TERMINATION: CONTRACTUAL RIGHTS TO TERMINATE CURTAILED

New legislation has been introduced in the UK which restricts the rights of parties to construction contracts to terminate or even suspend work. This means that even if your contract says you can terminate or suspend – for example, for non-payment – you may not in the future be able to exercise this right. These reforms are likely to lead to significant changes to how parties operate their contracts and credit lines.

Explanatory Note 1 - Prohibition on termination because of insolvency

Section 14 of the Act introduces a new Section 233B of the Insolvency Act 1986. Section 233B(3) states:

"A provision of a contract for the supply of goods or services to the company ceases to have effect when the company becomes subject to the relevant insolvency procedure if and to the extent that, under the provision—

the contract or the supply would terminate, or any other thing would take place, because the company becomes subject to the relevant insolvency procedure, or

the supplier would be entitled to terminate the contract or the supply, or to do any other thing, because the company becomes subject to the relevant insolvency procedure." [our underlining]

The underlined wording is key here. Its precise scope is likely to be debated in the courts. However, in our view, it should be given a narrow reading. Only termination rights that are directly triggered by the insolvency are ineffective. If the insolvency in turn triggers some other right to terminate (i.e. a further non-payment during the insolvency period), arguably that right can be enforced, provided it does not flout the other prohibitions. Note also that some construction contracts define "insolvency" more widely than the Act. If a contractor can show that the contractual right to terminate due to insolvency arises from one of the scenarios contemplated by the contract but not the Act, the termination right may remain available.

The Corporate Governance and Insolvency Act 2020[1] has been introduced in the UK to give parties 'breathing space' to combat the economic challenges posed by the coronavirus crisis. To achieve this, the Act imposes a number of restrictions on the right of a party supplying goods and services to exercise their contractual right to terminate or suspend. This applies to all industries, including the construction industry. These restrictions apply in England & Wales, Scotland and Northern Ireland and are permanent; i.e. it is not intended that they will come to an end when the Covid-19 crisis subsides.

The rationale of the Act is to protect firms as going concerns, allowing them an opportunity to trade out of insolvency. Restricting termination and suspension rights should ensure firms continue to be supplied with goods and services to facilitate this. Inevitably, this will cause difficulties for creditors, particularly in the construction sector where margins are tight. The Act attempts to balance these interests by allowing suppliers scope to terminate or suspend for non-payment after the insolvency occurs. As we will see, some suppliers will still suffer misfortune as a result of this balancing act.

For ease, in this article we will refer to the party supplying the goods and services as the **"contractor"** and to the customer as the **"employer"**. That said, the rules equally apply to subcontractors undertaking work for main contractors. In short, the legislation limits the right of the contractor to terminate its contract with the employer and the right of the subcontractor to terminate its contract with its main contractor. Indeed, in practice, we expect that this change is more likely to impact subcontractor termination in view of the challenging market conditions main contractors are likely to face over the next year.

Prohibitions imposed by the Act

The Act imposes three restrictions on contractors' rights to terminate or suspend their supply of goods and services.

- **Prohibition on exercising rights triggered by insolvency** – Contractors are prohibited from exercising contractual termination rights triggered by insolvency. The Act also prohibits contractors from relying on any other contractual right that would have equivalent effect. For example, a contractor cannot rely on a contractual right to terminate the contract, by giving notice to the employer, immediately on the employer becoming insolvent. See Explanatory Note 1 for a more detailed discussion of this provision.
- **Prohibition on terminating for pre-insolvency events** – During the insolvency period, contractors are prohibited from exercising termination rights that accrued before the start of the insolvency period. For example, an employer misses a final date for payment of 1 August. There is no dispute over the sum payable. By 8 August, the payment is still outstanding and the contract states the contractor is entitled to terminate the contract on the grounds of that non-payment. The employer becomes insolvent on 11 August, by which time the contractor has not exercised its termination right. The Act prohibits the contractor terminating because of the 1 August non-payment until the insolvency process has come to an end. See Explanatory Note 2 for a more detailed discussion of this provision.
- **Prohibition on making further supply conditional on paying outstanding sums** – Contractors are also prohibited from making their ongoing works conditional on payment of outstanding sums that fell due before the insolvency. For example, say that the final date for payment for services performed by the contractor during the month of June was 1 August.[2] The employer does not pay but then becomes insolvent on 2 August. The Act prohibits the contractor from suspending its services after 2 August on the basis of the non-payment for its June services. What is not immediately clear is

