



Weightmans

# Weightmans

## Construction sector resilience

Weathering the storm

July 2020

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## What we will cover

- **General overview**
  - Common problems/relief
  - The future of construction
  - Bresco v Lonsdale (Supreme Court decision)
- **Restructuring for the future**
  - Practical measures and early intervention
  - Case studies
- **Reforms introduced by the Corporate Insolvency and Governance Act 2020**
- Take-away messages
- Questions



# General overview

## Common problems

- **Cash flow issues** – Bad debts & failure to pay suppliers on time (domino effect).
- **Claims** up and down the contractual chain (inc ‘force majeure’ since COVID-19).
- **Low margins** (race to the bottom on pricing).
- **Poor pipeline** – brexit/COVID-19/economic crisis.
- **Safety on Site** since COVID-19.
- **Materials** – 70/80% of construction materials are UK sourced but demand can outstrip supply due to disrupted production.
- **Supply chain fragility** – Risk losing industry capacity if we have wide scale supplier consolidations and collapses.

Worst performing sectors in 2019						
Sectors in trouble	INTO ADMINISTRATION	Proportion of total	INTO LIQUIDATION	Proportion of total	INTO CVA	Proportion of total
1	Manufacturing	16.7%	Professional, scientific and technical activities	16.2%	Construction	16.3%
2	Construction	15.7%	Construction	13.8%	Professional, scientific and technical activities	16.1%
3	Wholesale, retail, repairs	12.7%	Wholesale, retail, repairs	11.7%	Wholesale, retail, repairs	10.4%
4	Professional, scientific and technical activities	10%	Administrative and support service activities	11.2%	Administrative and support service activities	10,3%
5	Accommodation and food service activities	9.4%	Accommodation and food service activities	9.9%	Accommodation and food service activities	9.8%

Source: Building Magazine, 14/02/20

## Government COVID-19 rescue schemes and other relief

- **Business Interruption Loans** – Loans of £10k to £5m for SMEs with up to £41m turnover.
- **Corporate Financing Facility** – Min loan £1m. Larger businesses making material contribution in UK.
- **Future Fund** – £125k to £5m loans to innovative businesses.
- **Bounce Back Loans** – SME's fast track £2k to £50k loans (too little too late for some).
- **Job Retention Scheme** – £100 billion/9 million workers/1 million businesses. **Autumn outlook!**
- **Public Procurement Notes 02/20 & 04/20** – Supplier relief. Applies to public body projects. Not mandatory. Call for similar relief for private sector.
- **Trade Credit Insurance** – £300 billion loans market (one third to construction). Plus new £10 billion capped Government backed trade credit re-insurance scheme

## The future of construction

- **CBI report – Fine margins and financial sustainability:**
  - <https://www.cbi.org.uk/media/4121/fine-margins-february-2020-cbi.pdf>
- **Construction Leadership Council – Recovery Roadmap:**
  - <https://www.constructionleadershipcouncil.co.uk/wp-content/uploads/2020/06/CLC-Roadmap-to-Recovery-01.06.20.pdf>
- **Weightmans – virtual roundable construction leaders:**
  - <https://www.weightmans.com/insights/construction-sector-challenges/>
- **Weightmans – kick starting the economy – build, build, build:**
  - <https://www.weightmans.com/insights/kick-starting-the-economy-build-build-build/>
- **Glenigan – 2020/2022 Forecast:**
  - [https://www.glenigan.com/market\\_analysis/construction-industry-forecast/](https://www.glenigan.com/market_analysis/construction-industry-forecast/)

## CBI report – Fine margins & financial sustainability

- **Culture** – Traditional relationships continue to drive negative behaviours. *A better approach for the future* will raise quality and trust; reduce disputes; speed up payments; enable greater investment in innovation and new technologies; increase productivity; and improve the bottom line and sector sustainability.
- **Outputs** – 2% increase in productivity could deliver an additional £30bn in value to the UK economy by 2029.
- **Procurement** – (i) engage contractors early enough to influence project design before it is signed off; (ii) incentivise collaborative working towards outcomes that focus on ‘whole-life’ value.
- **Risk allocation** – Consider gain/pain approach to incentivise fair financial and liability risk allocation [pushing all risk down the contractual chain is not a sustainable model – PI insurers made that clear in the wake of Grenfell Tower fire].



