

Article Information

Author: Ted Williams

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Impacts of insolvency on construction projects

The insolvency of one of the principals, contractors or subcontractors can seriously impact a construction project at all levels of the supply chain. Infrastructure and Projects partner, Ted Williams looks at the issue and some practical thoughts on drafting contracts to help mitigate these risks.

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"How did you go bankrupt?"

Two ways. Gradually, then suddenly."

— Ernest Hemingway

These impacts may be mitigated by early action, however before action is taken, it is critical that those likely to be effected by the insolvency of a counterparty have a clear understanding of whether an insolvency event has in fact occurred, whether such an event may be proven and what rights (if any) are expressed to accrue upon the occurrence of an insolvency event.

Key Strategic Considerations

Importantly, in contemplating a response to the potential insolvency of a counterparty, the following should be understood:

- Determining whether (and when) a party is insolvent is a question of law which is often difficult to establish.
- There is no common law right to terminate a contract on the grounds of a counterparty's insolvency (i.e. a party can only rely on such rights as are expressed in the agreement).
- Generally, such express rights may only be exercised on the happening of an insolvency event. Getting wrong the question of whether such an event has occurred, can give rise to wrongful repudiation of the contract which can give rise to termination rights and damages in favour of the other party.
- The common standard form contracts, AS2124 and AS4000 provide for termination rights in the event of insolvency on the part of the contractor (in the event of the insolvency principal), however the principal has no equivalent right in the case of contractor insolvency.
- Insolvency, of itself is not a substantial breach (giving rise to termination rights) under these standard forms. Abandonment or failure to adequately progress the works are breaches which may give rise to termination rights.
- In all cases, steps to terminate a contract should be taken with the greatest care. If gotten wrong, severe adverse consequences are likely to result.

Practical contract considerations

In contemplating likely insolvency of a participant, it generally pays to plan for the worst. Consideration should be given to contracts/subcontracts addressing a number of practical issues.

- **Ownership of materials and security of the site.**

Expect that those caught in the fallout of insolvency will take matters into their own hands and may "take back" what is considered theirs (or not theirs, as the case may be).

Whilst terms of contract will not always be conclusive as to ownership (particularly where 3rd party Personal Property Securities Act claims are involved) contract terms should be drafted to provide that those materials brought to site will, once delivered, be the property of those for whom they have been provided (i.e. the principal in the case of supply by the contractor or the contractor in the case of supply by the contractor).

In case of likely insolvency, steps should be taken to ensure that materials are not unlawfully removed.

- ***Pre-payments***

Australian Standard contracts generally provide that a principal is not obliged to make a payment for materials not incorporated into the works without first obtaining adequate security for performance.

Where, for any reason a payment has been made in advance of delivery or installation of materials, it is possible to register a Purchase Money Security Interest on the Personal Property Securities Register in order to gain some priority in the event of insolvency.

- ***Variation by omission***

Contract terms may include a power to omit works by way of variation. It is important that such clause also contemplates the award of such omitted to another party and provides that such an award shall not be considered a breach of contract.

- ***Proof of downstream payment***

Contracts should be drafted to ensure that providing evidence (usually statutory declaration) of payment to downstream suppliers (i.e. subcontractors and suppliers engaged by the potentially insolvent party) is pre-condition to any progress payment becoming due.

- ***Termination/Suspension rights***

Contracts should provide that the occurrence of insolvency events (and/or likely precursors to such events) give rise to immediate termination rights. Consideration should also be given, allowing the additional option of suspend work on the occurrence of such events: this would allow a party time to consider whether, in the circumstances, termination may be feasibly avoided (such as in circumstances where a receiver or administrator elects to affirm the contract and complete the works)

- ***Security and Bank Guarantees***

Generally, construction contracts allow for access to securities where moneys are due and owing or damage (including arising from the consequences of non-performance) is incurred.

It is important to understand the form of security provided and the nature of the security obligation. Ideally, securities should be from an Australian rated bank with a local branch and are expressed to be payable "on demand" and without recourse to the party providing it.

As a minimum, the form of security should include:

- the issuing bank and branch
- the full name and ABN of subcontractor against which it is given, as named on the document
- the value of the security
- the expiry date of the security

Care should be taken in ensuring that there is a proper basis to call upon any such security and the manner of the call. Where an improper call is attempted, the opportunity to make a future call may be lost.

- ***Termination***

Wrongful termination is likely to give rise to a right in damages by the party improperly terminated.

Notwithstanding issues of validity, termination will often result in the loss of recourse to future contractual rights, such as the right to call on securities.

A well drafted contract will provide for appropriate rights to omit or suspend works, without loss of future rights as a consequence of termination.

Whilst operational impacts will differ depending on the circumstances of a project and can be extreme, with good management and the appropriate contractual tools, the consequences of contractor insolvency can be mitigated. Participants should check their contracts to ensure that they provide adequate protection and ensure that their contract administration staff are appropriately skilled to understand the options available to them and take advice where appropriate.

For more on this topic, please contact [Ted Williams](#).