1 https://www.legislation.gov.uk/ukpga/2020/12/contents/enacted

2 For these purposes, assume that the contractor and employer have served an appropriate payment application and payment notice and that the sum due is not in dispute.

how this prohibition interacts with the statutory right to suspend under the Construction Act. See the Explanatory Note 3, where this conflict is discussed in more depth.

It will be clear from the above that this change could have far reaching implications for the construction industry. For example, if a main contractor becomes insolvent, its subcontractors and suppliers will have to continue working even though they have many months of unpaid bills and their contract expressly gives a right to terminate or suspend.

It is therefore likely that over the coming months the precise wording of some of the Act's provisions will be subject to careful scrutiny. The nuanced language may create opportunities for contractors to administer their affairs to minimise their exposure to insolvent employers, without flouting the prohibitions. We discuss the language of each prohibition in Explanatory Notes 1 to 3 (respectively).

The "relevant insolvency period"

Our summary of the three prohibitions above refer to the restrictions kicking in when there is an insolvency. Strictly speaking, the Act refers to the start of a *"relevant insolvency period"*. This is therefore a critical reference point. The Act provides a range of circumstances that will trigger the insolvency period. It also prescribes the event that will end the period in each circumstance. These beginning and end points are listed in the table opposite.

Start and end points of the relevant insolvency period

Period begins	Period ends
A moratorium under Part A1 of the Insolvency Act 1986 comes into force for the company.	When the moratorium ends.
The company enters administration.	When the appointment of the administrator ceases to have effect under: • paragraphs 76 to 84 of Schedule B1 of the Insolvency Act 1986; or • an order under section 901F of the Companies Act 2006.
An administrative receiver of the company is appointed (otherwise than in succession to another administrative receiver).	When the receiver (or any successor) ceases to hold office without a successor being appointed.
A voluntary arrangement approved under Part 1 of the Insolvency Act 1986 takes effect in relation to the company.	When the arrangement ceases to have effect.
The company goes into liquidation.	When: • the liquidator complies with sections 94(2), 106(2) or 146(3) of the Insolvency Act 1986 (duties relating to final account); or • the appointment of the liquidator ceases to have effect under an order under section 901F of the Companies Act 2006.
A provisional liquidator of the company is appointed (otherwise than in succession to another provisional liquidator).	When the provisional liquidator or any successor to the provisional liquidator ceases to hold office without a successor being appointed.
A court order is made under section 901C(1) of the Companies Act 2006 in relation to the company (order summoning meeting relating to compromise or arrangement).	When: • An order made by the court under section 901F of the Companies Act 2006 takes effect; or • The court decides not to make such an order.

When does the Act not apply?

A limited number of contracts are excluded from these new prohibitions.

Until 30 September 2020, in England & Wales and in Scotland the prohibitions will not apply where the contractor is a "small entity" at the time when the employer becomes subject to the insolvency procedure. The Act prescribes a number of criteria that will indicate whether a contractor is a small entity, relating to the contractor's turnover, aggregate assets and average number of employees. A contractor will be a "small entity" if it meets at least two of the criteria. The relevant thresholds are relatively low. For example, one is that the contractor's turnover exceeded £10.2 million in the previous financial year (pro-rated if the financial year is not twelve months).

