

Construction contracting in insolvency

Construction contracting is a demanding and complex sector for the insolvency practitioner. Rob Pearce outlines some pitfalls and shows how the input of a specialist quantity surveyor can help IPs to avoid them.

It has long been recognised by IPs that any insolvency involving a *property asset* requires the appointment of a chartered surveyor. But what about the *construction contract assets*? Is the IP qualified to make a judgment as to the value of these contracts and is he or she best placed to realise these assets?

The process of construction or 'construction contracting' is probably the most fertile of industries for insolvencies due to its very low margins and its ease of entry (and re-entry). It is also one of the most contractually complex, and this has given rise to more contract case-law than any other. From the contractor's viewpoint, each job is a prototype. It is usually a different end product, using different materials to a different design, in a different place, for a different client, under different terms and conditions. Construction contracting is, in short, highly specialised.

Things to watch out for

Contract assets take numerous forms and, in many cases, are liabilities and not assets at all. 'Book debt', in the true sense, can be quite limited due to self-billing systems. This affects the VAT tax point and reduces recovery by accounting for post-appointment 'trading' VAT. In this way, there *should* be very little incidence of lengthy aged debt but, in practice, this is commonplace due to disputed applications for payment and contractual claims. These often over-stated accounts and claims are typically used to hide poor performance or to prop up an otherwise ailing trading position. Work in progress (WIP) may be carried, sometimes for years, to mask an untenable final account position or the deduction of liquidated and ascertained damages (LADs). Conversely, the unpaid application, claim or WIP may be of real value, but it is difficult for the untrained eye to spot the difference.

The Construction Act

The Housing Grants Construction and Regeneration Act 1996 often known as 'the Construction Act' was intended to improve the lot of the contractor.

Withholding notice: Among other things, the Act imputes payment terms into construction contracts where the contract itself is deficient, and importantly introduces a regime of 'withholding

notices'. The absence of a withholding notice can be fatal to the debtor's attempts to apply set-offs and deductions. This very issue, in the context of an insolvent main contractor under a JCT contract, came before the House of Lords this year in the case of *Melville Dundas Ltd (in receivership) v. George Wimpey UK Ltd*. Their lordships narrowly decided that the employer had a better right to the unpaid monies than the contractor in receivership. This is likely to increase the incidence of employers

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holding payment without grounds and without a withholding notice, based on a suspicion of the contractor's insolvency. The knock-on effect will be more insolvencies and more difficult realisations.

Due date: Another notion introduced by the Construction Act is that of a 'due date' when payment is *not* due, and a later 'final date for payment' when it is. This continues to confuse many in the industry while others are using it to their advantage. We recently had a dispute with a 'top five' contractor who argued that its payment terms amounted to a four-and-a-half month payment period as opposed to 56 days as the subcontractor believed. The correct interpretation was a 116-day payment period – still bad enough.

Construction Industry Scheme

Perhaps the most significant recent development in relation to construction contracting insolvency and recovery is the

new Construction Industry Scheme (CIS) for deduction of tax, which started in April 2007. This adversely affects the IP as it amounts to a renewed Crown set-off by stealth. No longer is the IP exempt from deduction of the old 18 per cent tax from realisations at source. Non-exempt status now means a deduction of 20 per cent on realisations from within the industry; and on non-registration, a deduction of 30 per cent. This tax, while potentially recovered though the contractor's tax return, may be

set against unpaid PAYE, NICs, CIS and even student loan repayments and hence, in most cases, is lost forever. This is a potentially huge diminution in realisations not to mention funds available for fees. The insolvency practitioner also has to administer the CIS, including monthly returns to HMRC with fines imposed where he fails to do so.

2005 editions of the JCT

As a final note, just when everyone was getting to grips with the 1998 versions of the JCT standard form building contract there are new ones to grapple with – the 2005 editions, which are now finding their way through to construction insolvencies. The 'termination' (previously 'determination') clause has been re-drafted with the assistance of R3 and now includes a wider definition of insolvency, which would include many of the preparatory stages of insolvency. However, the automatic determination prevalent in the old JCT contracts in the case of liquidation has gone, meaning that all terminations under the new JCT contracts now require written notice. This could perhaps be of benefit, but is a topic for another day. □

What is the difference between a chartered surveyor and a quantity surveyor?

- A chartered surveyor deals with *property* (the *product* of construction). He is in quite a different profession and has different training and experience from a quantity surveyor.
 - A quantity surveyor deals with *construction contracts* (the *process* of construction).
- Both may be chartered and members of the Royal Institution of Chartered Surveyors or other professional bodies.



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