**BLAKE-TURNER & CO SOLICITORS**

# Insolvency in the Construction Industry: Resolution of Disputes with a focus on Adjudication

February 2010

## Precis

The construction industry accounts for approximately ten percent of the GDP of the United Kingdom. The industry has developed a sophisticated and in some ways complicated system of dispute resolution. There has increasingly been an overlap with the insolvency industry. Although there is a basic understanding as to how the Construction Industry works, there is a lack of real knowledge as to how the various dispute resolution procedures work and how moneys can be claimed.

The purpose of this seminar is to explain the different forms of resolution available, in particular, litigation, arbitration, mediation, adjudication and expert determination.

There is also a body of case law which has evolved over the last eight years relating to insolvency practitioners and adjudication.

## Introduction: What are the main forms of dispute resolution available?

### High Court v Arbitration

- The difference between arbitration and litigation.
- When can arbitration be used:
    - If there is an arbitration clause in an agreement usually binding unless parties agree otherwise (may not have any choice);
    - Parties can otherwise agree to arbitrate.
- When can litigation be used:
    - At any time (although subject to the terms of any applicable dispute resolution clause in any agreement (s) between the parties).
- Applicable procedure:
    - High Court;
    - Arbitration.
- Pros and cons of arbitration;
    - Pros of arbitration:
    - Confidential;
    - Choice of arbitrator;
    - More flexible;
    - Procedure less strict ie no obligation to disclose all documents relevant to your case; and
    - Arbitrator's decision binding.
- Cons:
    - Can be more expensive than High Court proceedings as the parties are obliged to pay the arbitrator's fees and other disbursements such as room hire etc;
    - Process usually takes longer;
    - Lack of disclosure may be unhelpful;
    - An arbitrator who has been chosen for technical expertise may not have the necessary expertise in terms of hearing witnesses and determining who is telling truth;
    - Very few grounds to overturn an arbitrator's decision.

Pros and cons of High Court proceedings:

- Pros of High Court proceedings;
    - Judge;
    - Tightly controlled procedure;
    - Efficiency (courts now more efficient than previously);
    - Do not have to pay the costs of judge and courtroom etc
- Cons of High Court proceedings;
    - Not private;
    - Ability to appeal judge's decision, which has an impact on time and costs.

## Mediation

- Consensual resolution;
- Pros and cons.
    - Often effective; but
    - Can be a delaying or fishing exercise

## Adjudication:

- Mandatory dispute resolution procedure in the field of construction contracts (section 108 of the Housing Grants Construction and Regeneration Act 1996); and
- Fast track (28 days or as otherwise agreed between the parties)

## Adjudication

What is adjudication?

S108 of the Housing Grants and Regeneration Act 1998 ("the Act");

- Applies to all construction contracts;
    - Definition of what constitutes a construction contract under the Act;
    - Which construction contracts are excluded under the Act (ie residential, certain agreements entered into under statute, a contract entered into under a private finance initiative ("PFI") (nb does not apply to the construction contract or any related contracts), certain other finance agreements and development agreements; and
    - Requirement that the construction contract must be in writing;
- The requirements of the Act:
    - Timetable;
    - Adjudicator must reach decision within 28 days of referral (or 42 days from that date with the consent of the parties);
    - Adjudicator has a duty to act impartially;
    - Adjudicator to take the initiative in ascertaining facts and law;
    - Adjudicator's decision is to be binding until dispute finally determined by legal proceedings, arbitration or agreement;
    - Adjudicator is not liable for anything done in discharge of his obligations.

## Procedure in Adjudication

- Right to refer a dispute to Adjudication at any time;
- What constitutes a “dispute”;
- What types of disputes are likely to arise for an IP under a construction contract
- How to commence an Adjudication;
- Application for leave from the court is necessary to commence Adjudication when a company enters into administration (see s11 (3) of the Insolvency Act 1986).
    - *Straume Ltd v Bradlor Dev. Ltd* [1999] CILL 1520 confirms the position that once a firm enters into administration, leave of the court is required to enter into an Adjudication under the Housing Grants and Regeneration Act falls within the definition imposed by s 11 (3) of the Insolvency Act.
    - *Canary Riverside Development v Timtec International* [2000] Royal Court of Justice 69/2000 confirms that consent to adjudicate is unlikely under s11 of the Insolvency Act where a defendant is in administration.
    - Notice of intention to refer a dispute to adjudication.