There are two further exclusions from the prohibitions on termination:

- **Consent** – A contract may be terminated with the consent of the insolvent company.
- **Hardship** – A court may permit the termination of the contract if it is satisfied that continuing the contract would cause the contractor *"hardship"*. Unfortunately, neither the Act nor any guidance defines *"hardship"*. Logically, we presume that the hardship must be more than

Explanatory Note 2 - Prohibition exercising accrued termination rights during insolvency period

Section 14 of the Act introduces a new Section 233B of the Insolvency Act 1986. Section 233B(4) states:

Where—

under a provision of a contract for the supply of goods or services to the company the supplier is entitled to terminate the contract or the supply because of an event occurring before the start of the insolvency period, and

the entitlement arises before the start of that period,

the entitlement may not be exercised during that period. [our underlining]

There are several points to note here:

- *"Under a provision of the contract"* – It is not clear whether this prohibition also bars a contractor from relying on its implied termination rights (i.e. to terminate for repudiatory breach at common law). Our view is that the prohibition is likely to apply to both express and implied rights.
- *"Because of an event occurring"* – The prohibition applies to all rights to terminate, regardless of the events that gave rise to those termination rights. I.e. it will include neutral events, such as a prolonged suspension due to force majeure.
- *"The entitlement arises before the start of that period"* – There are two key points here.

  First, the contractor is still entitled to exercise any termination right that arises during the insolvency period as a result of events which take place in that period. Imagine the following scenario: (1) The employer becomes insolvent on 01 August. The contractor continues its supply. (2) The contractor applies for payment on 01 September for services performed during August. The employer is still insolvent at that time but there is no dispute about the sums due and all payment processes are fulfilled. (3) The final date for payment is 15 September. Under the contract, the contractor acquires a right to terminate if payment remains outstanding by 22 September. Payment is not made by 22 September and the employer remains insolvent. In these circumstances, the contractor **is** entitled to terminate for this non-payment. None of the prohibitions apply in this scenario.

  Second, many contracts requires parties to follow a process before a termination right crystallises. For example, if there is non-payment, the contractor may have to notify the employer of the non-payment, with the right to terminate only crystallising if the sum remains due after a specified period. It is not clear what happens if the event triggering the termination right happens before the insolvency period begins but the right to terminate only crystallises after that time. For instance, if the contractual notice period straddles the beginning of the insolvency period. It may be arguable that the prohibition should be read narrowly and termination is possible in such a scenario.
- *"During that period"* – The Act does not say that the right is lost. It may theoretically be possible to exercise the right once the insolvency period has concluded. Parties may wish to notify the existence of this sort of termination right in writing to reduce scope for argument that the contractor has waived or otherwise given up this right.

the ordinary difficulties that any company would face if it was forced to continue to supply an insolvent entity. Any lower threshold seems to frustrate the objective of the Act. Quite how high the threshold must be will inevitably be tested in the courts.

Practical considerations

The Act means that a right to terminate due to insolvency cannot be enforced. It also means that if a significant debt is built-up the contractor may lose its ability to recover that money. It may be forced to work for the insolvent company for some time longer even though ever being paid looks doubtful. These changes represent a significant erosion of contractors' (and of course subcontractors') rights. They may wish to take practical steps to mitigate the additional risks to which this exposes them. We discuss some of those steps below.

Contractors – existing contracts

Before the employer becomes insolvent – Contractors should monitor cash flow and credit lines closely. It remains possible for contractors to termiate for non-payment prior to the employer becoming insolvent, if the contract provides this right. Contractors may want to act quickly to exercise any such termination rights if they consider the employer's insolvency to be imminent.

Where the employer is already insolvent – This scenario presents a difficult judgment for contractors. The Act prevents the contractor from terminating or suspending the supply due to insolvency or exercising any other termination right that may have accrued before the insolvency period. To terminate or suspend during this period creates a risk of the contractor being in repudiatory breach. That is, the employer is entitled to accept the repudiation, terminate the contract and sue the contractor for the losses flowing from that termination (i.e. the cost of engaging a replacement supplier). There are two points to consider here, one legal and one practical:

