

Don't hit the wall: how to deal with (and prevent) default in real estate projects

Real Estate and Insolvency Commissions

Prague, 2014 – Working Session 2

National Report for UK

Alex Fox

Penningtons Manches
Abacus House, 33 Gutter Lane
EC2V 8AR, London, UK
Tel: +44 (0) 20 7753 7724
alex.fox@manches.com

1. Construction Contracts

1.1. Defending Employer's interests

1.1.1. Before entering into a construction contract, how can the employer¹ check the financial standing of the contractor²? Is credit/financial information publicly available in your jurisdiction?

In practice there is very little an Employer can do. We undertake a due diligence exercise in which we review the contract documents, risks to and obligations on the Employer. As part of this we check Companies House to see if the contractor is an active company and whether any winding up petitions have been filed against it. There is no more we can do, and so we disclaim liability to our client on this point.

Often the Employer relies mainly on the references and reputation of the contractor as is known by way of previous projects.

While more in depth investigations are available on the market care needs to be taken not to infringe data protection/privacy restriction in obtaining financial data.

1.1.2. Does your jurisdiction have standard conditions for construction contracts? If yes, what type of clauses do they provide for employers in case of contractor's insolvency?

¹ The person, company or organization who contracts the constructor to design (if applicable), execute and complete the construction works.

² The person, company or organization hired to execute the construction works.

The JCT (Joint Contracts Tribunal) publishes the forms of its Standard Building Contract. The forms contain similar terms with the differences between the forms relating to how the price for the Works is calculated and the way in which the Contractor is paid.

The JCT has specific clauses providing for the Contractor's insolvency. The Employer can terminate the Contractor's employment under the JCT at will for insolvency. The Contractor must also notify the Employer if it becomes the subject of any insolvency proceedings.

Upon termination, under the JCT the Employer may employ or pay other persons to carry out or complete the Works and/or complete any design and/or make good any defects, and subject to obtaining any necessary third party consents they may use any temporary site buildings, tools, equipment, goods and materials belonging to the Contractor/Contractor's Persons. The Contractor must also assign the benefit of any agreement for the supply of materials/goods and/or for the execution of any work pursuant to the Contract if required by the Employer.

The JCT also provides that the Contractor will be paid for work completed up to the date of insolvency in the event the contract comes to an end. The obligation on the Employer to pay for any further Works is terminated.

1.1.3. What kind of securities does the employer usually demand from the contractor?

Insurance

- Professional Indemnity
- Contractor's All Risk
- Public Liability
- Employer's Liability

Performance Bond

This is a standard document that might be entered into and will be required where there is doubt regarding the Contractor's perceived financial strength. A third party (typically a bank or insurance company) ensures payment of a sum (usually 10% of the contract value) in the event the Contractor cannot complete the works to enable the Employer to find a new Contractor. Bonds can be 'on demand' or 'conditional', with conditional bonds requiring that the Employer provides evidence that the Contractor has not performed their obligations under the contract and that the Employer has suffered a loss as a consequence. The cost of the bond (usually borne by the Contractor but reflected in the tender price) gives the Employer a good guide as to the credit worthiness and reputation of the Contractor in the bond market, which will view each Contractor differently in respect of its history, management and financial health.

Parent Company Guarantee

The Employer can seek comfort from a Parent Company Guarantee when dealing with a subsidiary. However, this is only as strong as the credit/financial strength of the parent company. If the Contractor is well known and reputable there may be less of a problem, however if the Contractor is unknown to the Employer the PCG merely provides a second route for the Employer to pursue in the event of default.

Retention

A sum of usually 5% of the contract price is retained by the Employer at least until practical completion and usually released at the expiry of the defects liability period (12 months after practical completion) to ensure the Contractor performs the entire contract and rectifies any defects arising during that period (known as the rectification period).

1.1.4. In case of contractor's insolvency during the project, what alternatives does the employer have in order to carry it through?

JCT Termination Clauses

As discussed above the JCT has a specific clause allowing the Employer under the build contract to employ or pay other persons to carry out or complete the Works. This clause and the associated provisions essentially allow the Employer to appoint a new Contractor to carry out and complete the project and to recover the cost of doing so from the original (insolvent) contractor, or to offset the cost against sums it owes to the original contractor.

In addition the JCT imposes an obligation on the Contractor to proceed "regularly and diligently" with the project giving the Employer the right to terminate the Contractor's employment on grounds other than insolvency. This allows the Employer to terminate before the Contractor becomes insolvent if its performance is already inadequate or delayed.