## Construction Leadership Council – ‘Road to Recovery’ 3 phase plan – nationwide strategy

- ***Restart***
  - increase output, maximise employment and minimise disruption (0–3 months);
  
- ***Reset***
  - drive demand, increase productivity, strengthen capability in the supply chain (3–12 months); and
  
- ***Reinvent***
  - transform the industry, deliver better value, collaboration and partnership (12–24 months).

## Bresco Electrical Services Ltd v Michael J Lonsdale (Electrical) Ltd [2020] UKSC 25

### Supreme Court decision

- **Insolvency and adjudication are not incompatible** – IP has right to use adjudication as a DRP to help establish the net balance owing to the insolvent Co (TCC).
- Adjudication by insolvent Co is not an “*exercise in futility*”. Mere existence of cross-claims is not a reason to resist summary enforcement (Court of Appeal).
- **Security for costs** to protect responding party (*Meadowside*) can be considered at summary judgment stage and is NOT a bar to insolvent Co. adjudicating in the first place.



# RESTRUCTURING ‘PRACTICAL TIPS’

23 July 2020

DUFF & PHELPS

# Issues with Restructuring Through Insolvency



Construction companies are notoriously difficult to restructure through an insolvency or immediately prior through a formal restructure such as a Company Voluntary Arrangement (CVA). The principal reasons are set out below, and are primarily due to the standard insolvency clause in the Joint Contract Tribunal and New Engineering and Construction suites of contracts.

## JCT – Administration

- On insolvency, the employer usually terminates the contract and then appoints an alternate contractor.
- When this happens, the insolvency practitioner does not have a contract to novate, and it is then difficult to secure the payment of any sums due under the contract with valuations and work disputed.

## Issues with CVAs

- A construction company can propose a CVA to deal with its financial position.
- However, the credit rating of the business will likely be zero and it may be precluded from public sector contracts as they are in a defined insolvency process.
- For subcontractors, the likelihood is that main contractors will not want to use them.
- In addition, a CVA would usually involve a compromise on unsecured creditor debt.
- If some of these unsecured creditors are sub-contractors, before the recent changes to the insolvency legislation, there was a risk that they would stop work and move to another site.

- Therefore, the CVA needs to be carefully considered.
- The key message here is not to leave it too late and to seek professional advice early.



# Warning Signs



## Expansion into new markets

- Typically, your medium third and fourth generation construction business move from a market that has served them well with good margins to a much more competitive market. For example, a number of firms have faced insolvency after they moved from public to private sector clients, usually as a result of the bigger contractors chasing work in their market.
- Contractors may also move from one sector which they know well to another where they don't have the same experience or contacts.
- In these circumstances the effects on margins can be detrimental and put strain on profitability.
- Cash flow may be stretched by a change in the mixture of debtors, with private debtors typically slower to pay and insisting on longer payment terms.
- There is a greater risk of a private contract not finishing if the developer runs out of funds due to either an overspend or pressure from the developer's finance provider.

