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# Are we entering the eye of an insolvency storm?

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According to the Construction Products Association, by May 2021 construction output began to surpass pre-pandemic levels and in 2022 is forecasted to rise 6.3%[1]. This positive outlook is underpinned by the expected growth in key sectors, such as housebuilding and infrastructure through the government's commitment to invest £600 billion over the next 5 years as part of its "*Build Back Better*" programme.

Whilst employers and contractors will be buoyed by the investment and forecasted recovery, they will need to tackle this rising demand with the dual constraints of the growing skills and materials shortages.

Shortages in materials have been widely reported by market commentators in recent months. Whilst it is difficult to determine the specific causes, various issues have been identified.

- Brexit – reluctance to trade with the UK due to perceived issues regarding regulation, processing of imported goods and materials, customs etc.
- Covid – factory closures and new working practices reducing output within the UK and internationally
- A shortage of shipping containers further impacted by the blockage of the Suez Canal
- Global shortages of supply of core materials, such as timber, steel, and cement.
- Large infrastructure projects, such as HS2, are monopolising available supply

As for labour, there has been a growing shortage in skilled labour over the years, which has been recently accentuated by the fall in EU-born workers from the UK market, as many leave the UK[2].

Given these current market conditions, is the construction sector entering a perfect storm? If not, it certainly has many challenges to navigate to allow it to prosper.

Throughout the pandemic, the government has endeavoured to support businesses by deploying a series of financial incentives and fiscal measures such as the furlough scheme, government-backed loans and the deferral of tax payments. As a sector, it seems that construction has benefited; as reported by the British Business Bank, the construction sector was one of the biggest recipients of funds, having received the highest proportion of total Coronavirus Business Interruption Loans and Bounce Back Loans, with £2.5 billion and £7 billion of loans offered respectively[3].

In addition to these supporting incentives, on 26 June 2020 the government also introduced the Corporate Insolvency and Governance Act

[1] Construction Products Association Summer Forecast
[2] See https://cityam.com/brexit-exodus-uk-construction-staff-shortages-leads-to-project-delays-and-fewer-new-homes
[3] See https://www.british-business-bank.co.uk/coronavirus-loan-schemes-continue-to-support-businesses-evenly-across-the-uk-new-analysis-shows

2020 ("CIGA") in an attempt to protect businesses in financial distress as a result of the pandemic. Whilst originally set to expire in November 2020, due to the continued impact of the pandemic, the protective provisions have been extended to 30 September 2021.

The key provisions of relevance within this statute can be summarised as follows.

**Permanent Reforms**
*Restructuring Plan* – This plan provides a company in financial distress the opportunity to agree a restructuring arrangement with its creditors.

*Moratorium* – this "freeze" is intended to provide companies with a formal process to explore and develop a viable restructuring plan. Importantly, it also offers the company in question legal and enforcement protection. It is worth noting that, whilst the company remains under its own management during this moratorium period (initially 20 business days but with the ability to extend by agreement or as ordered by a court), an insolvency practitioner is appointed to help protect creditors and provide some supervision.

*Termination* – This provision seeks to limit the ability of a supplier from terminating the contract in the even that a company becomes insolvent.

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**Temporary Reforms**
*Statutory Demands and Winding-Up Petitions* – this provision removes the threat of winding-up petitions as a means of debt collection, and to protect a distressed company as it seeks to explore other trading options.

Moreover, it is also worth noting that through the Construction Playbook, the government has also attempted to reinforce the principle of prompt paying for all suppliers, and in turn its supply chain, in order to safeguard the delivery of public sector projects and programmes.

In support of this fundamental provision, public sector employers, such as Network Rail, led the way by implementing other methods of relief for any "*at risk*" suppliers within its supply chain with the use of the following measures to be considered on a case-by-case basis – immediate payment terms, advanced payments, increased frequency of payments, relaxation of relevant contractual terms and the payment of reasonably incurred additional costs arising as a direct result of COVID-19.

According to recent commentary, it seems that the above fiscal, legal and commercial measures have had a positive impact as there has been a dramatic reduction in the insolvencies from 3,228 in 2019, to 2,042 in 2020.[4]

[4] See https//www.constructionnews.co.uk/financial/there-is-going-to-be-a-massive-bang-the-coming-rise-in-insolvencies-18-02-2021

Whilst such support and protection provided by the government and enacted by public sector employers should be applauded, there is a danger that such measures have only delayed the inevitable. Are a number of these businesses unlikely to recover from the pandemic and, have they in fact, become "*zombie*" companies?
If this is the case, as we start to take tentative steps forward with the removal of the COVID-19 restrictions, and as the fiscal and legal support noted above are gradually phased out, there is a risk that such zombie companies may struggle to fend off insolvency, and that insolvencies will begin to materialise in the tail end of 2021 and into 2022.

Consequently, it is important that companies are alert and monitor their supply chain so as to protect themselves from any failures with their supply chain. In terms of protective measures, it seems that both employers and contractors alike are seeking appropriate guarantees, warranties, and bonds throughout their supply chains. We are also aware that a greater level of financial due diligence and scrutiny is being imposed throughout the market in order to validate the financial well-being of suppliers.

Notwithstanding these protective measures, constant monitoring is vital. However, early visible signs of financial distress can manifest themselves in a number of ways; for example,

- A high turnover of staff.
- A general decrease in labour on site.
- A slowdown in the progress of the works or the works not achieving project timescales or milestones.
- Poor quality workmanship and/or an increase in defects.
- Removal of plant, equipment and/or materials from site.

Also, as a consequence of its financial hardship, a company may take certain actions to improve its cash flow which may be a cause for concern. These may include:

- Requests from the contractor for changes to the payment mechanism.
- Inflated applications for payment and/or unsubstantiated claims.
- Complaints from sub-contractors regarding payment.
- A lack of response to correspondence.
- Late filing of statutory accounts and annual returns.

If any of these warning signs start to manifest themselves, and the risk of insolvency for a company increases, it is essential that it acts quickly to protect itself. There are some simple "*do's and don'ts*" that can be adopted to help safeguard the company's position and ensure that it does not fall victim to a number of pitfalls.

For example, without taking legal advice, the 'don'ts' include:

- Not terminating, novating or assigning contracts.
- Not appointing a new contractor to carry out relevant work.
- Not paying sub-contractors directly.
- Not making advance payments or paying for off-site materials.

Notwithstanding risks attached to the potential insolvency of a supply chain member, there are pre-emptive steps that a company could adopt to prepare and ready itself. These include:

- Ensuring that it has a complete set of contract documents (including warranties and guarantees) as it is often the case that these documents are not conveniently stored and /or are incomplete, which causes problems.
- Establishing a full list of the contractor's management team.
- Identifying sub-contractors that are critical to the timely completion of the works, and checking whether collateral warranties are in place.
- Clarifying its rights and obligations in the event of an insolvency, such as seeing if it has step-in rights.
- Scheduling and, if possible, safeguarding any plant, equipment and materials that it has paid for.
- Getting the paperwork in place. Instigating full monitoring of progress and determine the scope and value of the work remaining – mark up drawings, take photos, and so on.
- Preparing a contingency plan in the event of the contractor's insolvency (in the form of identifying other suitable suppliers, identifying critical supply chain members and materials, etc).

It remains unclear as to how the construction sector will respond to the challenges of the current climate as the government support is eased but it is imperative that firms remain vigilant.

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