Collateral Warranties (with "step in" rights)

Where the Contractor appoints the sub-contractors and professional team the Employer does not have a direct contractual relationship with them and is not able to issue instructions to them to continue the Works and is not in a position to pay them. To provide for this, there is usually an obligation in the various appointments for the sub-contractors/consultants to enter into collateral warranties with the Employer thus creating privity of contract. The right of "step in" should the Contractor be unable to finish the project due to, for example, insolvency is an important clause to insert from the perspective of the Employer. The "step in" right effectively allows the Employer to "step in" to the shoes of the Contractor allowing it to issue instructions and pay the team to complete the project.

The JCT standard collateral warranties do not have these clauses and so it is usual practice for collateral warranties to be drafted in bespoke form.

1.1.5. What kind of role do clauses regarding transfer of title play in construction contracts? Are clauses under which the contractor's materials, equipment and tools are deemed to be the property of the employer upon the moment the contractor brings these to the site valid in your jurisdiction and do they limit the powers of the bankruptcy estate?

The Employer should consider including express provisions in the building contract giving it:

- Rights over off-site materials
- The right to enter the site to secure the project and any plant, equipment and materials on the site. (If the contractor goes into administration, the employer's right may be subject to a statutory moratorium on creditor action)
- The right to take possession of any plant, equipment and unfixed materials on site, to sell them and apply the proceeds towards satisfying the Contractor's debts under the building contract. The Employer may want to use plant, equipment and unfixed materials to complete the works before selling it and the building contract may also permit this. The Employer should consider registering its rights over the plant, equipment and unfixed materials as a floating charge in order to seek to avoid the Contractor's insolvency practitioner having a claim over them. If the Employer decides to register a floating charge, it should do so as soon as possible, as a floating charge may be avoided if it is registered in the six months before a contractor goes insolvent

The Employer should resist any proposal by the Contractor to include a retention of title clause in the building contract. However, if such clause is included the following should be considered:

- once the goods are incorporated in the works, they become the property of the landowner. The supplier loses its title, even if there is a retention of title clause in the parties' contract
- It will be necessary to ascertain which goods have been paid for at each level as this may determine entitlement. It may be impossible to be sure on this point until a full termination account is drawn up.
- Look at the contractual clauses at each tier of contracting. What type of retention of title clause does the sub-contractor have?
- Does the statutory exception under section 25(1) of the *Sale of Goods Act 1979* apply? This effectively serves to pass title to a sub-purchaser for value of goods where they were bought without notice of the retention of title clause.
- Check if the sub-contract contains a clause to the effect that the sub-contractor will not deny that title has passed to the contractor and then to the employer, as envisaged in clause 3.9.2 of the *JCT Standard Building Contract*
- Is there a vesting clause in any of the contracts? Or is there a vesting certificate signed by the contractor or sub-contractor? Even if only the contractor has signed, the certificate may be backed by a bond which can be enforced if the contractor did not, in fact, have title to the goods

- Is the election of title clause void? For example is it an unregistered charge (void for want of registration) or ineffective due to “intermingling” with other goods

1.1.6. In case of employer’s insolvency or loan default of the employer, is it typical that construction contracts contain instruments (e.g. novation agreements) for the financier to take over the project and the construction contract?

It is usual for the building contract to contain an obligation to provide collateral warranties to any beneficiary, and this definition will include a funder. The collateral warranties will provide that the funder or its nominee have a right of “step in” as discussed above. This allows the funder, or more usually its nominee to “step in” to the role of the Employer to carry through the project.

In addition, the finance/security documents will contain a provision that they can be novated to the nominee upon default of the Employer to ensure that the contractual arrangement continues as envisaged.

1.2. Defending Contractor’s interests

1.2.1. What kind of securities does the contractor usually demand from the employer? Are any of these securities mandatory in your jurisdiction?

- If the contractor is concerned about the employer's ability to pay for the project, it may insist on funds for the project being paid into an escrow account. The escrow agreement should state:
 - who is entitled to interest accruing on funds in the escrow account; and
 - whether one party is entitled to the release of funds in the escrow account if the other becomes insolvent

- Weighted stage payments. The contractor may insist that payments to it are "front-loaded", with more payable at the start of the project and less as it nears completion.
- A contractor may be able to justify an advance payment where it has to commit funds before the project commences in order to ensure that plant, equipment, materials or sub-contractors are available when work starts. An employer who agrees to make an advance payment will almost always require the contractor to procure an advance payment bond in favour of the employer.
- Project bank account The employer is obliged to maintain a positive balance in a project bank account. In theory, this ensures that funds are always available to pay the contractor and its supply chain. Although it has not been tested by the courts, it is widely thought that, if the employer becomes insolvent, if it has been set up correctly the funds in a project bank account will not be swallowed up with the employer's other assets (the project bank account will need to create a trust)
- Direct payment by a funder. Although an employer and a funder will resist any provision that obliges the funder to make a payment (the funder will not want to act as the employer's guarantor), the parties may agree that regular payments under the building contract pass direct from the funder to the contractor (without passing through the employer's bank account). The parties may agree this in a non-binding side letter or, on a larger project, more formally in the contract documents. The contractor will need to consent to this arrangement, so that it is clear that a payment by the funder discharges the employer's payment obligation under the building contract

None of the above are mandatory.