## Rationale of using an Adjudication for an IP

- Advantages to an IP in commencing an adjudication
- Methods of defending an adjudication:
    - No contract in writing;
    - No construction contract within the meaning of the Act;
    - The statutory requirements of the contract;
    - No dispute being capable of being referred to adjudication;
    - The Adjudicator did not have jurisdiction over an issue or question or has gone outside his terms of reference;
    - The adjudicator has conducted the adjudication so as to breach the principles of natural justice;
    - Breach of European Convention of Human Rights;
    - The adjudication provision does not, by operation of law, bind one party; and
    - The adjudicator was not properly appointed under the terms of the contract.
- The costs implications of an adjudication for an IP

## Enforcement of an adjudicator’s award

Rule 4.90 of the Insolvency (Amendment) Rules 1995. Unlike other forms of set off this is mandatory and cannot be contracted out of. It displaces other rights of set off available to winding up. The dealings require to have taken place pre-liquidation and the claim and cross claim must be monetary obligations.

*Bouygues v Dahl Jensen* [2000] BLR 522.

In this case, the Court of Appeal made clear that where a successful claimant company which was in insolvent liquidation seeks to enforce an Adjudicator’s decision in the Courts then the court will not grant summary judgment where the unsuccessful respondent has competing cross claims. This will be dealt with under rule 4.90 of the insolvency rules.

The facts were as follows, Bouygues was the main contractor for building works under a PFI Contract, Dahl Jensen was the mechanical and engineering sub-contractor. The sub-contract contained both arbitration and adjudication clauses, and also provided for retention of 5 % of the contract price, pending certification under the main contract. Bouygues determined Dahl Jensen’s employment and arranged for the subcontract work to be completed by others. Dahl Jensen issued a notice to adjudicate, claiming payment for work done but not (allegedly) valued under the sub-contract and various breaches including repudiation. Bouygues shortly after issued its own notice to adjudicate, claiming the refund of payments already made, delay and costs arising from the determination. It was agreed that Bouygues’ claim should be treated as a counter claim in the adjudication.

The Adjudicator in his decision was obliged to value the contract sums. The effect of the Adjudicator’s calculations was that Bouygues was obliged to pay the 5% retention sum even though it was not yet due under the contract. It was clear that the Adjudicator’s decision was wrong. Bouygues consequently argued that the Adjuciator’s decision should not be enforced. The Court of Appeal held that Dyson J was right when he commented that such an outcome was inherent in the exceptional and summary procedure contemplated by the 1986 Act. Effectively, the Court of Appeal held that an Adjudicator’s decision to be upheld even if it is wrong.

Most important for these purposes is the second argument which was raised by Bouygues which was that summary judgment should not be given because Dahl Jenson was in liquidation. The rationale of this argument was that if Bouygues was obliged to pay Dahl Jenson the amount awarded by the Adjudicator, then, those monies, when received by the liquidator of Dahl Jenson, would form part of the fund applicable for distribution amongst Dahl Jenson’s creditors. If Bouygues itself had a claim under the construction contract and was required to prove for that claim in the liquidation of Dahl Jenson, it would receive only a dividend pro rata to the amount of its claim.

At the time the Adjudication was commenced, Dahl Jensen was in liquidation. In these circumstances, Rule 4.90 of the Insolvency Rules 1986 would have effect. That rule applies where, before the company had gone into liquidation, there have been mutual dealings giving rise to mutual debts and credits between a company which subsequently goes into liquidation and another party. An account is taken

and the sums due from the party are set off against the sums due from the other. There remains only a single claim, represented by the balance of the account, which is either payable to the liquidator or provable in the liquidation, depending upon the party in whose favour the balance lies. Section 411 (2) of the Insolvency Act 1986 provides that the Lord Chancellor may make provision by rules or regulations as to the debts that may be proved in the winding up.

