. This consequently makes it difficult for an insolvency practitioner to sell the business as a going concern.

Practical steps construction firms can take

- Keep to known markets, do not reduce margins to bring in new customers
- Ensure robust financial controls are in place
 - Keep debtor concentration to under 30% with any one client
 - If expanding, maintain a mix of ‘bread and butter’, and new contracts
 - Keep main funders and creditors on board
 - Put payment plans in place with major creditors where necessary
 - Credit insure debts

Pinch points

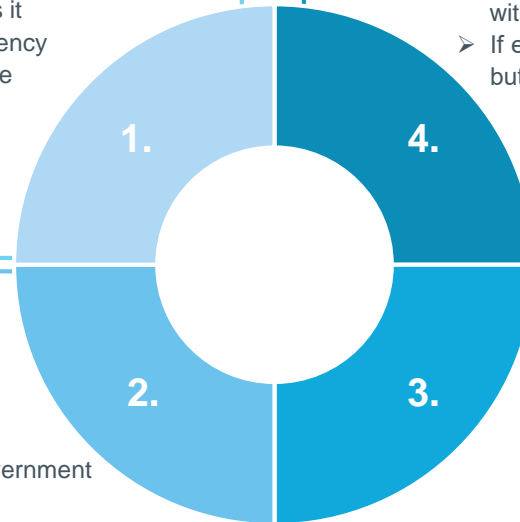
What will the pinch points be in the next 12 – 18 months?

- Withdrawal of government support schemes
- Increased levels of debt, with CBILS, HMRC deferment, etc.
- Working capital stretched
- Margins squeezed as materials become more expensive and productivity falls

Warning Signs

What are the key warning signs of potential issues ahead?

- An accelerated expansion into new markets, chasing work
- Difficulties with the supply chain
- Debtor concentration
- Reducing margin in order to chase contracts



Case Study One

Construction Sector Resilience – Weathering the Storm (Part Two)



BACKGROUND

- 60-year established North of England family construction business
- Projects – worked on many diverse projects, including hotels, retail, office and residential developments
- Main clients – public sector

CAUSE OF INSOLVENCY

- There was a contractual dispute on three projects which impacted 2018 revenues by c£3.2 mn
- Change of client mix from public sector, well paying clients to private sector clients, who were slower to pay causing cash flow pressures
- A slowdown in new work opportunities in 2019 created a hole in the cash flow whilst new contracts were negotiated
- As the pipeline of new work reduced, the company took on new projects at a reduced margin which left little room for manoeuvre should there be any unforeseen cost overruns or project delays
- All the above placed a huge pressure on cash flows and therefore the company's ability to service sub-contract debts, wages, and creditor payments

OUTCOMES

- The directors placed the company into administration.
- As main employers terminated contracts under the insolvency clause in the JCT, the administrators were unable to save business as a going concern. The following steps were therefore taken:
- The business ceased to trade and all sites secured
 - All employees were made redundant
 - Property assets realised for the benefit of creditors
 - QS appointed to agree deals with debtors on outstanding WIP
 - Contracts novated and claims against the Company reduced from £12 mn to £3 mn, thus improving overall outcome for creditors

Case Study Two

Construction Sector Resilience – Weathering the Storm (Part Two)



BACKGROUND

- Long established contractor with contracts across the Midlands and North England
- Traditionally serviced private and public contracts on new build and refurbished private and social housing developments

CAUSE OF INSOLVENCY

- Developer on one of the company's projects lost its funding when its main funder went into administration and was then unable to secure alternate finance to finish the project
- As a consequence the company suffered a £3.2 mn loss on the specific contract, with an additional loss of future profits
- The company lent £3 mn to connected companies who use the funds to invest into loss making contracts
- Consequently one of the connected companies went into an insolvency process, creating a significant bad debt and cash hole in the company's balance sheet
- The company expanded into new markets without the requisite expertise and they were unable to control the cost and time overruns, which affected margins with a subsequent negative effect on cash flow
- Pricing was reduced to secure new contracts, with the resultant effect on profitability

OUTCOMES

The directors placed the company into administration.