The Housing Grants Construction and Regeneration Act 1996 (The Construction Act) has led to less exposure for Contractors in terms of cash flow and provides them with enhanced rights of payment from Employers.

1.2.2. What other provisions (e.g. title retention, down-payment clauses etc.) are usually included in a construction contract to protect the contractor?

- Title retention
- Advance Payment
- Right to suspend performance of the contract
- Retention Bond or retention Trust Account
- Specific provisions allowing the Contractor to terminate it's employment under the building contract in the event of the Employer's insolvency
- The Contractor can sometimes suspend the Employer's right to use and/or copy project documents or can suspend the Employer's copyright licence in respect of the same in the event any fee has not been paid to the Contractor

- The Contractor can require the Employer to enter into a Parent Company Guarantee as above
- A payment security bond covers the employer's liability to pay the contractor under the building contract. This type of bond is rare in UK projects, but an employer may be willing to procure an on demand payment security bond (a letter of credit) on a large international project

1.2.3. Please describe the main effects on the contract in case of insolvency of the employer and focus on the following points:

- a) Does your jurisdiction have standard rules for termination of a contract in case of insolvency of the employer? If yes, can the parties deviate from these rules in their contract?**

The JCT gives the Contractor the right to terminate its employment under the contract in the case of Employer insolvency. However, if the Contractor has entered into collateral warranties with rights of “step in” in respect of third parties, if the third parties notify the Contractor that they intend to “step in” to the contract within the notice period then the Contractor’s right to terminate its appointment is extinguished. In addition, some “step in” rights will suspend the operation of the notice period by stipulating that it is extended until the third party steps in.

Further, it is always open to the parties to amend the JCT standard form by way of a schedule of amendments; however amendment of the termination provisions is rare in practice.

- b) If the contract does not end by law, who gets to decide whether the contract is terminated or not?**

The contract is not automatically terminated on insolvency of either party. Under the JCT termination of the contract on insolvency only takes effect on receipt of the notice to terminate. The obligations of the parties under the contract are, however, suspended on insolvency.

Technically, a liquidator can also disclaim a contract if it is deemed to be “onerous”.

c) If the contract is carried forward, is the employer still in charge or does the liquidator take over?

From the onset of insolvency the Employer's obligations are suspended, and, if the Employer is insolvent, the Contractor's obligations to carry out and complete the works are also suspended until a final account is issued. This means that the works can only continue by agreement between the parties. The liquidator will take on the role of the Employer from its insolvency.

Such agreement may take the form of a novation to a third party who assumes the obligations of the insolvent employer or contractor. This would enable the insolvency practitioner to realise any value remaining in the contract, while minimising any disruption to the other party.

There may be "step in" provisions in the Contractor's collateral warranty to any funder which will prevent the Contractor terminating the contract and allow the funder or its nominee to "step in" and manage the contract.

1.2.4. What happens to the claim for remuneration of the contractor towards the employer:

a) In case of termination of the contract?

Payment obligations are suspended on termination. Upon termination for insolvency of the Employer by the Contractor, the Contractor will submit a final account for:

- the total value of work properly executed at the date of termination;
- any sums ascertained in respect of direct loss and/or expense;
- the reasonable cost of removal of plant and tools from site;
- the cost of materials and goods properly ordered for the works for which the Contractor has paid or is bound to pay; and
- any direct loss and/or damage caused to the Contractor by the termination.

b) In case the contract is carried forward?

If the contract is carried forward then the provisions of the contract will remain live.

1.2.5. During the project, who usually owns the parts of the building that have already been finished? Are there any rules in your jurisdiction that would allow the contractor to get a freehold of the construction site and continue the project with a different employer?

The Employer will own the parts of the building that are finished and fixed to the building. Subcontractors' standard terms and conditions often contain "retention of title" clauses stating that the ownership of materials will only pass to the contractor when the subcontractor has been paid.

Such clauses do not prevent the Employer acquiring the ownership of materials which have been fixed to the building, but if the Employer has paid the Contractor for any unfixed materials, and he has not paid the subcontractor, the subcontractor may be able to claim back its property.

The Contractor obtains a licence to carry out the works from the building contract and this right remains as long as the contract is live.

1.2.6. What kind of provisions should/can a contractor include in the contracts with his subcontractors to protect himself in case of the employer's insolvency?

- Suspending performance of the subcontract on Employer insolvency
- Termination of subcontract on Employer insolvency

BUT will the sub-contractors accept these points? Depends on the commercial relationship between the parties and their bargaining positions.