Lord Justice Chadwick held that in circumstances where the Insolvency Act 1986 and also paragraph 36 of the Model Adjudication Procedure applied, and the account could be reopened, it was difficult to see how summary judgment would be of advantage to either party. In circumstances where there were latent claims and cross claims between the parties, one of which was in liquidation, there was a compelling reason to refuse summary judgment. All claims and cross claims had to be resolved in the liquidation, in which a full account could be taken and a balance struck. That was what was required under 4.90 of the Insolvency Rules.

Lord Chadwick said that these matters ought to have been considered on the application for summary judgment. This did not happen. Nor did either party bring it to the attention of the Court of Appeal. In these circumstances, Lord Justice Chadwick held that he could not set aside the order of the judge in the lower court in exercise of his discretion and dismissed the appeal. Summary Judgment was upheld and a stay of execution was granted.

While summary judgment was given and upheld in Bouygues, largely because Rule 4.90 was not argued, the Court made clear that in future cases summary judgment would be unlikely where the claimant is in insolvent liquidation and there is prospects of a crossclaim.

What is the position where a claimant who is insolvent, but not in liquidation, tries to enforce an adjudicator's decision?

In *Herschel Engineering Limited v Breen Property Limited* [2000] Build L.R 272 a Claimant sought enforcement of an adjudicator's decision on matters which were also being contested in court proceedings. The main issue here was whether the Judge upheld the validity of a reference to adjudication at any time, including after the issue of court proceedings in respect of the same dispute. Having given summary judgment, the Judge issued some relevant comments obiter. He stated that enforcement may be refused if proof of inability to repay was established. No such evidence had been adduced in this case.

In *Herschel Engineering Limited v Breen Property Limited (No.2)* (unreported) the claimant subsequently applied for a stay of execution on the grounds that the defendant would have no money to re-pay in the event of being required to do so in the county court proceedings. The Judge refused to grant a stay of execution, taking into account various factors. One such factor was that the defendant had not taken steps to retrieve its position since the first decision was issued. The second was that the defendant had not discharged the burden of proof that the sums in issue would not be honoured if necessary by the claimant.

*Rainford House Limited v Cadogan Limited (2001)* unreported Cadogan, the Employer, resisted

summary judgment on the basis that the Contractor was in receivership. The judge distinguished the case from *Bouygues* on the basis that where a company was in liquidation, the process contemplated by rule 4.90 of the Insolvency Rules 1986 would be undertaken. It was not clear what the outcome of receivership would be. Cadogan also argued that there should be a stay of execution on the basis that it had served a defence and counterclaim. His Honour Judge Seymour agreed mainly with the approach taken in *Herschel* but disagreed with the view that the party applying for a stay must prove the inability to repay as at the time of repayment fell due. It was enough to adduce credible evidence that showed that at the time the company would be insolvent.

In *Rainsford House* (in Administrative Receivership) v *Cadogan Estates* (2001) (unreported), Rainsford (the contractor) obtained an adjudicator's decision in its favour. Cadogan (the employer), resisted summary judgment on one ground only, namely that Rainsford was in receivership. That argument was rejected by the court and summary judgment was given. His Honour Judge Seymour distinguished the decision in Bouygues as follows:

> *"Where in the case of a company in liquidation it is inevitable that the process contemplated by rule 4.90 of Insolvency Rules 1986 will be undertaken, that is not the position in a case where the claimant company is a company in administrative receivership. In the latter case, one cannot tell what the outcome of receivership will be. In a case in which there is not, inevitably, a need for determination more or less as matters then stand between the parties of the net state of accounts, in which proceedings the correctness of the decision of the adjudicator must be evaluated, and there is not otherwise any defence to a claim to enforce the award of an adjudicator, it seems to me that the factors which led Chiswick L.J in [Bouygues] to consider that it would not be appropriate to give summary judgment are not present".*

*Total M & E Services Limited v ABB Building Technologies Ltd* [2002] 87 Con LR 154. In this instance the judge refused to grant a stay of execution. This was because although Total M&E were not an asset rich company there was no evidence as to their insolvency/inability to pay and moreover there had been no change to their financial position since they entered into the contract with ABB.

