Webiner ePaper

Rise in prices & insolvencies on construction projects

RIDGEMONT

Ridgemont is an established, boutique law firm with offices in central London that specialises in construction and real estate law.

We represent exciting clients that have the same enterprising ethos as we do.

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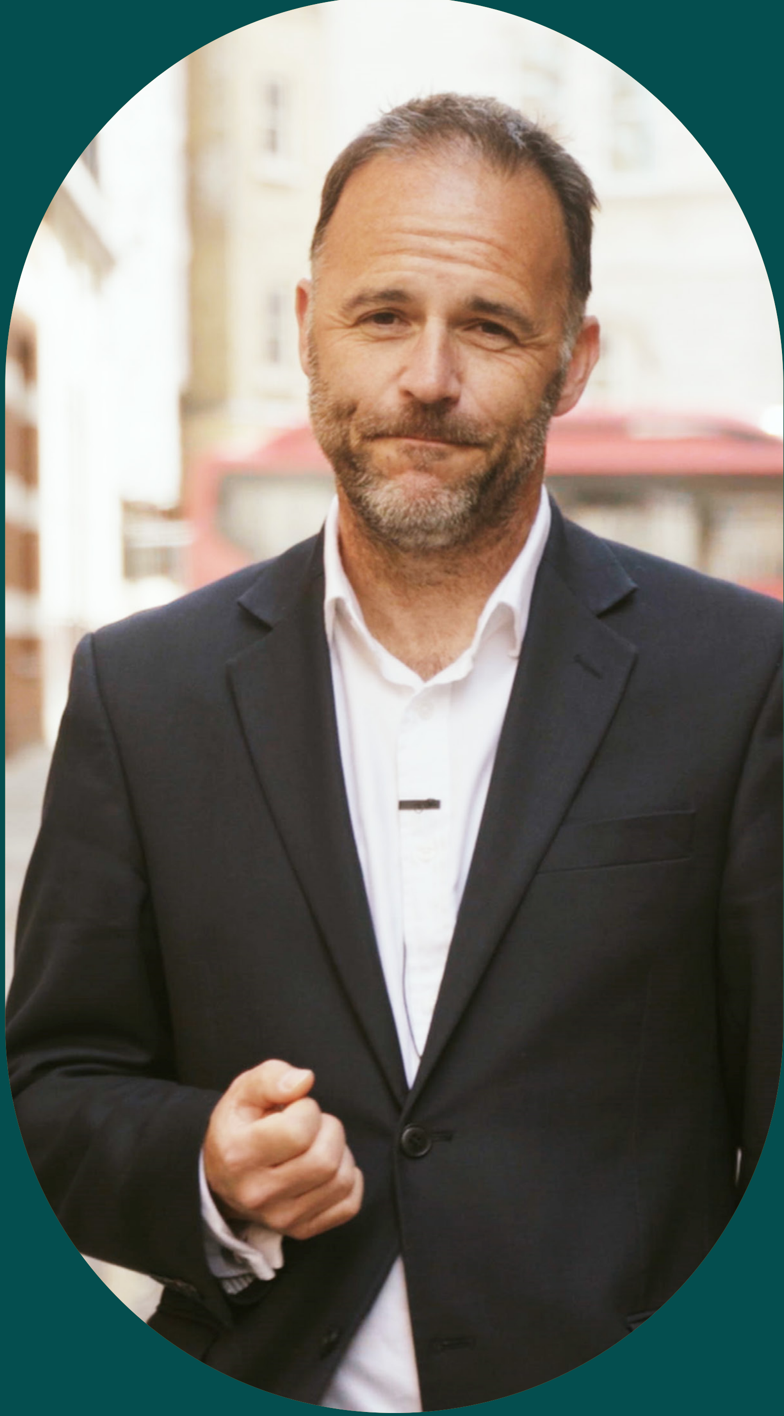

Tim Seal

Head of Construction

Tim has spent nearly 20 years advising all parts of the construction supply chain. Tim worked for some of the largest commercial law firms in the UK, before becoming a consultant. He joined the Ridgemont team in December 2020 and became Head of Construction in February 2022 adding huge experience to the firm.

Tim focuses on dispute resolution and advisory work. He has advised clients on all standard form domestic and international contracts and across both public and private sectors. Tim has published articles, given talks and provided training throughout his career.

Let's Connect!

