Avoiding the costs of contractor insolvency

Contractor insolvency is one of the biggest risks faced by any project owner (the Employer) and their financiers and investors during a construction project. News of contractor insolvency is increasingly commonplace in the construction sector. Escalating inflationary pressures and materials shortages are among many obstacles now pushing firms to breaking point.

In this article, Jason Baston, expert in construction risk solutions at Miller, discusses some of the circumstances and consequences faced by owners and their supply chain when the contractor becomes insolvent, and how – with pro-active approaches and solutions – owners can help to mitigate these risks from the outset of any project and circumvent false-economies.

What is happening in the construction sector?

Construction is a high-risk enterprise, and when the unexpected occurs, a contractor will require financial resilience to withstand shocks and potential losses. However, in recent decades, competitive tendering processes and the race to reduce prices have eroded already thin profit margins for the contractor supply chain, putting cash flow and working capital under increasing pressure.

In 2021, the construction sector had the highest insolvency rate of all industries in England and Wales.

High profile victims such as Carillion, NMCN, and MIDAS are just the tip of the iceberg among increasing rates of contractor insolvency in the UK. In recent months, substantial inflationary pressures and challenging supply chains are compounding an already stressed sector.

Where financial and cash-flow problems escalate, the contractor may be liquidated or attempt to continue trading through informal creditor agreements, company voluntary agreements, or may be placed in administration (increasingly 'pre-pack') under the Insolvency Act 1986.

Why does this matter for owners and their financiers?

The consequences of contractor insolvency can be far-reaching and impact all project stakeholders. Once a contractor is declared insolvent, the project site will typically be vacated by the contractor and the gates will be locked to all (including the owner). Site security may have also departed unpaid - leaving a partially completed project (often a multi-million-pound asset of the owner) enormously exposed to numerous perils, including arson, theft, malicious damage, and to weather/storm events. A major site incident left unchecked can now severely damage or destroy the whole site.

Worse still, any insurances provided by the insolvent party will typically become ineffective, potentially leaving the site uninsured, and the owner's/financier's asset at substantial risk. If the site is damaged or destroyed, the owner may now also be at risk of insolvency too.

Unpaid subcontractors, suppliers, and other unsecured creditors are often also at risk of insolvency – a well reported domino effect. For subcontractors, plant and equipment may also be locked within the site compound, at risk of damage while still incurring hiring fees and unable to be retrieved.

Whilst robust contractual step-in rights may enable some continuation of subcontractor appointments and works, a formal cession of works will often occur whilst a replacement contractor is tendered. Myriad changes will also result for the remaining project; typically including a delay to practical completion, an increased contract value, and an exclusion for defects associated with the prior contractor's works.

The implications of the contractual changes can be widespread. Owners experience difficulty obtaining structural warranties and consequently face future sale issues. Owners also face delays to or loss of future revenue streams and inevitable additional costs such as extra debt servicing or alternative accommodation, and financiers the potential project failure or default.

How can contractor insolvency risks be mitigated?

Although contractor insolvency is enormously disruptive to any project, there are a host of pragmatic measures that can be taken at the outset, that will substantially reduce the impact.

✓ Seek expert risk advice at the pre-construction project stage

Construction is a high-risk enterprise. Appointment of pre-construction risk expertise is highly cost-effective and critical to the identification of, and solutions to, insolvency and other project risks. A bespoke risk strategy can be developed pre-construction to determine how best to mitigate, manage and transfer insolvency and other project risks. For the most effective result, undertake this prior to contract drafting and tendering.

Miller tip

The value of expertise

Ensure your appointed project broker can provide expert pre-construction risk advisory services.

✓ Ensure a robust owner-controlled asset protection approach

In life we all understand the importance of insuring our own assets - such as our cars, homes, and business premises. A construction project is no different and the substantial sums involved are best insured by the owner. Critically, a robust owner-controlled project insurance will continue to operate even if the contractor changes due to insolvency mid-term. The owner also has the full oversight and control of cover to ensure the policy evolves with changing project characteristics.

Miller tip

'Square peg' dangers

'Off the shelf' policies may leave owners exposed. Make sure your broker can provide a bespoke policy that is written uniquely for your project needs.

✓ Make expert-informed decisions for optimum contract selections

The path chosen at the outset of the contracting process can determine the consequences thereafter. The risk and insurance section of your JCT (or other) contract should be drafted by your legal team in collaboration with appointed risk experts, to implement the asset protection strategy and ensure optimum selection to avoid risks of insolvency and maximum negotiating leverage in tender.