## Labour

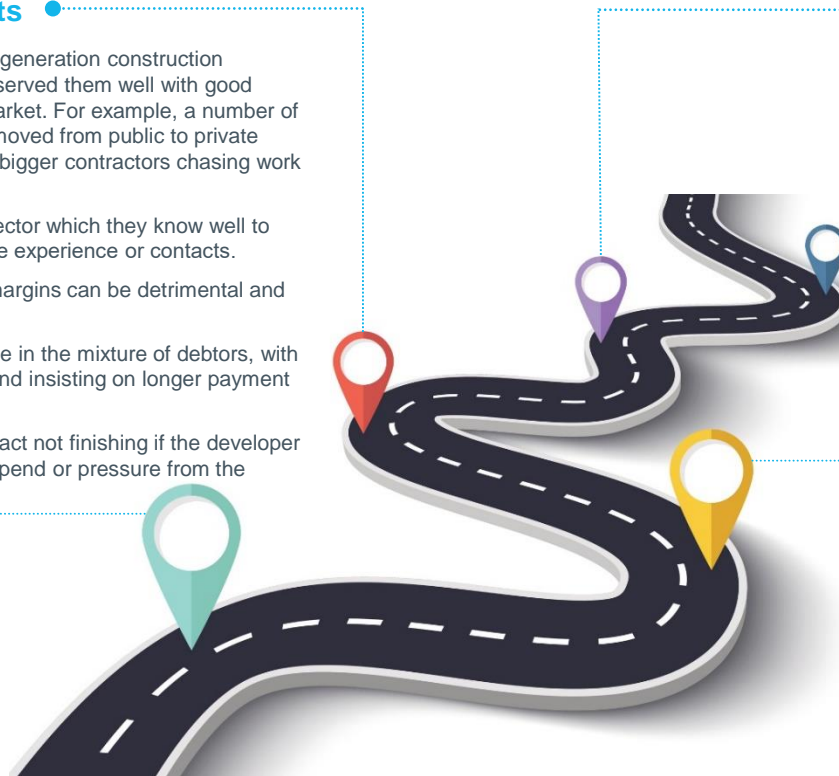
- Subletting labour to reduce payroll costs

## The supply chain

- A large turnover of sub-contractors may indicate that invoices are not being paid due to funding issues with the Employers or the business is stressed financially..
- Changing from larger more established sub-contractors to smaller sub-contractors.
- The issue here is that the larger sub-contractors are more likely to credit insure their debts and will not be adversely effected longer term should they suffer a large write off. Smaller sub-contractors, on the other hand, typically do not credit insure and are susceptible to a bad debt, and may go into insolvency, leaving the main contractor having to replace the sub-contractor and incurring additional costs.

## Debtor concentration

- Asset Based Lenders (ABLs) will normally require that debtor concentration be no more than 50% with any one debtor, some demand less than 30%. The general rule is to aim for 30% and peaks at 50% are acceptable if there is a large contract that can be managed.
- The reason behind this is... if you take 10 typical contracts:
  - Six will break even
  - Two will be profitable
  - Two will be loss making
- The issue therefore, is, whether or not the business has the financial capability to deal with the impact of the loss-making contracts. If one client represents over a third of all contracts, then the business may have an issue if a contract makes significant losses.





## Pinch points in the next 12-18 months

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- HM Revenue & Customs (HMRC) allow for the deferment of VAT between 20 March 2020 and 30 June 2020. Moving forward, companies will not only have to factor in the payment of their ongoing liability, but how they repay the arrears which have built up during Q1 and Q2 2020.
- As the government employee furlough schemes come to an end in the autumn and the liability for wages reverts back, decisions will need to be made on the makeup of the workforce and whether companies need to retain all of their staff or whether redundancies will need to happen.
- Working capital is available via the ABLs in government backed loans (CBIL's), however only 6% of construction firms who applied were successful in securing the first tranche of CBIL loans, albeit the second tranche loans were more readily available. The 'tap' will be turned off in the autumn and companies therefore need to review their short and medium-term working capital requirements now.
- Materials have become scarce and expensive, affecting margins and delaying projects.
- Productivity is down by c. 25% due to a lack of labour in some sectors and lack of materials to finish projects. While trades conducted outside are less affected since social distancing is easier to adhere to outside.
- As a consequence, contracts will be delayed with the threat of disputes between the employer and contractor.
- These issues will inevitably lead to a drain on cash flow and profitability.