Introduction

As anyone with even a passing interest in construction industry news will know only too well, currently we are living in a time of steeply rising inflation, workforce shortages and other project pressures. They are part of a societal wide struggle with those same problems, caused by the war in Ukraine and Brexit to name but two of the more obvious causes.

Inevitably this then impacts on the work that construction lawyers do, both in terms of type of work and volume, and it affects those lawyers that draft contracts and advise on procurement, as well as those that deal with dispute resolution.

One construction law issue that falls back under the spotlight at times like these, is the use of fluctuations clauses in construction contracts. So in this paper I take a quick look at what they are, specifically in JCT.

JCT Fluctuations clauses

• Fluctuations clauses in JCT contracts are found at the back in one of the schedules. They take the form of three options, A, B and C.

• They allow for adjustments to be made to the Contract Sum. They provide that if certain stated rates, levies, prices etc, that have been used in the calculation of the Contract Sum, go up or down after the contractual Base Date, then the Contractor is paid or it must pass on an adjustment reflecting that increase or decrease.

• Each option offers a different approach to managing these fluctuations and/or focusses on different specific fluctuations.

• These clauses have fallen into relative disuse because of a lengthy period of stable inflation etc and so they are routinely struck out of the contract by the parties. In fact JCT do not provide them automatically in the 2016 standard form and therefore you have to deliberately add them in. However, in these more volatile times, they are making a comeback.

Option B

• In this note I am looking at Option B in the 2016 D&B contract: labour and materials cost and tax fluctuations, because I think it is the most relevant of the three options.

• Option B runs to 5 pages and it works basically like this:

Deemed calculations

• Option B states that the Contract Sum has been arrived at via, amongst other things, deemed calculations as to three matters to be paid by the contractor: (i) wages for its workforce (ii) levies and taxes regarding those wages and (iii) the price of materials, goods, electricity and fuels. Option B also says that those things have been calculated based on certain rules, schemes, agreements and market conditions, prevailing at the time of contract.

Change in such rates, prices etc

• If however any of those three things subsequently change after the Base Date, because of a change in the said rules, agreements and markets etc that underpin them, then the net amount of the increase or decrease in wages, prices etc, is paid to the contractor by the Employer or it must be allowed for by the Contractor, as the case may be.

Sub-contracts

• If the Contractor sub-contracts any part of the Works, it must incorporate the same fluctuations clauses into that sub-contract.

Notification

• The Contractor must notify the Employer of these changes within a reasonable time after their occurrence and that is a condition precedent to any payment to the Contractor.

Net sum payable or to be allowed

• The Employer and Contractor can agree the net sum payable to or to be allowed by the Contractor, or the Contractor must provide such evidence and computations to the Employer as it may reasonably require, as soon as is reasonably practicable, so that the Employer can ascertain the sum.

No change to profit

• The amount of Contractor profit is not impacted by this fluctuation clause.

Percentage addition to fluctuation payments

• The percentages stated in the Contract Particulars are then added to any fluctuation payment or allowance. So these must be inserted into the contract when incorporating the fluctuation provisions.

The Base Date

• As stated above, these clauses are looking at increases/decreases taking place after the Base Date. That date is stated in the Contract Particulars.

Observations on Option B

• From the above summary it's obvious that such adjustments are sometimes far from straightforward to calculate and unsurprisingly can be disputed as whether they arise at all or as to the specific amounts

• The benefits to a contractor of having a fluctuations clause in the current climate are obvious, ie there is some protection against steepling costs on jobs that may have been priced some time ago before covid. But what about employers: why would they want them? Well it won't suit them to see their supply chain go bust on a job and a fluctuations clause gives some pre agreed framework for managing these turbulent times

• Of course parties can tailor these fluctuation clauses to their own needs, eg providing for changes in prices of certain materials, but not others.

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Stewart Owen

Director, Head of Business Development

Stewart Owen MBA MCR is a highly experienced, General Management focused, Pre-Construction, Sales, Marketing and Business Development Director with extensive success in delivering revenue growth.

Stewart has a strong ability to identify and access major opportunity through analysing and researching the market and by utilising effective networking skills to create, build and maintain strong client and consultant relationships. He has outstanding Project Management skills in building and leadership of a variety of high performing, cross functional teams, ensuring delivery of world class, work winning strategies.

Stewart has successfully won a large number of project tenders through effective leadership of bidding and presentation process and by planning and negotiating with high value clients.

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"The prevailing level of increasing costs in construction, especially around materials and product costs is the most frequently raised subject we are asked about on projects we are asked to help deliver …but by no means limited to that."