2. Lease contracts

2.1 Is a lease affected by the foreclosure of a mortgage or other in rem guarantee over the leased property? May the new landlord terminate the lease?

It depends on the terms of the lease.

In some cases the lender will become the landlord – but only if the lease is binding on the lender. In this case an order for repossession does not affect tenant's rights under the lease.

In many cases the lease is not binding, however the tenancy may be binding if:

- a. the defaulting landlord had a buy-to-let mortgage
- b. the lender gave permission for the landlord to grant the tenancy
- c. the landlord's lender has recognised the tenancy in some way – eg by asking you to pay rent direct to them or by accepting rent from you (although it does not count if this arrangement was made as part of an agreement to delay the date of possession for a non-binding tenancy – see below).
- d. you were already living in the property at the time the mortgage was granted
- e. the property was sold to the current landlord after your tenancy started.

Practically speaking lenders will have difficulty in getting possession against a non defaulting tenant. However there are ways to ultimately get possession, the easiest being if there is a right set out in the lease.

2.2. Does your jurisdiction afford any protection for the tenant in this case, for example, by guaranteeing the continuity of the lease agreement or a right of first refusal for acquisition of the leased property? Are there any requirements that need to be fulfilled if the tenant wishes to oppose these rights (if applicable) against his new landlord.

If the tenancy is not binding on the lender, then the Mortgage Repossession (Protection of Tenants etc) Act 2010 offers following protection:

- lender must send a notice to the property before the repossession hearing informing 'the tenant or occupier' (ie everyone living there) of the date of the

hearing. They have to do this within five days of the hearing date being confirmed by the court.

- send a second notice to the property by first class post, recorded delivery or by hand, to inform tenant that the lender is going to ask the bailiffs to carry out an eviction. This will only happen if the court has already made a possession order. A special form must be used for this notice. The bailiffs cannot evict tenants for at least 14 days after the landlord has given this notice.
- The tenant can apply to the court for the repossession to be delayed for up to two months at any one of these points in the process:
 - at the repossession hearing
 - after the court has made an order for possession
 - at the warrant stage.

Although most private tenants with tenancies that are not binding on the landlord's lender will be protected by this new law. The only exceptions are:

- if tenant is a [service occupier](#) or [service tenant](#), living in tied accommodation
- if tenant is an [excluded occupier](#) (eg if you are a lodger in your landlord's home), or
- if tenant is an [occupier with basic protection](#) (this may be the case if they live in the same building as the landlord, don't pay any rent, or live in a holiday let).

Often a lender will want a decent commercial tenant to remain in the property. Ultimately, an "onerous" lease can be disclaimed by a liquidator (supported by a lender with regard to an unsecured claim).

2.3. In case of insolvency of the tenant, is the landlord entitled to terminate the lease? Are insolvency clauses common in lease agreements in your jurisdiction? Are they normally upheld in court?

If there is an insolvency clause in the lease, the landlord is entitled to terminate the lease.

Modern lease agreements almost always have an insolvency clause in jurisdiction of England and Wales.

2.4. What kind of securities does the landlord usually demand from the tenant? How tenant's insolvency may affect the ability of the landlord to execute these guarantees and collect rent and other monies due to under the lease?

Securities:

- Rent deposit with rent deposit deed which details circumstances in which deposit can be drawn against (usually held under trust) .

Attractive to landlords because an immediately accessible source of money that can be withdrawn as soon as the tenant is in breach of a relevant covenant in the lease, e.g. becomes insolvent. There is no need to take legal proceedings to recover the debt or secure performance of the obligation. However deposits are usually limited to up to two months rent.

- Bank guarantee or bond – where a bank or insurer agrees to pay a sum of money to landlord if tenant defaults.

Bank guarantees are unaffected by the tenant's insolvency. The bank must pay the landlord even though the indemnity from the tenant to the bank may prove worthless. Usually the tenant has to pay the bank a sum of money to underpin the indemnity.

- Director guarantee
Such a guarantee will not be attractive to a landlord unless the director has proven financial worth. The landlord may want a charge over the director's assets to secure his obligations. Whether or not such a charge is required, directors are often reluctant to put their personal assets at risk in this way.

- Parent company guarantee (if tenant is a company) - the parent company agrees to indemnify the landlord against losses resulting from the tenant's failure to observe the covenants in the lease. Usually the parent company also agrees to perform the covenants in the lease if the tenant fails to do so.

Only attractive to landlord if parent company is of good covenant strength

- Letter of credit -a contract under which a bank agrees to pay the landlord. Issued at the request of the tenant in favour of the landlord.

Used mostly by US based companies who are familiar with them. In England and Wales the use of a letter of credit for this purpose is rare (they are generally used as a form of payment in international trade). However, the influence of US companies may see them become more popular as an alternative to a rent deposit.