# What steps can construction firms take now?



- ✓ Keep to the markets you know and trust.
- ✓ If venturing into a new market, do so gradually ensuring a mix of work with your 'bread and butter' contracts and be confident that the business has the financial robustness to deal with cost overruns and/or bad debts on these new projects.
- ✓ Ensure the business has robust financial controls in place with a strong commercial management team who should take this time to review their operations, procedures, workforce, short- and medium-term cash requirements so they can effectively plan to navigate the next 12-18 months.
- ✓ Speak to your funders, are they supportive? Do you need to consider alternatives?
- ✓ Make sure you are talking to your other creditors and have payment plans in place, if necessary.
- ✓ The deferment of HMRC schemes will end shortly. Consider how you will repay the arrears incurred. Do you need to agree a formal arrangement through a time to pay agreement?
- ✓ If not already doing so, take steps to credit insure debts to protect against future debtor issues.
- ✓ Do not be tempted to reduce margin to secure the work, as that inevitably puts the pressure on profitability and the business is left exposed if other contracts are loss making.
- ✓ Keep a good mix of projects and avoid having more than a third of contracts with one particular client.

# Case Study – Project Build



## CLIENT CHALLENGE

**Issue** – A construction business retained losses of Heavily loss-making construction business with **retained losses of c. £4m in the two years up to 2016.**

**Reasons** – A combination of loss-making contracts (caused by the pursuit of turnover and therefore squeezing the margins), and a significant overspend on overheads.

**Threats to the business** – The losses were funded by the accumulation of substantial creditor and HMRC arrears, with the resultant creditor pressure being placed on the business. The subsequent cash pressure was compounded by poor credit controls and cash outflows to cover debt servicing costs.

## KEY ACTIVITIES

**Director Actions** – The directors and secured lender were concerned as to the financial position of the company, so they sought independent professional advice and an independent business review (IBR) was commissioned.

### **Duff & Phelps Recommendations:**

We made several recommendations for immediate implementation, including:

1. A full review of all contracts to be undertaken, identifying the negligibly profitable and loss-making contracts.
2. A full review of the overhead base.
3. An independent review of the collectability of the debtors.
4. Independent ongoing monitoring put in place to review trading performance to ensure the business is trading to forecast against key KPI's such as, turnover, margin, EBITDA, as well as monitoring working capital and the trade/HMRC creditor position.

## OUTCOMES

The company implemented the recommendations which resulted in a material improvement in the trading performance during 2017, with retained losses reducing to £165k in the first six months and achieving a breakeven position by the end of 2017, **with a return to a profitable position by 2018.**

This was achieved by increasing the gross margin by 8.5% (before labour costs), a significant reduction in staff costs through a redundancy programme, the closure of one of the company's depots and tighter controls on the finance function to ensure cash flows were planned and managed effectively.

*The key lesson here is the directors took action before they were forced to by a creditor or funder and were committed to making the necessary changes to ensure the long-term success of the business.*



# Reforms introduced by the Corporate Insolvency and Governance Act 2020 (CIGA)

## Corporate Insolvency and Governance Act 2020

CIBA was passed on the 26<sup>th</sup> June 2020. Its aims are:

- To introduce by way of permanent measure greater flexibility into the insolvency regime, allowing companies breathing space to explore options for rescue whilst supplies are protected, so they can have the maximum chance of survival
- To suspend temporarily parts of insolvency law to support directors to continue trading through the emergency without the threat of personal liability and to protect companies from aggressive creditor action
- To ease administrative pressure on companies and other bodies by providing temporary easing of the company filing requirements and requirements relating to meetings including annual general meetings

## Corporate Insolvency and Governance Act 2020

The main insolvency provisions in CIGA include:

### Temporary provisions:

1. Modifications to directors personal liability for wrongful trading retrospective from 1<sup>st</sup> March 2020
2. A prohibition on the presentation of winding-up petitions from the 27<sup>th</sup> April 2020 unless the creditor can show that the coronavirus has not worsened the financial position of the company