Developers, especially SME and emerging Corporate Developers, are seeking ways to introduce cost stability into their feasibility and development viability modelling, to secure funding, as well as in protecting assured returns from the actual build out process. Developers should expect, and be able to achieve, reasonable returns, however there are few ways of mitigating the impact of price volatility, which lies outside of the direct control of the parties involved in the contract.

Developers understandably want their 'cake and eat it' – limits on price increases, but with competitive pricing 'baked in' to the contract. In order to do this, contractors and their supply chain are compelled to build in contingency to cover the potential risk of increases. With reported increases in double digits, variously as high as 20-30% p.a. (the DfBEIS report for May 2022 quotes a headline figure of >25%) and with few encouraging indicators showing any slowing down, how can this stack up where yields and returns are typically 5-10%?

In simple terms, it can't stack up under that conventional model in times of rapid price inflation. However, development continues, and the country needs houses, and offices and infrastructure, so waiting for prices to stabilise is not a realistic option.

One factor yet to make itself apparent, is that raw material costs must, surely, at some point, adjust downwards. Production and distribution were affected by Covid, Brexit, the blockage of the Suez Canal and, more recently, the war in Ukraine. A lot of materials/products were forward ordered to secure continuity on sites, and much of it is probably being deployed as projects close out and on-site and local stocks are being depleted. To meet demand caused by shortages, raw material processors and manufacturers will have turned production up and may be enjoying exceptional returns as this rebalances. However, it can be anticipated, once the balance has been reached, capacity will exceed demand, prices, will fall and this will work through to material costs on live projects.

So, Developers having demanded cost certainty will have incorporated the contractor/supply chain contingencies, with associated 'inflated' pricing. Once operations start, any increases are constrained, but there is no mechanism (or incentive) for any savings from price decreases, from reduced material costs, to be returned to the Employer. For the Contractor, quite rightly, they receive improved margins in exchange for their acceptance of the price increase risk, when markets go their way. For the Employer client, this 'saving' is not available to them.

In essence, cost certainty is by definition expensive and a one-way ratchet.

One option, and one that is not popular but maybe whose time has come, is 'Open Book' contracting – this is where the Contractor and Employer agree that the Contractor will receive a fee to cover prelims and OHP, (and possibly a 'modest' mark up on material costs and Sub - Contractor packages) but that there is full transparency of costs of the various packages.

The challenges that arise usually revolve around the Employer believing they are seeing the full actual final cost (as in there are no hidden discounts or rebates that are not declared, nor that additional margin has been built in to cover these but which the client cannot see). The other risk is there is less incentive for the Contractor to obtain the most competitive packages.

A common version of this, but one that is often chosen for speed as opposed to transparency and certainty, is two stage tendering/contracting. Two stage contracting is common, especially in smaller scale projects and more intense contracts such as fast track fitout and refurbishment.

This method of procurement offers some interesting aspects that may well be relevant for the current market.

In any case, the issue should not be either one party or the other enjoying exceptional returns at the cost of the other, nor in less than efficient procurement than should be the case, but it should be about equitable allocation and acceptance of risk and commensurate opportunity. It does the client no good at all, if the Contractor goes bust because they have been pressed too hard due to unmanageable cost increases, nor if the Developer is unable to complete the scheme or does so without fair return and is forced to be reluctant to pay the final account – there can be no repeat business then, or worse, the Contractor may not be paid in full, especially where retention may be in jeopardy.

Most of this would seem to be common sense yet there is still the temptation for the parties to try to take advantage of each other to make a decent return. In the current market, this approach is fraught as it is in a very intensive context where consequences are multiplied. As ever, the industry should be encouraged to seek collaboration, partnering, equitable behaviours and respecting the other participants' right to make a sensible profit.

Of course, as expert QS/cost consultants, who are often engaged when disputes have arisen because of conflict between the parties, we see the consequences of the lack of an equitable deal. Often, it's because thin margins become fatally stretched when costs increase and can no longer be sustained.

To quote an issue of Inside Housing from earlier in the year: In the final quarter of 2021, a total of 866 construction firms became insolvent in England and Wales. That compares with 717 in Q3, 597 in Q2 and 403 in Q1. In the equivalent three months in 2020, 426 firms went under.

This is a worrying trend.

