

Contractor Insolvency Cheat Sheet



Contractor insolvency has been a frequent occurrence in the Australian construction industry. It shows no sign of slowing down. For each 'headline grabbing' insolvency, there have been numerous insolvencies of smaller contractors and subcontractors. Insolvencies, big or small, have major repercussions on construction projects.

It is often difficult to spot the warning signs in time, and to work out which steps to take, to prevent time and cost blow outs on a project. This paper will help you spot the warning signs and take steps to mitigate the consequences of contractors' financial difficulties.

Warning signs

You will know a contractor is insolvent when you are notified that an administrator or liquidator has been appointed. You should, however, be looking for earlier warning signs of financial difficulties to enable you to prevent time and cost blow outs. Warning signs include:

Tangible

- Slowdown of progress, project delays and missed deadlines.
- Resignation of key personnel and reduction of the workforce attending site.
- Removal of plant, equipment and materials from site.
- Lack of response to day-to-day correspondence.
- Increased defects and a general drop in quality.

Financial

- Requests for early payment.
- Inflated payment claims and the inclusions of spurious variations.
- Delayed payment of suppliers and sub-contractors (which may manifest in late delivery of materials, trades abandoning site, rumours).
- Requests from the supply chain for deposits or direct payments.
- Increased financial oversight by third parties, the involvement of a financier or the assignment of accounts receivables.
- Inability to provide security.

Other

- Rumours / market intelligence – this should be treated with caution.
- Court or ASIC searches evidencing statutory declarations or Court action being filed against the contractor.

Steps to take

If you notice some warning signs, steps to consider taking are:

1. Seek confirmation from the contractor that all payments to subcontractors and suppliers are up-to-date.
2. While you need to balance contractual rights and the operation of the SOP Act, is there a contractual basis to withhold future payments to the contractor? Can you agree an arrangement with the contractor to pay its subcontractors directly?
3. Issuing a formal 'show cause' notice to preserve your rights.
4. Checking security has been provided and is valid. If not, asking for it.
5. Ensuring all relevant insurance policies are up-to-date.



Steps to take (cont..)

6. Do not automatically terminate the contract. Often there are better contractual options to take (e.g. taking all work out of the contractor's hands), and the "ipso facto" regime under the Corps Act also needs to be considered. Accordingly, get legal advice about your rights and obligations. The types of key questions to consider are:
 - Has an "insolvency event" occurred under the contract?
 - What rights are available under the contract on the occurrence of an "insolvency event"?
 - If step-in or termination for insolvency is problematic, are there any other "substantial breaches" which may enable you to complete the project yourself?
 - When does title in materials pass?
 - What steps precede having recourse to security?
 - What set-off rights exist?
 - Can subcontractors be paid directly and, if they can be, when and how?
7. Start preparing a 'Plan B' to complete the project. This may involve approaching the contractor, its subcontractors and/or your project manager or consultants to:
 - discuss the steps required to complete the project;
 - identify key personal and subcontractors that would need to be engaged directly to complete the project; and
 - compile a list of materials needed from the contractor if it were to wind-up, e.g. copies of approvals.
8. Identifying whether any outstanding payments are due, the extent of any financial exposure and whether there are any claims against other parties which could be impacted by contractor insolvency. Where claims are identified checks should be made to ensure that any necessary demands, or notices, have been issued and any relevant provisions within the contract have been complied with.
9. Ultimately, terminating of the contract or taking work out of the contractor's hands if there is a contractual right to do so, and then appointing a replacement contractor.

Dealing with an administrator or liquidator

Once you have been notified that your contractor is insolvent, you will need to negotiate directly with the administrator or liquidator, as they will have control of the company. Some tips for doing this include:

- Before commencing your discussion, identify what leverage you have, including any forms of security or cash retention that you may draw upon.
- Clearly articulate (and preserve) any existing contractual rights or claims you have against the contractor such as for defects, liquidated damages, set-off, etc. You want to paint yourself as a potential creditor, not a source of money to pay creditors.
- Ensure that discussions are all on a without prejudice basis. Whilst under administration, the company continues to trade until a decision is otherwise made at a Creditor's Meeting - so you do not want to prejudice any rights potential against it if it 'trades out'.
- Engage in open and frank discussion and try to understand the administrator's or liquidator's position at the outset. Often they will be more willing than many realise to want to cut a deal.
- It is necessary to keep in mind that the administrator or liquidator is under an obligation to act reasonably and in the interests of the creditors, so they will be principally concerned with receiving a reasonable price – and may be willing to give up property, materials, access to subcontractors, etc. in return. The administrator or liquidator will want to recover money quickly, so may accept a lower price for immediate payment.

For further information, please contact Hugh Watson HWatson@moores.com.au or Dan Raso DRaso@moores.com.au