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Sector Focus

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Construction and insolvency: what does Q3 2022 and beyond hold for the industry?

KEY POINTS

- The construction industry has witnessed the highest number of company insolvencies over the last few years, with an upward trend starting prior to the COVID-19 pandemic.
- This reflects the number of major, unforeseen challenges the industry has faced and is facing, which could see a further uptick in the number of insolvencies during Q3 2022 and beyond.
- Those in the industry with exposure within their projects or supply chain ought therefore to look out for the warning signs of insolvency and protect their position prior to an insolvency process commencing.

FIRSTLY, WHAT DO THE STATISTICS TELL US?

The Insolvency Service publishes quarterly company insolvency statistics (ie the number of companies going into insolvency procedures). Those for the quarter July to September 2022 will be published at the end of October. At the time of writing, the latest available quarterly statistics are those for the quarter ended June 2022, Q2. The main messages from those Q2 statistics were as follows for England and Wales:

- During Q2, there were a total of 5,629 registered company insolvencies;
- Of these, the overwhelming majority were creditors' voluntary liquidations (4,908), including 368 compulsory liquidations and 320 administrations;
- The number of company insolvencies in Q2 2022 was up 13% compared to Q1 2022, and up by 81% compared with Q2 2021.

WHAT ABOUT THE CONSTRUCTION INDUSTRY SPECIFICALLY?

It is broadly possible to isolate the statistics by industry by drilling down according to the 'SIC' (Standard Industrial Classification) used to describe the nature of a company's business recorded at Companies House. This analysis for England and Wales shows that in the 12 months ending Q2 2022 the construction industry had the highest number of company insolvencies (3,665), representing 19% of cases. Similarly, in the previous 12 months ending Q2 2021, the construction industry came out 'top' at 16%.

If we then take the pandemic out of the equation by looking at the statistics up to and including the early months of 2020, the construction industry again had the highest number of company insolvencies.

The Construction Leadership Council (CLC) Construction Product Availability Statement of September 2022 stated 'we are

saddened to note that the year to June recorded the highest annual level of insolvencies amongst UK construction firms since the financial crisis over 10 years ago, despite strong demand throughout the first half of the year. The key risk going forward, given the substantive rise in insolvencies, is to what extent sharp cost rises and slowing demand over the next six months will exacerbate the rise in insolvencies.'

WHAT HAVE BEEN THE PARTICULAR CHALLENGES?

What particular challenges has the construction industry been facing that have contributed to this high number of insolvencies and which may see the numbers increase again? The last few years have been incredibly tough for the construction industry, hit by a number of major challenges, including many unforeseeable ones:

- **Brexit:** In 2020, the UK left the European Union. This has created challenges for the industry in terms of a reduced number of available EU workers, and the additional steps now needed to recruit EU workers. In 2021, the RICS looked at the effect of Brexit on UK construction, explaining that at that time 'latest figures indicate that 10% of all workers within the industry are EU nationals. Within the London construction industry this proportion increases to 33%' – and around the same time, there were concerns that bringing in an EU worker could cost up to £10k. There have also been changes to legislation, and the movement and marking of goods (replacing the CE marking on the UK side), and more. Whilst all of this is not insurmountable, it has created extra effort, time, and cost for construction businesses.
- **The pandemic:** Next, at the start of 2020, the UK was blindsided by the COVID-19 pandemic. Construction was particularly hard hit, which saw shortages as materials were not manufactured, imported, or delivered to site with their normal regularity. There was also a reduced number of workers on site, as they became exposed to COVID. Legislation and guidance, including for construction, swiftly changed – in some cases on a daily basis – as the entire country got to grips with the new situation we were all in. Employers and IT departments had to work out who could work from home and how. Those on site had to find new ways to work safely, changing how work was carried out, with employers facing conundrums which they had not come across before. Those procuring works had to have open conversations with their contractors about delays and disruption and who was bearing what risk, and what concessions each was willing to make. We are now, of course, living with COVID, but it continues to have impacts when workers contract COVID, and there is always the risk of future mutations of the virus.

Biog box

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- **Material and labour shortages** – in 2021 the industry was seeing materials shortages continue, due to the perfect storm of Brexit and the pandemic. Again, in an unexpected turn, shortages were exacerbated by a shortage of HGV drivers. The government highlighted the main causes of this being *'HGV driving tests not taking place because of the coronavirus (COVID-19) pandemic, the economic bounce-back from COVID-19, an ageing workforce and a lack of diversity in the industry, a reliance on overseas labour with a lack of long-term investment in the UK domestic workforce.'* We continue to see shortages with the CLC September 2022 Construction Product Availability Statement noting extended lead times for aircrete blocks, bricks, gas boilers and various items containing semi-conductors and other electronics.