Miller tip

Avoid false economies

Allowing the contractor to arrange the project insurance may seem convenient, but this will leave the owner most exposed to insolvency risk.

✓ Consider protection for latent structural defects risks post-completion

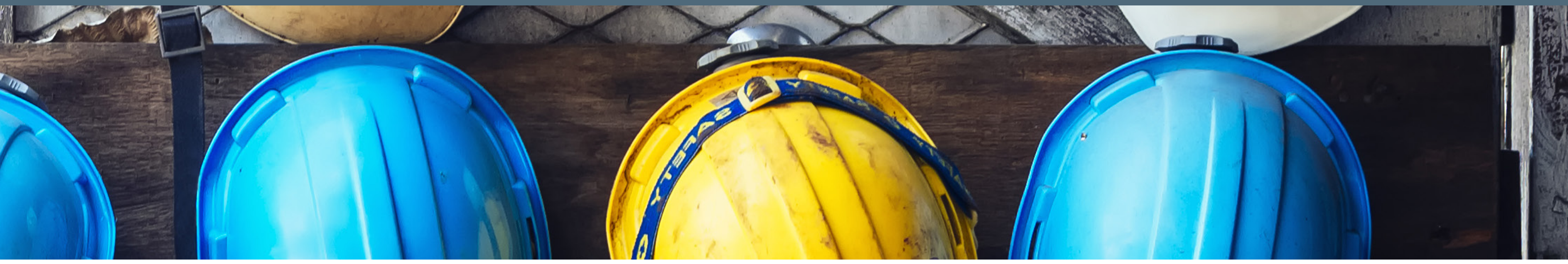
Addressing structural defects that emerge post-completion can be a devastating problem for any owner, particularly when contractors change mid-term. Latent defects insurance (LDI) can be secured as a robust solution to address rectification costs post-completion.

Miller tip

The 'early bird' benefit

Secure your LDI cover pre- construction to minimise costs.

Learn more about LDI solutions here.



Implement a resilient due diligence and risk governance regime

Significant risks to a project exist within the supply chain, and failure to check and manage these risks can leave the owner highly exposed to contractor insolvency.

Where a contractor continues to provide project cover, these policies should be assessed and reviewed at each renewal. Professional Indemnity (PI) is one such example where contractor's cover may have already been eroded by existing claims or notifications.

Miller tip

Check your fire safety cover

Understand your protection. Assessing the quality of your contractors PI cover will allow informed decisions and appropriate negotiations.

Secure robust contractor performance bonds

Any monetary compensation due to non-performance will help to bridge the financial challenges if contractor insolvency occurs. Parent Company Guarantees (PCG) however continue to expose the project owner to insolvency risk, so be sure to seek the help of surety experts to safeguard against insolvency and discuss bond suitability.

Miller tip

Be trigger happy

Understanding your bond triggers, the wording, and your enforceability is critical.

How can Miller help?

Our UK Construction team are experts in the provision of pre-construction risk advisory services, helping project owners and their financiers navigate their contractual and commercial project risks at the outset of their development, including the mitigation of insolvency risks.

Industry experts

With extensive expertise across all aspects of UK construction risk, we have supported many clients faced with a contractor in administration. Our team can help you navigate this complex issue and provide a bespoke yet straightforward and cost-effective solution.

Client-first service

We place our clients at the front and centre of everything we do and believe in building long-term partnerships. Our service model, based on this ethos, is what differentiates us from our peers.

Collaboration

We work in partnership with our clients to identify and understand your problems, and together as a team to deliver solutions. We always act in your best interests, without exception.

Proactive claims advocacy

We never overlook the importance of a prompt and helpful claims service and the peace of mind this can offer. As a result, we have built one of the strongest claims teams in the industry, where our construction claims specialists work alongside our placing brokers and technical teams for maximum efficiency.

Get in touch

For further information please visit https://www.miller-insurance.com/what-we-do/Construction or contact:

Jason Baston
T +44 1473 794 569
jason.baston@miller-insurance.com

Jonathan Burke
T +44 20 7031 2461
jonathan.burke@miller-insurance.com

Charlie Cain
T +44 20 7031 2400
charlie.cain@miller-insurance.com

About Miller

We are a leading independent specialist (re)insurance broking firm with more than 750+ people across our UK and international operations.

Our reputation as the strongest advocates in the business comes from our exceptional people delivering exceptional results for over 120 years.

With a client-first approach, we value our long-standing relationships and continue to build strong and rewarding partnerships.

Chartered Insurance Broker

Miller is a Chartered Insurance Broker, the industry's gold standard for insurance brokers. We have committed to delivering professional excellence and adhering to a Code of Ethics.