PROTECT YOUR BUSINESS FROM THE INSOLVENCY OF A CONTRACTOR OR SUBCONTRACTOR

To protect your business from the risk of insolvency in the construction industry, you must understand the risks facing the key contractors or subcontractors.

It is important for both head contractors (relying on subcontractors to perform works) and subcontractors (relying on head contractors for payment for works completed) to take steps at various stages during the contracting process to protect themselves from the credit risks and threat of counterparty insolvency. This is an ongoing process that should be assessed at various stages during the contracting process.

Measures Pre-contract

The following issues should be considered when undertaking pre-contract due diligence:

- Limit reliance on individual counterparty - the loss of a key work-provider may be fatal. This applies to both a contractor that is reliant on one subcontractor across a number of projects or a subcontractor who is critical to a particular project as well as a subcontractor that is reliant on workflow from one particular contractor.
- The risk associated with a key contractor/ subcontractor will vary depending on the relative size and complexity of the counterparty (i.e. are they SMEs, large corporates or government bodies) and also the nature of your own business and its overhead and employment structure.

Some key issues to consider include:

- What is the credit worthiness of the counterparty (a government body is considered to have a very low credit risk in comparison to an SME)?
- If a subcontractor has large fixed costs, and a portion of these costs are attributable to workflow from a key contractor, and that work ceases unexpectedly, how does the subcontractor bridge the gap and find a replacement in a short time frame, particularly considering the lead time for large scale projects?
- Can a contractor's/subcontractor's balance sheet sustain a large provision for debtors? Could a significant debtor provision cause balance sheet insolvency? Will a restricted balance sheet limit contractor's/subcontractor's ability to secure new work?

- Analyse the forward book - the size of the forward book in comparison to historical turnover. Is the work being won actually profitable or is the contractor/subcontractor "buying work" to generate cash flow? In our experience, where contractors/ subcontractors are experiencing financial difficulties they will often underquote to win work, generate cash flow and hope that variations can be achieved during the contract to make the overall project ultimately profitable. In a tight market, where margins on contracts are low, a tender that is substantially lower than that of competitors is an obvious warning sign;
- Perform forecast creditor assessment - most creditor assessment is based on historical, often dated and unaudited information. Considering the speed at which the construction industry changes and the impact it has on contractors/ subcontractors it is important to also assess counterparty's short and medium term forecast financial position. There are many specialised advisers in the market place that can conduct this type of forecast credit analysis.

The following factors will be generally considered in the analysis:

- The current financial position of the counterparty but also where they will be during and at the end of the contract relationship. Can they continue to meet their financial obligations to you and others during the contract term?
- Could the counterparty sustain a loss on a project and to what extent?
- Assessment of the forward book, overhead structures, profitability of existing contracts and implications of the current market on current and future contracts.
- Review of the capital base, the ability of the shareholders and the directors to raise funds if needed to meet a cash shortfall gap (bearing in mind the majority of the SMEs already have limited access to commercial finance);
- Review forecast surplus cash flow in comparison to the size of turnover. For example if a business is turning over $100m per annum ($8.3m per month) and surplus cash flow or cash at bank at any time is only $1m this highlights the risk that, should a progress claim be delayed, there will likely be a substantial deficiency in cash reserves to meet liabilities until the progress claim is received.

Measures During the Contract

Continued assessment is critical to identify potential risks and implement strategies to mitigate them. More often than not in the construction industry, participants' financial position can vary substantially in a short period of time based on timing of cash flows, outcomes of litigation and contractual issues as well as on going warranty liability post-completion. These risks are not only evident in current contracts, but also completed projects, within the warranty period. Some of the key signs to consider include:

- Loss of key staff - this is an indication of an underlying problem, within a business and something that needs to be investigated further;
- Program and quality control issues - this is an indicator of an underlying issue, where management are struggling to control quality of works and can highlight the requirement to manage competing issues;
- Examples of contractor/subcontractors leaving or not attending site/union interventions - this is one of the more obvious warning signs as contractors/ subcontractors are the first to get paid on a regular payment cycle. If a group of subcontractors are refusing to attend site an audit should be undertaken immediately and consideration should be given (subject to legal advice) to pay the contractor/subcontractors directly;
- Winding up notices - are creditors initiating recovery action?
- Deviations from core competencies - This can often include taking on additional risk for i.e. development risk or expanding into areas outside of the contractors/ subcontractors area of expertise (i.e. moving from commercial to residential);
- Adverse litigation outcome – In particular warranty issues stemming from Home Building Act (NSW). Liability warranty for the seven years following residential projects and contractual warranty for non-residential projects, is not generally recorded on the balance sheet as a liability, and is particularly detrimental to the balance sheet where litigation is commenced many years after completion of a project takes place. If the customer/supplier loses the litigation and is faced with a substantial damages claim, this could have a substantial impact on the performance and solvency and the business.

Where the above signs are evident and there is doubt as to the financial position of the counterparty and the likelihood of contract performance, measures should be taken to investigate further but also plan for possible outcomes. Measures will vary on the circumstances, however in general it should include:

- Securing documentation and certificates;
- Additional supervision of the quality of work;
- Identifying possible replacements; and
- Identifying any key staff; and
- Minimising the ageing of amounts owed (in terms of a subcontractor's payment claim).

Measures in the Event of Insolvency

The options available to contractors/ subcontractors faced with counterparty insolvency will vary depending on the stage of completion of works, the nature of the works and also the contracting relationship. In the contractor's situation, where a subcontractor is placed into external administration, consideration needs to be given to the following:

- How critical are the subcontractor's works?
- Can they be easily replaced by an alternate contractor/subcontractor?
- Are the staff of the contractor/ subcontractor critical to the works and can they be retained/ re-employed?
- Warranty and certification issues and collating all documentation;
- Managing relationships with key stakeholders, i.e. banks, principal, unions, etc; and
- Defects – due to cost cutting and focus being diverted away from quality presence of potential.

In the subcontractor's situation, where a head contractor is potentially insolvent, consideration needs to be given to the following:

- Negotiating with the principal or bank in order to facilitate completion of the project; and
- Protecting the outstanding claims and ensuring as much as possible is recovered.

More often than not, following an external administration, a contracting party will terminate a contract or subcontract and seek to find a replacement contractor to complete the works. In our experience there is a substantial additional cost to this process (we have seen increases of up to 40%) as well as substantial delays and warranty implications. Accordingly, consideration should be given to all options available, including the use of an insolvency practitioner to complete works where possible. Whilst this may not be viable in all circumstances, it can have the following benefits:

- Continuity of workmanship;
- Limit argument as to responsibility for defects (i.e. the original/ replacement contractor);
- Minimise time delays and additional cost;
- Maintain any Home Owners Warranty Insurance;
- Creditor demands threatening legal action; and
- Creditor requesting cash on delivery or stopping supply.

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