As main employers terminated contracts under the insolvency clause in the JCT, the administrators were unable to save business as a going concern. The following steps were therefore taken:

- All sites were secured
- The business ceased trading with immediate effect
- Employee contracts terminated
- QS appointed to agree deals with debtors on outstanding WIP
- Contracts were novated to reduce creditor claims and improve outcome for unsecured creditors

Case Study Three

Construction Sector Resilience – Weathering the Storm (Part Two)



BACKGROUND

- 200-year old family construction business, based in southern England
- 73 employees
- Main contracts within the educational sector and restoration of listed buildings
- Trade was seasonal with main contracts in the summer months
- Recorded an operating loss of £1.3 mn in the year prior to insolvency

CAUSE OF INSOLVENCY

- There was a significant fall in turnover as a result of lost tenders and delays on several projects
- The delays had in part been caused by cash constraints which delayed payments to sub contractors
- Gross margin fell by 2% caused by costing errors
- Several projects were delayed due to planning consent not being secured on several projects, which put a strain on trading
- Investments in IT functions had been funded from trading rather than from the expected funds received from an asset sale due to delays with the sale process, further exacerbating the pressures on cash flow
- Significant creditor arrears were built up and the company agreed a time to pay with HMRC on VAT/PAYE arrears
- Further tenders of £8 mn were lost to competitors and with a strain on future revenues and with a lack of funding available insolvency was inevitable

OUTCOMES

- The directors placed the company into administration.
- As main employers terminated contracts under the insolvency clause in the JCT, the administrators were unable to save business as a going concern. The following steps were therefore taken:
- All sites were secured
 - The business ceased trading with immediate effect
 - Property assets secured and sold
 - Employee contracts terminated
 - QS appointed to agree deals with debtors on outstanding WIP

What were the Key Warning Signs in Each Scenario?

Construction Sector Resilience – Weathering the Storm (Part Two)



Chasing low margin contracts to secure work



Expansion into new markets without having the inhouse expertise



Change of client mix from public to private sector clients



Lack of due diligence on employers funding position – are they in a position to honour their obligations?



Poor budgeting on contracts, resulting in cost overruns



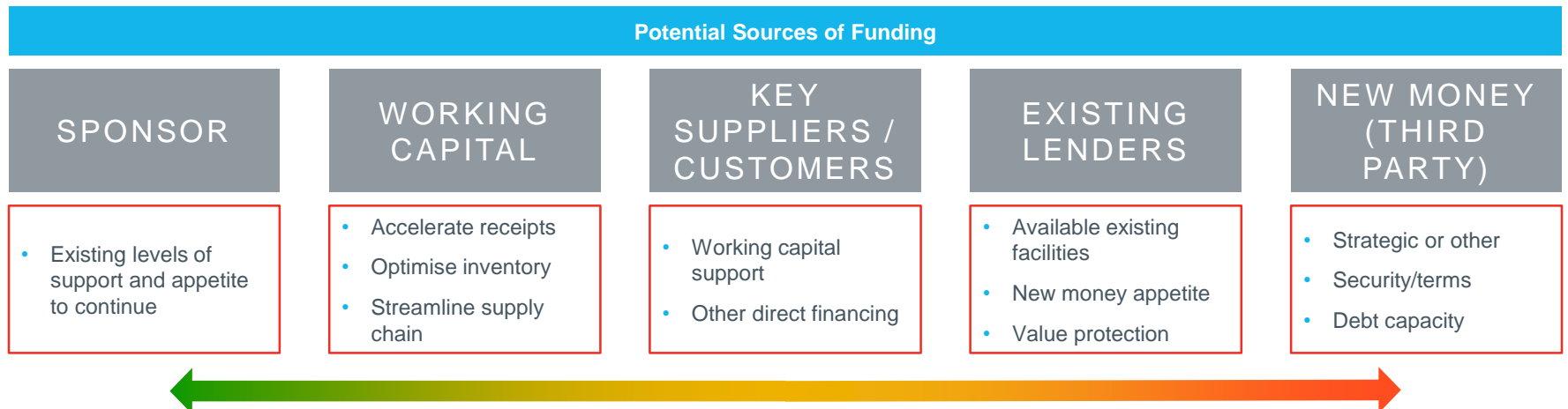
Lack of pipeline new work due to unsuccessful tenders

Cash Resilience and Funding

How should companies address cash and funding?



- As businesses re-emerge, they will need to demonstrate cash resilience to their stakeholders
- With reduced government support some businesses will be required to assess their ability to weather any continued storm from profitability, loans, revolving facilities and cash reserves in a competitive market
- Businesses may want to capitalize on potential opportunities in the industry as a result of the pandemic (i.e. potential consolidation) to aide its recovery
- Businesses will need to strengthen their balance sheet and ensure they are financially sound and capable of navigating through a period of any future losses of income
- Given the uncertain economic environment, businesses should expect and plan for a recovery that may not arrive in the remainder of this year or the next
- It is likely that businesses will require additional funding or financial restructuring to protect their positions and bridge to a full recovery



Key Considerations

Construction Sector Resilience – Weathering the Storm (Part Two)



GOVERNANCE

- Corporate strategy will need to evolve and adapt as challenges and opportunities materialise in the “new normal”
- Directors must be in a position and able to make effective and prompt decisions to react to challenges and opportunities.
- Ensure a governance framework that provides an appropriate forum to discuss strategy regularly, identifying opportunities and risks, and reprioritising strategic objectives where required.