- **Legal** – As explained in Explanatory Note 2, arguably, the contractor is still entitled to terminate on the basis of termination rights that arise during the insolvency period because of events occurring in that period. Contractors should therefore closely monitor whether any new termination rights accrue after the start of the insolvency period.
- **Practical** – The contractor may be prepared to accept the risk of a potential repudiatory breach in the knowledge that any claim against it will face considerable difficulties. The reality is that some employers will be reluctant to terminate the contract in these circumstances as this will disrupt

the project. The employer may therefore seek a compromise with the contractor rather than relying on the repudiatory breach. Even if the employer elects to accept the repudiatory breach, there is no guarantee that it will bring or succeed with any claim to recover the losses flowing from the termination, particularly if its resources are limited. Finally, if the employer pursues its claim via adjudication and remains insolvent when it seeks to enforce its award, the contractor may be entitled to apply for a stay of execution of the adjudicator's decision; i.e. the decision may not be enforced if the contractor is able to show that the employer would not be able to reimburse it if the contractor referred the dispute to litigation/ arbitration and won. This is a bold strategy. A contractor should carefully consider all of the relevant factors and the likely scenarios before electing to pursue it.

Credit insurance – The guidance that accompanies the Act suggests that contractors may wish to procure credit insurance to mitigate the risk of non-payment by employers.

Contractors – future contracts

It seems that it is not possible to contract out of the operation of the Act. Contractors may seek to include various provisions in their future contracts to provide greater flexibility in light of the Act. Some of these may include:

- **Security from employers** – Contractors may wish to request that an employer provides security for its payment obligations. This provides alternative recourse in the event of non-payment. Some commentators have argued that making a call on a guarantee may amount to *"doing any other thing"* as a result of the insolvency, which the Act prohibits. Much will depend on the precise wording of the security and whether it is provided under a separate contract.
- **Shorter payment periods and weighted payment profiles** – Shorter payment periods will provide contractors with more opportunity to take proactive steps before any insolvency period begins if payment is not forthcoming. Similarly, contractors may wish to adjust payment profiles to ensure the bulk of the contract price is paid earlier in the duration of the service.
- **Rights to terminate for non-payment** – Usually, a contractor's right to terminate for non-payment is contingent on a specified amount being outstanding for a specified period. Contractors may wish to remove or reduce these thresholds.
- **Automatic rights to terminate if upstream contracts are terminated** – This will be particularly useful for subcontractors and suppliers. If a main contractor becomes insolvent, the ultimate employer may be entitled to terminate the main contract. The Act will not curtail this right. Subcontractors may therefore seek to include a right to terminate automatically if the main contract is terminated. Arguably, this does not flout the Act as the termination right in

Explanatory Note 3 - Suspension under the Construction Act

Section 14 of the Act introduces a new Section 233B of the Insolvency Act 1986. Section 233B(7) states:

"The supplier shall not make it a condition of any supply of goods and services after the time when the company becomes subject to the relevant insolvency procedure, or do anything which has the effect of making it a condition of such a supply, that any outstanding charges in respect of a supply made to the company before that time are paid." [our underlining]

A question of timing

As with the other subsections, timing is critical. Contractors are prohibited from making further supply conditional on payment of outstanding sums relating to a supply made before the insolvency. The question of when payment fell due is not relevant. This can create some unfortunate situations for contractors. One contractor may not be able to suspend to leverage payment for services performed in one week; another contractor supplying the same employer may be able to suspend for services performed during the following week, i.e. after the insolvency.

What is unclear is whether a contractor is entitled to continue a suspension that began before the insolvency. Take the following simplified example: the contractor performs services in August. The final date for payment in respect of those services was 1 September. The employer fails to make payment and has no defence. The contractor exercises its contractual right to suspend, with the suspension taking effect on 8 September. The employer becomes insolvent on 10 September. It is unclear whether the contractor is entitled to continue with his suspension or whether this would amount to making supply conditional on payment of *"any outstanding charges in respect of a supply made to the [employer] before that time [i.e. the insolvency] are paid"*.

Statutory right to suspend

This prohibition appears to curtail a contractor's contractual rights to suspend its services. Does this remove the contractor's statutory right under Section 112 of the Construction Act? First, it is important to note that this prohibition prevents a suspension of services because of non-payment for services performed before the start of the insolvency period. Any suspension for non-payment of services performed after this date (statutory or contractual) will not be affected because a non-payment during the insolvency period triggers a fresh right.