### Permanent provisions

1. Introduction of a new moratorium with monitoring and Court oversight
2. A new restructuring scheme including a “cross class cram down” i.e. binding dissenting classes of creditors
3. Restrictions on the termination of supply contracts

## Wrongful trading

- Claims can be brought by liquidators or administrators (Section 214 of the Insolvency Act 1986)
- Personal liability of directors where at some point before the commencement of winding up, a person who is a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation
- Applies to all types of directors
- The test of what a director knew or ought to have concluded includes the knowledge skill and expertise that may be expected of a person carrying out the same functions carried out by that director and those that the person actually has
- Defence –director took “took every step with a view to minimising the potential loss to the company’s creditors he ought to taken”

## Wrongful trading

- A director may be ordered to make a contribution to the company's assets which will usually reflect the amount by which the deficit to creditors increased from the point when the director should have realised that there was no reasonable prospect of avoiding insolvent liquidation up until liquidation
- CIGA provides that when determining the contribution a director should make the Court is to assume that the person in question is not responsible for any worsening of the financial position of the company (or its creditors) during the period from the 1<sup>st</sup> March 2020 to 30<sup>th</sup> September 2020. This period could be extended up to 6 months
- Directors duties prescribed by the Companies Act 2006 (the duties to promote the success of the company and to exercise due care, skill diligence etc.) and the Insolvency Act 1986 (misfeasance, fraudulent trading and directors disqualification) remain in place.

## Points to note

- Resignation as a director does not exonerate that director from acts carried out prior to resignation
- Maintain accurate and up to date financial records
- Monitor the company's financial position and cash flow
- Hold regular board meetings and take detailed minutes and note the decisions made and importantly the reasons for them
- Take professional advice.

## Statutory demands and Winding up petitions

- The restrictions apply to all creditors and not just landlords despite the Government's initial announcement on the Bill that the measures were designed to “protect the UK high street from aggressive rent collection and closure”
- They do not apply to individuals – bankruptcy proceedings can still be taken
- Statutory demands served between the 1<sup>st</sup> March and 30<sup>th</sup> September 2020 can never be relied on to found a petition.
- Restrictions on statutory demands apply irrespective of whether Covid-19 had any financial impact on the debtor company

## Statutory demands and Winding up petitions

- No winding-up petitions are to be presented between 27 April 2020 and 30 September 2020 unless the creditor has reasonable grounds for believing that (1) coronavirus has not had a financial effect on the company or (2) that the company would have become unable to pay its debts even if coronavirus had not had a financial effect on the company. The petition must contain a statement to this effect
- Petition cannot be advertised until such time as the court has made a determination in relation to the question of whether it is likely that the court will be able to make an order winding the company up on the ground that it is unable to pay its debts in the light of the new restrictions. In practice there will often have to be a preliminary hearing prior to advertisement
- The court will only make a winding-up order if satisfied that the grounds of petitioning would have arisen even if the coronavirus had not had a financial effect on the company



## Statutory demands and Winding up petitions

- Void winding-up orders – any winding up order made between 27<sup>th</sup> April 2020 and the coming into force of CIGA, which would not have been made by the court if the 2020 Act had already been in force, will be regarded as void and the company must be restored to the position it was in immediately prior to the presentation of the petition
- Section 127 Insolvency Act 1986 would usually render disposition of a company's property void (subject to Court validation) where it has taken place after presentation of the petition where a winding-up order is ultimately made
- A company subjected to a petition presented between 27.04.20 and 30.09.20 will not have to apply for validation order under Section 127



## Take-away messages

## General points

- Brexit + COVID + economic crisis will test the mettle of the entire construction sector.
- Cultural Change – true collaboration + better risk allocation = best chance to emerge, recover, and rise up again ready for the future.
- Don't leave it too late to seek professional advice.
- Take this time to put plans in place with all key stakeholders including funders, customers, creditors so that you can successfully navigate through the next 18 months to 2 years.
- It may be dangerous to rely on the “suspension” of the wrongful trading provisions in CIGA
- Delay WU petitions + consider other debt recovery action

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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