

SOCIETY OF CONSTRUCTION LAWYERS

Seminar 7th March 2000

Security and Construction Contracts

A well-attended meeting of the Society of Construction Lawyers gathered at the National Liberal Club to hear Richard Davis, consultant with Masons, talk about the ramifications of contractors' insolvency for construction disputes.

Mr Davis was clearly wary of the effect such a topic might have on his audience. He began by recounting the response of his publisher on being told that Mr Davis was planning a new edition of his book, *Construction Insolvency* (1999 Palladian Law Publishing): "It's just such a depressing subject," he had complained. However, if any member's spirits were faltering at the evening in prospect, they were soon restored by Mr Davis's announcement that the talk would be fully inter-active. The audience was to play the part of adjudicators for the evening and to pass their own verdicts on an imaginary scenario in the construction insolvency field.

Before he allowed them to do so, however, Mr Davis set out the basic principles of construction insolvency.

Insolvency Procedures

Mr Davis gave a brief outline of the differences in procedure and nomenclature between insolvency for individuals and for companies. He then set out three types of security available to the creditor of an impecunious contractor: proprietary, contractual and procedural.

Proprietary Security

If a debtor can divest himself of his property before he is declared insolvent, it will not be available for distribution to the creditors, subject to challenges made under the Insolvency Act 1986. But in construction law it is often the case that the contractor has few assets other than his contractual rights. So in this field the risk that the liquidator runs is that the contractor will assign his interest, for instance in money owed by the employer, to a sub-contractor before he can claim it. Such an assignment was held to be valid even though it was an informal assignment in Golden Sand v Easy Success Enterprises (unreported, 31 March 1999, High Court of Hong Kong).

The right of a beneficiary under a trust can be a more valuable form of proprietary security, as the beneficiary has both a personal right against the trustee and a proprietary right in the trust property. In the construction industry, this is most likely to consist of a bank account which the law treats as a chose in action in the form of a debt owed by the bank.

Difficulties can occur if the contractor cannot satisfy requirements for payment from the account, especially where compliance is beyond his control, for instance when it is dependent on the issue of a certificate by an architect. Such a difficulty arose in Rafidain Bank v Saipem (unreported, 2nd March 1994, CA) where the relevant certificate, which would release the money owed to the contractor, was to be issued by an Iraqi state agency, but where this had not been done before the imposition of sanctions during the Gulf War. The Court of Appeal applied a two-stage approach: firstly, they examined the terms of the contract and concluded that the certificate was a condition precedent to payment from the account. They then considered the matter in equity and held that the contractor had acquired an unconditional vested interest in the fund. The certificate was merely part of the administrative machinery with which the Court could dispense, so the money was released to the contractor.

Contractual Security

In the absence of a proprietary right or a security interest, a creditor will have only a personal contractual right against the debtor. Such a right is converted on the debtor's liquidation to a right to prove for a dividend. In many cases, it will therefore be worthless. However, some contractual rights operate so as to confer an informal security on the payer. In particular, Mr Davis looked at insolvency termination clauses and suspension of payment.

All of the standard forms allow the employer to terminate on the contractor's insolvency, sometimes quite unfairly. In Westminster Properties v Comco Constructions (1991) 5 WAR 191 (CA Western Australia) the unfairness worked against the employer where the contract allowed the contractor to terminate in the event of the employer's insolvency. The contractor owed no implied duty to act fairly once the termination event had occurred.

Similarly, where the contract allows the employer to suspend payments on the termination of the contractor's employment, for instance for insolvency, the employer can withhold certified sums and, it appears, judgment debts, even where the employer had previously been in breach and even where the employer's failure to pay on time had helped cause the contractor's insolvency.

Procedural Security

Procedure can also act as security, for instance liquidation and bankruptcy set-off, legal set-off, adjudication and the withholding notice required by the Housing Grants, Construction and Regeneration Act 1996 (HGCRA).

Thus, since creditors cannot issue proceedings against the company or enforce security while an administration order is in force, without the permission of the administrator or leave of the court (s.11 Insolvency Act 1986), even a reference to adjudication requires

the leave of the court once the contractor enters administration (see Straume v Bradlor Developments [1999] CILL 1520).

The impact of the HGCRA

Finally, the audience were invited to apply what they had learned to an imaginary scenario. Mr Davis set out the problem as follows: the contractor had gone into administrative receivership and its employment terminated; sums which had fallen due to the contractor were also suspended under the contract, although the employer had failed to serve a withholding notice; thus, the employer relied solely upon his right to suspend payment under the contract. The question was whether the contractor's receiver could use s.110 of the HGCRA to override the contract and require a withholding notice to be served before the employer could suspend payment.

Arguments raised on the receiver's behalf included the suggestion that suspension is a form of withholding payment, so that it falls squarely within s.111 of the HGCRA, and that to hold otherwise would allow the employer to benefit from his own breach. Heart strings were also tugged with the thought of the threat to all the contractor's employees' jobs.

On the employer's side it was said that HGCRA does not prevent the parties agreeing suspension of payment on termination as a security for the excess cost to complete, that the suspension is the first stage in a new payment regime leading to a contractual set-off

or that, if the Act applies to it, the right to suspend payment under the contract was itself a standing withholding notice.

In a display of peremptory justice of which any adjudicator could be proud, the audience voted on a show of hands marginally in favour of the receiver/contractor. The fine balance of opinion showed how difficult it was to predict the impact of the HGCRA on the construction insolvency field and the importance of a firm grasp of this complex and interesting field.

A complete version of the above talk is available to members on request from the SCL.

GIDEON SCOTT HOLLAND

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