2021 also saw shortages in labour, which had been a longstanding concern for the construction industry pre-pandemic, but which had continued and worsened. By the second half of that year, we were seeing the effects of those shortages with advertised construction salaries reported as increasing by 6.7% in the first half of 2021 and skilled site labour costs increasing by 3.6% in that September alone. This had an impact on the costs of building work, which contractors were unlikely to recover under the terms of their build contracts, placing contractors under further pressure. These shortages are set to continue too with the CITB reporting that *'over a quarter of a million extra construction workers may be needed by 2026'*.

- **Ukraine:** Following the unprecedented war in Ukraine earlier this year, the construction industry quickly became aware of how important both Russia and Ukraine were in the supply of metals, raw materials, chemical products, machinery, and equipment vital to the sector. Fuel and energy costs for businesses have soared and – unlike for domestic properties – the energy price cap does not apply for businesses. This is causing great concern for businesses, not least due to the uncertainty around what will happen next with energy prices. Of course, the surge in fuel and energy costs has also caused a cost of living crisis for construction employees, with many concerned about how they will pay their household bills or travel costs to work. The end is not yet in sight for these issues, with the CLC's September 2022 Construction Product Availability Statement reporting that *'price inflation remains the biggest issue for the entire industry and further significant increases in inflation are anticipated due to energy, raw material and labour cost rises'*.
- **Extreme heat:** Summer 2022 in the UK was marked by some incredibly hot days, with the mercury hitting in excess of 40°C in July. For construction again, this has brought difficulties, with those on site finding it hard to work as productively in these temperatures, and employers needing to take into account the health and safety of those workers (not least to comply with their health and safety obligations), with some major contractors considering whether to shut their sites in the worst heat. We are also seeing drought warnings and restrictions. All of this could have an impact on the quality of work and on work programmes

with contractors needing to consider what the terms of their contracts say about extreme heat conditions – and in light of worsening climate change trends, it is expected that these conditions will be seen again each year.

And of course there are many other challenges coming (not far) down the line for construction which construction businesses will need to adapt to if they are to survive and thrive – such as changes to the building safety regime over the next few years, the wider adoption of BIM (building information modelling) particularly in the public sector, and the UK's Carbon Net Zero targets and the sweeping changes required to our relatively traditional industry if these are to be achieved.

WHAT ABOUT THE ENERGY/COST OF LIVING CRISIS AND THE LIKELY DIRECTION OF THE NEW PRIME MINISTER?

At the time of writing it is yet to be seen what the precise terms of Liz Truss' policy regarding the on-going energy crisis will be. The escalating energy costs and wider inflation will be a significant issue for all businesses in terms of their own direct energy use but also indirectly in the costs of raw materials, which may not be capable of being passed on.

We query also whether the government's plan will include a drive to incentivise energy efficiency, which could be good news for certain sectors of the construction industry.

WHAT ARE THE WARNING SIGNS OF INSOLVENCY TO LOOK OUT FOR?

Warning signs that an employer, contractor or subcontractor could be facing financial difficulties and is about to enter an insolvency process include:

- cash flow issues;
- late payment or non-payment of supply chain invoices or employees' wages;
- attempts to negotiate changes in payment terms, such as renegotiating credit limits;
- persistent rumours within the industry about their financial position;
- official announcements to shareholders or the market regarding financial performance;
- suspension of work without explanation or surprising or uncommercial omissions from a project;
- personnel being removed from the project unexpectedly;
- late filing of accounts or annual returns at Companies House;
- unsatisfied court judgments, County Court Judgments or High Court Claims being issued against them; and
- creditors presenting winding up petitions.

In particular, with the remaining temporary restrictions under the Corporate Insolvency and Governance Act 2020 (as amended) having expired on 31 March 2022 (ie the end of Q1), creditors have been

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free, once again, to present winding up petitions as before. As such, it is expected that an increasing number of petitions will be presented and, as a result, winding up orders made. This isn't yet reflected in the statistics, with there being a lag time between petitions being presented and orders made and the restrictions having been relaxed during 2021. There were 331 compulsory liquidations in England and Wales during Q1 2022 (out of 4,896 total company insolvencies), whereas there were 368 compulsory liquidations during Q2 2022 (total 5,629). To put this into context, during Q1 2020 (ie the last quarter before the pandemic), there were 701 compulsory liquidations in England and Wales out of total company insolvencies of 3,883.

