Impact of insolvency reform on the construction industry

With the threat of increased insolvencies as an effect of the COVID-19 pandemic remaining very real, the construction sector needs to be aware of the impact of changes to insolvency laws.

By Julian Bailey

Changes to insolvency laws in the UK, Australia and Singapore may affect how parties deal with the termination of construction contracts where one party to the agreement is insolvent.

Construction contracts commonly contain provisions which entitle a party to terminate the contract if the other party becomes insolvent. These provisions are sometimes referred to as 'ipso facto' clauses, because it is the fact of insolvency which gives rise to the right to terminate.

The purpose of ipso facto clauses is to enable a contracting party to end a contractual relationship if the insolvency of the other party is likely to have a real impact on the counterparty's performance of its obligations.

The motivation for the recent insolvency law reforms, however, is to give insolvent companies breathing space to try to reorganise their affairs and allow viable businesses to continue to trade. One of the ways that this is done is to curtail the operation of ipso facto termination provisions.

The theory applied here is that permitting a contract to be terminated for a party's insolvency may prevent that company from being able to reorganise its business.

Although the relevant insolvency laws in the UK, Singapore and Australia have much in common, there are some noteworthy differences between them.

The UK's Corporate Insolvency and Government Act 2020 (CIGA), which took effect on 26 June 2020, applies to any contract 'for the supply of goods or services' to a company that becomes insolvent, including construction contracts with limited exceptions.

For these purposes a contractor performing work for an employer will be treated as a supplier, as will a subcontractor performing work for a main contractor.

The legislation prevents reliance upon an ipso facto clause, or a clause allowing it to do 'any other thing' as a result of the insolvency. There is, however, no prohibition upon the buyer of the goods or services from exercising rights which arise due to the supplier's insolvency.

CIGA will prevent a supplier from terminating a contract when the counterparty is insolvent, where the right to terminate arose when the counterparty became insolvent. It also prevents a supplier, during the insolvency period, from making its continued supply of goods or services conditional upon the payment of outstanding charges, or doing 'anything' which has the effect of making continued supply conditional upon payment of outstanding pre-insolvency charges.

On these issues, there are two points to note in particular. Firstly, the legislation permits a supplier to apply to the court to relieve it from continuing to perform its contractual obligations in circumstances where this would cause it 'hardship'. 'Hardship' is not defined by the legislation, but it will inevitably take account of the potential financial detriment to a supplier if it is forced to continue performing a contract with an insolvent counterparty.

Secondly, while CIGA would prevent a party from exercising a right to suspend its supply of goods or services as a result of insolvency, it seems unlikely that this prohibition will cut across the right of a party to a construction contract to suspend its works in the event of non-payment of a 'notified sum' as provided for under the Housing Grants, Construction and Regeneration Act 1996 (HGCRA) section 112(1).

However, the prohibition on doing 'anything' which would have the effect of making continued supply conditional on payment of outstanding charges is not expressly limited to the exercise of contractual rights, and may affect a party's rights under section 112(1) of the HGCRA. As CIGA does not expressly address this statutory interfacing issue, the matter will not be free from doubt until resolved by a court.

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Insolvency reform in Singapore and Australia

Singapore's insolvency law reforms took effect through the Insolvency, Restructuring and Dissolution Act 2018, which came into force on 30 July 2020. Australia's reforms saw amendments to the Corporations Act 2001, which came into effect in 2018.

Singapore's and Australia's revised insolvency laws prevent, subject to limited exceptions, the use of ipso facto clauses, but in ways which differ from the UK legislation.

Firstly, unlike the UK law which imposes a one-way ban on ipso facto clauses, the Singaporean and Australian legislation creates a two-way prohibition. In the construction context, this means that neither an employer nor a contractor may rely upon an ipso facto provision to terminate each other due to insolvency.

The Singapore and Australian legislation prevents the use of ipso facto clauses in circumstances where a company has become insolvent but has not gone into liquidation. In contrast, the UK insolvency laws prevent reliance upon an ipso facto clause where a company has gone into liquidation and has no prospect of reviving its fortunes. This approach may be questionable, given that the purpose of the prohibition on ipso facto clauses is to give companies some breathing space to restructure.

Thirdly, whereas the UK legislation precludes the termination of a contract during the period of a company's insolvency for any reason arising before the insolvency that would otherwise give rise to a right to terminate, the Singapore and Australian legislation does not preclude termination during this period for grounds other than insolvency.

The impact on construction contracts

These insolvency law reforms will certainly have an impact on the drafting of construction contracts and market practices to address insolvency concerns.

Parties to existing construction contracts need to be aware of the impact of the legislation on those agreements. An express right to terminate for insolvency may no longer be valid, meaning that any attempt to terminate in reliance upon the provision may be ineffective, and amount to a repudiation of the contract.

In future construction contracts, termination provisions will need to be drafted to reflect the restrictions on ipso facto clauses in the applicable jurisdiction. Those drafting contracts will have to give closer attention to the possibility of termination for reasons other than insolvency—for example by terminating for convenience.

To mitigate insolvency risks, contracting parties may bring greater focus to requiring their counterparties to procure forms of security which will be available in the event of that party becoming insolvent, for example performance bonds or undertakings from a parent company or financial institution, or through insurance.

That said, the new reforms may also restrict parties' rights to call on such securities—CIGA, for example, will render ineffective a clause allowing a supplier to do 'any other thing' as a result of an insolvency, which could include utilising certain forms of security, depending on the wording of the contract and the relevant security.

Clear drafting and consideration of the law is essential to protect parties. Project owners and contractors alike would be wise to make sure their contracts reflect the new insolvency reforms.

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