Our advice? Sound cost consulting, a sensible attitude to pricing and risk, acceptance of risk, matched by retaining control, and an informed procurement strategy built on trust. Above all, employ an experienced and knowledgeable QS firm, and let them help select the most appropriate form of contract, build in provision to sense-check actual costs as they arise compared to the market, and recent actual rates, and ensure the contract, with sound legal advice from a specialist construction lawyer, reflects the shared attitude to risk and reward and has provision for these strategies to be deployed.

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Secure Trust Bank

Mike Feasey

Relationship Director

Mike joined Secure Trust Bank as a Relationship Director in March 2022 from Handelsbanken where he held various roles, latterly a senior corporate manager.
He works as part of the Reading-based team supporting Investors and Developers across the Thames Valley, Midlands, South and West and has experience across a range of asset classes and client types.

Mike joined Secure Trust Bank as he was keen to join a growing and ambitious bank. He enjoys working with real estate Investors, structuring deals to support them with their goals.
When not in work, Mike spends his time playing golf, in the gym, watching football or walking his dog.

Let's Connect!

The impact of increasing costs and supply constraints are becoming ever more apparent in the construction industry. Land values remain high, whilst the cost of materials and labour continue to rise. Supply chains pose a major challenge, with Developers finding it increasingly difficult to source materials because demand is rapidly outpacing supply. This is all of great significance to Developers and their Lenders who provide a substantial amount of funding in support of the construction of new homes.

It is now evident that the pressures have resulted in an increasing number of Contractor insolvencies. This in turn means that Developers are facing further delays and additional costs. They are also experiencing difficulties in sourcing replacement Contractors for a comparable price in the current market.

Aside from the delays and the extra costs already mentioned, the cost of a typical loan facility is also increasing. Interest rates are rising and are expected to continue doing so for the foreseeable future. This is being driven by the increasing costs involved in raising liquidity, as well as the pricing in of the additional risk that is perceived by lenders in the current market. Furthermore, Lenders themselves are facing higher overheads. This all amounts to the cost of loan facilities going up.

The significance of the current challenges should not be understated. Nevertheless, Secure Trust Bank continues to be active in supporting Developers with finance, whilst ensuring that the existing development loan book is well protected. Below we consider some of the steps Lenders could take to help mitigate the risks associated with a rise in prices and insolvencies on construction projects.

1.Fixed price contracts

In an ever-changing climate of rising material costs and delays, lenders ought to pay close attention to the contract between the Borrower and the Contractor. Generally fixed price contracts are sought to protect the developments from sudden fluctuations in materials. However, rising costs threaten the ability of the Contractor to complete the project whilst maintaining a profit. Thinly capitalised Contractors may not be able to, or may not want to, absorb additional costs under fixed price contracts. If the Contractor is not pushed into insolvency there is the additional risk, particularly in high-demand markets, of the contractor walking away for more profitable works. Due diligence on the Contractor is therefore vital.

2.Due Diligence

In addition to an appraisal of the development and its profitability, Lenders need to fully consider the ability of the Main Contractor to deliver the development. This is not limited to just past experience but full due diligence on their finances. The experiences of the last few years have shown that Main Contractors are not infallible. The failure of the Main Contractor does not have to be terminal for a development provided that the Borrower and Lender can act promptly. In an ideal situation, a replacement Contractor is appointed although this will likely cause significant delays and repricing issues. Whilst price growth over the last two years has compensated for increased costs, going forward, a slowdown in house price growth due to rising interest rates and the cost of living may impact development viability. Therefore, due diligence needs to pay due consideration to both future and current market trends.

3. Strong level of contingency

Building in a good level of contingency is important, with that level needing to increase in more volatile periods. Lenders need to ensure they are satisfied that Borrowers are carefully considering and mitigating the risk of price rises as far as practicable and that they have sufficient contingency in their cost plans to account for likely price inflation.

On top of this the Borrower should look to retain additional liquid assets to act as a further buffer should the worst happen.

4.Lower leverage lending

Seeking a lower overall leverage ultimately reduces the risk. In the event of cost increases Lenders need to consider the benefit of increasing the funding to support a completion of the development, it can be very difficult to exit a part finished site. This assessment becomes more challenging when the starting leverage is that much higher. There is also the risk, if the Borrower does not have enough cash in on day one, that they may just walk away from the project if the ultimate profits aren't there any longer.

5. Staged Drawdowns

We operate with a staged drawdown structure that gives us greater control in allocating funds and ensures that funds are being used for the stated construction purposes. Strict time limits are set for the various stages of construction to be completed; the next stage of funding is only released to the Developer once a site inspection has been completed to confirm that the construction is proceeding satisfactorily.