In the case of *Wimbledon Construction Co v Derek Vago* [2005] EWHC 1086 [TCC] [in the TCC], the Judge set out the principles which will apply when granting a stay. In that case, Wimbledon carried out construction works to Vago's house in south west London. Disputes arose concerning the value of the works. An adjudication was held, the net effect of which was to award Wimbledon the sum of approximately £120,000. Vago refused to pay that sum and accordingly Wimbledon commenced proceedings in the High Court. At the same time as those proceedings, Vago commenced arbitration proceedings against Wimbledon to determine the matter.

Vago applied to the court for an order that the effect of the Adjudicator's decision was stayed pending the determination of the issue. The court refused to withhold enforcement of the decision on the grounds of financial insecurity. In this case, Wimbledon's financial insecurity had been the direct effect of the non payment by Vago of the sums the subject of the adjudicator's award. The Court considered all the relevant cases and the principles those cases had established with regard to stays of judgment and set

out the following points

- Adjudication is designed to be a quick and inexpensive method of arriving at a temporary result in a construction dispute;
- In consequence, adjudicators' decisions are intended to be enforced summarily and a claimant, being the successful party to the adjudication, should not generally be kept out of its money;
- In an application to stay the execution of summary judgment arising out of an adjudicator's decision the court must exercise the discretion it has under the Civil Procedure Rules when considering it was appropriate to grant a stay;
- The probable inability of the claimant to repay the sum awarded by the adjudicator will not constitute special circumstances within the meaning of the Civil Procedure Rules rendering it appropriate to grant a stay if:
    - The claimant's financial position is similar to its financial position at the time the relevant contract was made, or;
    - The claimant's financial position is due to the defendant's failure to pay monies awarded by the adjudicator.

*Middleton (G) Ltd v Berry Creek Overseas Development Ltd* [2007] EWHC 318. In this matter an application for a stay of enforcement on the grounds of an asserted inability to pay was declined. There was insufficient evidence as to the financial position of Middleton. Adjudication and arbitration were both compared by the Court.  The adjudication award was enforced and appeal refused.

The most recent finding was that of HHJ Coulson QC (as he then was) in Hart v Fiddler [2007] BLR 30 where the enforcing party was in insolvent liquidation and he was asked to enforce an adjudicator's award where the defending party had unresolved cross-claims:

*"… the essential point is that, in the present case, to enter judgment might amount to an inaccurate assertion of the parties' substantive rights because, after all, such a judgment would be based upon a decision which is only temporarily binding. There is at least a risk of inaccuracy. Thus I respectfully agree with Chadwick L.J.'s ruling in **Bouygues** that, because of the operation of the rules, insolvency is a compelling reason to reason to refuse summary judgment."*

## Statutory Demands

Statutory Demand as an alternative to adjudication

- An alternative course for a potential claimant is to circumvent the adjudication process and serve a statutory demand in respect of a debt.
- A statutory demand can be served where a sum has fallen due for payment under a construction contract and the final date for payment has passed without the service of a valid and effective notice of withholding (ie s.111 of the Housing Grants and Regeneration Act). This was considered in Re: A Company (number 1299 of 2001) (unreported). The Judge effectively held that in the absence of a valid and effective withholding notice, the respondent could not raise matters which should have properly been the subject of a withholding notice.

Statutory Demand to enforce an Adjudicator's decision

- Instead of commencing summary judgment proceedings to enforce an adjudicator's award the unsuccessful party can also issue a statutory demand. This is what happened in the matter of *Parke v The Fenton Gretton Partnership* [2000] (unreported). The court held that an adjudicator's award was a debt on which a statutory demand could be issued. However, Rule 6.5(4) of the Insolvency Rules 1986 allows the court to set aside a statutory demand where the debtor has a counterclaim which equals or exceeds the debt or if the amount is disputed on substantial grounds. In this case, the statutory demand was set aside because the Respondent had a valid cross claim which went to the heart of the issue and further disputed the debt. It is therefore submitted that where there is the possibility of the debt being disputed or a valid cross claim, the preferred course of enforcement should be through the summary judgment procedure.

## Miscellaneous Relevant Case Law in relation to Adjudication and insolvency

*Chorus Group v Berner (BVI) Ltd & Anor* [2006] EWHC 3622. This case involved a post adjudication settlement agreement with due date of payment and interest. The Employers were incorporated off-shore and there was a successful ex-pate order for a freezing order which was granted. There was a successful application to renew the freezing order and extend the scope and application for summary enforcement of the debt.