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Update on the temporary restrictions and the new rescue tools for companies under the Corporate Insolvency and Governance Act 2020

6 October 2020

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Update on the Temporary restrictions

- Extension of restrictions on statutory demands and winding up petitions to 31.12.20
- Statutory Demands served between 1.3.20 and 31.12.20 can NEVER be relied upon to support a petition. This applies irrespective of whether Covid-19 had a financial impact
- Between 27.4.20 and 31.12.20 creditors may not present a winding up petition against a company unless there are “reasonable grounds for believing” that the company would be deemed insolvent even if Covid-19 hadn’t had a financial effect on it
- The so called “suspension of liability for wrongful trading” provisions have NOT been extended

Moratorium – Overview

- A “breathing space” from enforcement action by creditors to allow the Directors a limited time to attempt to rescue the company as a going concern.
- Directors remain in control overseen to some extent by a Monitor.
- Payment holiday from pre-moratorium debts subject to certain exclusions.
- Moratorium debts and pre-moratorium debts for which there is no payment holiday must be paid in full.

Eligibility

- Companies are not eligible if they are in an insolvency procedure or have been in the last year.
- The Directors must be of the view that the company is or is likely to become unable to pay its debts.
- The proposed Monitor must be an Insolvency Practitioner who must state that it is likely that the moratorium will result in the rescue of the company as a going concern.

Obtaining a Moratorium

- Filing documents at Court or application to Court if the company is subject to a winding up petition.
- Initial period of 20 business days. This can be extended by 20 business days without creditor consent by the Directors filing documents at Court or up to one year with the consent of the creditors or an unlimited period by the Court.
- On each extension (1) moratorium debts and pre-moratorium debts for which there is no payment holiday must have been paid and (2) the Monitor must certify that it is likely that the Company will be rescued.

Debts payable in the Moratorium period and concept of “payment holiday”

- Pre-moratorium debts are debts and liabilities to which the company is subject before the moratorium.
- The company has no payment holiday for:
 - A) the Monitor’s remuneration or expenses
 - B) goods or services supplied during the moratorium
 - C) rent in respect of a period during a moratorium
 - D) wages or salary
 - E) redundancy payments
 - F) debts or other liabilities under a contract involving financial services

Implications for Creditors

- Landlords cannot forfeit leases without Court consent.
- Pre-moratorium creditors cannot enforce debts and cannot petition for winding up.
- No steps can be taken to enforce security (without Court consent) e.g. a creditor with a debenture cannot appoint an Administrator
- No legal process can be issued or continued against the Company.
- No security can be taken over the company's property without the Monitor's consent.

Restrictions on Directors

- No credit over £500 unless counterparty is informed of the moratorium.
- Pre-moratorium debts may only be paid over £5,000 or 1% of the total liabilities if the Monitor consents.
- No disposal of property other than in the ordinary way of business unless the Monitor consents or with a Court Order.
- No disposal of charged property except pursuant to the terms of the charge or Court Order.

Restructuring plan

- Applies where a company has encountered or is likely to encounter financial difficulties that are affecting or will affect its ability to carry on business as a going concern
- Mirrors the current Scheme of Arrangement procedure with some key differences
 - A compromise arrangement is proposed between the Company and its creditors and/or members.
 - Creditors are split into classes of voting groups.
 - Class confined to those persons whose rights are not so dissimilar as to make it possible for them to consult with a view to their common interest

Restructuring Plan

- At least 75% in value of each relevant class of creditors must vote in favour of the plan for it to proceed to court sanction (subject to cross class cram down).
- Binds the company and/or creditors of each relevant class.

Restructuring Plan

- If a class of creditors or members vote against the plan, the Court can still sanction the plan if two conditions are met:
 - None of the members of the dissenting class would be worse off than under a relevant alternative; and
 - At least 75% by value of a class of creditor or members, which would receive a payment in such alternative procedure has still voted in favour of the plan

Key Take Away Messages

- Get BREXIT ready – On new contract bids, factor in cost and time increases (labour and materials costs and potential delays on imported materials).
- Rebuild, revive and recover – Consider all options and put plans in place to help your business excel in the post COVID-19/post BREXIT world.
- Ensure that robust corporate governance strategies are in place.
- Do not sacrifice margin to secure new contracts as it will inevitably lead to liquidity issues.
- The provisions that temporarily limited directors personal liability for wrongful trading have now come to an end.
- If experiencing financial distress consider use of the new Moratorium procedure to give the company a breathing space for a rescue plan to be implemented.

Thank you

Please do contact us if you have any questions.

This seminar does not attempt to provide a full analysis of those matters with which it deals and is provided for general information purposes only. It is not intended to constitute legal advice and should not be treated as a substitute for legal advice. Weightmans accepts no responsibility for any loss, which may arise from reliance on this information.



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