HOW CAN THOSE WITH EXPOSURE SPOT THESE WARNING SIGNS AND PROTECT THEIR POSITION?

There are a number of things that can be done so as to be forewarned, including:

- on the project and in supply chain communication, where possible, to reveal 'on the ground' and early warning signs, albeit not every party will be involved in and have a window on day-to-day operations;
- obtaining credit reports;
- searching the Register of Judgments, Orders and Fines for County Court Judgements;
- searching the Central Registry of winding up petitions, application and notices filed at court;
- monitoring Companies House and the Gazette, for company filings and insolvency notices, and subscribing to the services they offer; and
- engaging a specialist creditor services provider or subscribing to the products they offer, which will often collate the above searches and package up the results.

In terms of looking to be forewarned against the impact of insolvency, when negotiating contracts and also during the construction phase of a project, parties should consider:

- **'Pay when paid' clauses:** Generally, these clauses are prohibited under the Housing Grants, Construction and Regeneration Act 1996 (also known as the 'Construction Act'). However, there is an exception to the prohibition in the event of 'upstream insolvency', so that a paying party does not have to pay downstream if its own payment is withheld upstream due to insolvency. This requires specific drafting in the contract.
- **Retention of title clauses:** These can enable an unpaid party to retrieve goods or materials belonging to them prior to receiving full payment. However, title to goods often passes to the buyer when the goods have been incorporated into the building or attached to the land, even if the supplier is unpaid. Again, very careful drafting is needed in a contract for a supplier to have the right to retrieve goods and materials, and even then it may not always be possible in practice.
- **Suspension and termination clauses:** Including a clause permitting suspension of performance or contract termination in the event of the other party's insolvency can protect a party. This needs to be thought through carefully though, for example with

drafting needed to particularise the parties' rights and the effect of suspension of work or termination of the contract, to ensure the definition of 'insolvency' is sufficiently wide to be effective, and to take into account any obligations the parties' may have to other interested parties such as project funders.

- **Collateral warranties and third party rights:** Whilst the employer on a project has a direct contractual relationship with its contractor, it does not have this with the contractor's consultants or subcontractors. Collateral warranties and third party rights create these direct contractual relationships – by which the consultant or subcontractor warrants to the employer that it has complied with its appointment or subcontract. This enables the employer to pursue them for defects despite not directly appointing them and is another avenue for redress in the event of a party's (including the contractor's) insolvency.
- **Parent company guarantee (PCG) and performance bonds:** Under a PCG, the contractor's parent company can guarantee the performance and cover the liability of the contractor in the event of the contractor's insolvency, if the drafting of the PCG is sufficiently clear. However in practice, the value of a PCG in this scenario will depend on the parent company remaining financially viable and holding additional assets. A bond can also provide a guarantee of the contractor's performance, but again the drafting would have to cover insolvency, and there is also a cost to be paid for a bond to be provided in the first place.
- **The Third Party (Rights against Insurers) Act 2010:** This legislation enables a party to bring a claim against the insurers of defaulting insolvent companies. This may assist an employer if latent defects arise after practical completion at a time when the contractor has become insolvent because a claim may still be possible if the defects are covered by the insurance policy.
- **Records:** Maintaining proper records demonstrating the losses arising out of the insolvency, eg recording what materials and equipment are on site (especially what has been paid for), can help protect a party's interests if insolvency does occur.
- **Dispute resolution:** Initiating an adjudication prior to the other party becoming insolvent can mean the difference between securing payment prior to the insolvency and ending up in the queue of unsecured creditors with minimal prospect of a return. ■

Further reading

- LexisPSL Restructuring & Insolvency; Industry/sector guides for R&I lawyers; Construction and social housing; Guide to insolvency in the construction industry
- LexisPSL Restructuring & Insolvency; Industry/sector guides for R&I lawyers; Construction and social housing; Construction insolvency – how to spot problems and how to protect yourself – contractors
- LexisPSL Restructuring & Insolvency; Industry/sector guides for R&I lawyers; The impact of the Corporate Insolvency and Governance Act 2020 on the construction sector