The ability to exercise the statutory right to suspend for non-payment in relation to services performed before the start of the insolvency period is unclear. The statutory guidance does not address this issue. The fact that the objects of the two Acts appear contradictory -- protecting insolvent employers and protecting contractor creditors respectively – compounds the issue. We anticipate that a court will have to determine this issue, taking into account various aides to statutory interpretation.

the subcontract is not triggered by the insolvency, although employers may challenge this.

In practice, if an ultimate employer terminates in this scenario, they are likely to seek to step-into any subcontracts via any existing collateral warranties. This right is probably not restricted by the Act, although much will depend on the precise wording of the relevant collateral warranty.

- **Rights to terminate for convenience** – Contractors may seek to include rights to terminate their contracts at will. It is at least arguable that the Act would not prevent a contractor exercising these rights, even if there was an insolvency. In reality, we anticipate that most employers will be reluctant to permit contractors such rights.

Steps which employer might take

While the Act does provide employers with greater flexibility, it does not remove all termination and suspension rights that would otherwise be available to contractors. In fact, as discussed, some contractors may be more proactive in exercising certain rights before any insolvency period begins. Employers should therefore continue to exercise good financial management and make prompt payment of sums owed to contractors or provide appropriate contractual notices for any non-payment.

Adjudication

The Supreme Court's recent decision in Bresco v Lonsdale[3] confirmed that it is possible to refer a dispute to adjudication, despite the insolvency of one of the parties. The prohibitions on termination included in the Act do not alter this position.

Concluding comments

The Act was intended to give firms 'breathing space' in the event of them suffering an insolvency event. In fact, it may create a significant headache for contracting parties as contractors may determine that their best course of action is to operate their contracts in a more robust manner. In other words, contractors (and subcontractors) may decide to terminate contracts for non-payment much more quickly than they would otherwise, fearing that if they delay and insolvency ensues, recovering sums owed will because much more challenging.

We expect that the Act will provide fertile ground for dispute in the short to medium term given the challenging market conditions, the scope for debate about the precise interpretation of a range of the Act's provisions and the diversity of responses that parties will adopt to resist or mitigate its impact.

Termination and suspension are contractual levers that should be applied with caution at the best of times. The Act underlines the importance of parties carefully considering the contractual and practical consequences of any termination or suspension before acting.

Explanatory Note 4 - Other insolvency changes

The Act also introduces a number of insolvency related reforms. The provisions relating to these processes are detailed and should be considered separately if of particular relevance to any situation. These are briefly outlined here for context and as they illustrate the objective of the Act. Namely, to allow companies time and space to trade their way out of insolvency.

New moratorium

Most companies are eligible to benefit from a moratorium outside of the formal insolvency process. The moratorium restricts the enforcement or payment of pre-moratorium debts (i.e. debts that fall due before or during the moratorium). There are limited exceptions, including for the supply of goods and services during the moratorium. Insolvency proceedings may not be commenced against the company save in limited circumstances. A monitor is appointed to ensure that it is appropriate for the moratorium to remain in place, including whether the company can be rescued as a going concern. There are protections for creditors and limitations on the companies that may enter the moratorium.

New Restructuring Plan

This is very similar to a scheme of arrangement. The key difference is the ability to 'cram down' a dissenting class. That is, a court may sanction the plan even when a class of creditors has voted against it, provided certain conditions are met.

Restrictions on statutory demands and winding-up petitions

There are temporary restrictions on creditors making statutory demands and prohibitions on bringing winding-up petitions against a company on the basis that it is unable to pay its debts when that inability is the result of covid-19. The restrictions apply to any statutory demand served between 1 March 2020 and 30 September 2020 and prevents them being the basis of a winding-up petition presented any time after 27 April 2020.

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[3] Bresco Electrical Services Ltd (in liquidation) v Michael J Lonsdale (Electrical) Limited [2020] UKSC 25.

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