*Re: A Company – A.M Environmental Services Ltd* (No 5606 of 2001) [2001] EWHC Ch. Div. In this case a petition for winding up was refused. This was because the petitioner had not issued a withholding notice against the Company so potentially, pending outcome of this dispute the Company might be in creditor to the petitioner.

*Pynes Three Ltd v Transco* [2005] EWHC. This case involved the successful application for a freezing order in support of a future adjudication. There was a clear concerted effort by a party to evade his financial responsibilities as it had threatened to enter into administration to avoid the debt whilst preparing to dispose of assets on a cash only basis. This decision demonstrates the court's willingness to support the adjudication process.

*Triodos Bank v Dobbs* [2004] EWHC 845 (Ch). Here, the court addressed the question whether a temporary final adjudication in a debtor's favour can reduce the trading debts of the debtors company and thus affect the creditor's rights to call in loans.

Melville Dundas Limited (in receivership) v George Wimpey Limited and Norwich Union Insurance Limited (2007)UKHL 18.

- A recent Scottish case (Melville Dundas (In Receivership) v George Wimpy UK) which came before the House of Lords has clarified the law concerning recovery by insolvent contractors in the Construction Industry.
- Although this is a Scottish case, the members of the House of Lords are those who also determine English Law. As such it is assumed that this case would be followed in England & Wales.

**The background**

- The Construction Industry is governed by the Housing Grants and Construction Act 1996. It provides for statutory adjudication as a 28 day fast track resolution procedure and sets out rules concerning notifications in order to withhold payment.
- Section 111(1) states that no payment due under a "construction contract" can be withheld after the final date for payment unless a valid withholding notice has been issued. This allows Contractors, even if they are subject to formal insolvency proceedings, to recover monies unless there is a valid withholding notice. (Insolvent contractors may be subject to specific restrictions depending on the contractual mechanisms in place).This has now been clarified as follows:

**The facts**

George Wimpy employed Melville Dundas under a JCT “With Design” Contract

- Melville Dundas went into administrative receivership
- Wimpey subsequently issued a valuation of Melville Dundas’ work
- Melville then sought payment on the valuation
- George Wimpy did not pay and did not issue a withholding notice
- George Wimpey terminated Melville Dundas’ employment on the basis of receivership as per clause 27 of the contract.

**The issues**

- Melville Dundas relied upon section 111
- George Wimpy relied upon clause 27 which stated that on termination it could withhold payment save for sums due 28 days or more prior to termination until the work was complete.

**The judicial findings**

- The Judge at first instance found that the legislative provisions were not intended to regulate the situation where a contract is legitimately determined by the employer.
- The House of Lords agreed and determined that section 111 does not apply where an employer wishes to exercise his rights to set off arrears where he has determined the contract.
- Lord Hoffman found that the contract prevented a debtor who was also a creditor being forced to pay in full and then only receiving a dividend with respect to the debt owed as a result of ranking with the other ordinary creditors.
- The contract contained a provision which was an expression of the parties’ freedom of contract to regulate such a situation.

  Lord Hoffman further determined that the legislation did not trump the contract provisions.

## Conclusion

Regardless of whether a valid withholding notice is given, an employer who terminates a contract for reasons of insolvency can, if the contract allows, set off arrears due against certificates for payment.

As, is often the case, the decision as to whether to pursue monies due to an insolvent contractor is determined by the governing contract. In this case there was a clause in the construction contract to the effect that an employer was not obliged to pay an insolvent contractor on determination. The contractor invoiced for works and then went into receivership. The issue was whether this amount could be claimed given the insolvency clause. It was held at first instance that that the relevant provision was inconsistent with the payment provision under the Act and therefore was payable. This was subsequently overturned by the House of Lords who held that there was nothing in the Act that prevented a construction contract from providing that, in certain circumstances, an instalment payment which was payable by an employer to a contractor should cease to be payable. Note, this is a Scottish House of Lords case and therefore persuasive rather than binding in the courts of England and Wales.

## Contact us


### Lewis Cohen

020 7264 7860
lewis.cohen@blaketurner.com

### Paul Cooper

020 7264 7861
paul.cooper@blaketurner.com