Underpinning all of the above topics is the need for a Lender to understand the specifics of each project whilst undertaking a robust level of due diligence. Whilst a fixed price contract is preferable, the Lender also needs to ensure they are comfortable the Contractor can deliver with that fixed price. However, the most important aspect remains, ensuring the numbers are strong enough to sustain sudden and unforeseen price rises or delays to the project.

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Brian Baker has been an insolvency practitioner for more than a decade and his aim is always to secure the best possible outcome for all parties concerned. He takes appointments on company liquidations, administrations, voluntary arrangements, bankruptcy and Law and Property Act Receiverships.

He works with directors of distressed companies, as well as creditors facing defaulted loans. Brian approaches each situation with sensitivity and integrity, mindful that it is people and their livelihoods involved. He provides reassurance during this unsettling time.

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1. Directors of construction companies minimise insolvency liability

The current construction market is particularly volatile at the moment and there will be both winners and losers. However, directors of companies can take steps to minimise the risk of insolvency for their company as well as personal liability and actions against them if their company does fail.

The issues currently buffeting the economy have been particularly severe for construction companies and have led to a steep rise in construction company failures this year. 23 construction companies entered into administration in July 2022 in the UK, an increase of 130% over July 2021. In addition to companies entering administration, the wider construction-related sector was responsible for almost a fifth (19%) of all insolvencies in the UK in 2020.

2. What is causing this situation?

The economy as a whole and construction in particular is suffering from a combination of Brexit, the situation in Ukraine and Coronavirus. This has led to steeply rising inflation, labour shortage, delays in critical supplies and rises in costs, such as fuel and insurance. Credit ratings are being affected, so obtaining funds for working capital is becoming harder.

Uncertainty in the economy is also leading to projects being delayed, postponed or cancelled. Additionally, fixed-price contracts mean that some businesses, particularly specialist Sub-Contractors, simply cannot complete contracts profitably.

These issues coincided with the end of governmental Coronavirus support, leaving many companies with significant loans and deferred tax liabilities that they now need to repay.

3. What are the risks to directors?

When companies fail, the appointed insolvency practitioner seeks to maximise the realisation of assets for the creditors owed money by the company. One way is taking action against directors who have not acted in the best interests of the company and its creditors. The Insolvency Act gives wide powers to insolvency practitioners to take action against directors. These include, among others:

Wrongful trading – if a director causes a company to continue trading after they should have realised that it could not avoid insolvency, they may be held personally liable for the increase in losses incurred by not ceasing to trade and taking every step to minimise the loss to creditors.

Transactions at undervalue – selling or transferring company assets at below current market value.

Preferences – if the company does something that puts one creditor in a better position than other creditors at a time that it is insolvent, this can be unwound by the insolvency practitioner applying to court.

Disqualification – directors can be disqualified from acting as directors for a period if the court considers that they have not acted properly.

4.How can directors minimise the risk to themselves?

The best way to reduce the risk of action against directors is to ensure that the company keeps reliable and up-to-date financial information and acts promptly on issues that arise to avoid the risk of wrongful trading. These include:

Cashflow forecasts – these should be regularly updated and reconciled to the balance sheet and profit and loss account. These should take account of all contracts and anticipated delays and over-runs.

Management accounts – maintain detailed up-to-date monthly management accounts.

Board meetings – hold regular board meetings to review finances and major contracts, including projections of future movements on contracts. Encourage all concerns to be raised and discussed properly.

Board meeting minutes – produce detailed minutes detailing the rationale for decisions.

Valuations – get third-party valuations for any asset disposals.

5.How can directors help the business survive?

Accurate management information is key as this will allow the position to be understood properly and options for the future to be explored with Advisers, Funders, Clients and Stakeholders.

If insolvency is a real risk, there are various options for restructuring the businesses to allow viable parts to continue. These can include the new restructuring plans that the government has introduced to help businesses survive. Other routes, such as moratoria, company voluntary arrangements and administration, can be used to enable all or parts of the business to continue.

Professional advice should always be obtained as soon as future solvency problems are forecast. Advice can help save both the business and protect the director against personal claims.

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This ePaper is a summary of the issues only and does not constitute legal advice and no reliance is intended nor should be placed upon it. Please consult a lawyer at Ridgemont for specific legal advice.

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