

legal

Construction companies and liquidation

Companies are warned to be careful who they contract with as they could be forced to pay back if their counter-party is liquidated

As bankruptcies of contractors in the construction industry rise at a rate of five liquidations a month, contractors and subcontractors are being warned that payments can be clawed back from them if their contracting counter-party winds up in liquidation.

In addition, upfront or advance payments to a contractor before the commencement of a project may be viewed by a liquidator as payments made when the employer was in fact insolvent (de facto insolvent), which would allow the liquidator to unwind that upfront payment and seek to recover the payment through the court process.

Taryn van Deventer is a senior associate at MDA Consulting, a specialist commercial advisory practice in the construction environment. "One of the most critical components of success in the construction industry is cash flow," she says. "There have been a number of high-profile liquidations, but we are also seeing a number of smaller entities adversely impacted because of cash-flow constraints. This has created an environment where contractors and subcontractors have been prudent in ensuring upfront or advance payments – but if the debtor is insolvent, the contractor or subcontractor may get caught up in the creditors' scramble for payment. This situation is not uncommon and extends to work completed, invoiced and paid for at a time when the debtor is insolvent on account of liabilities exceeding assets after making the payment.

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Section 29 of the Insolvency Act deals with situations when payments are made prior to insolvency in preference of one creditor over another. Section 30 allows liquidators to reverse the transaction via the courts. "It is a reality that funds can be

demanded from you by a liquidator where your contracting counter-party winds up in liquidation after having made payment," says Van Deventer. "If your contracting counter-party winds up in liquidation, the funds can be demanded from you if the requirements of Section 29 of the Act are met. All that needs to be proven by the liquidator is that, at the time of making the payment, the debtor was in fact insolvent and the intention was to prefer the party receiving the funds over other creditors."

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Van Deventer says that one way to mitigate against this risk is to arrange a counter-guarantee for payment. "Although standard form contracts don't specifically cover such guarantees, it is important to understand that even if you have a right to payment, it is not the same as having cash in hand," she says. "Where possible, or where the financial status of your contracting counter-party is unknown, you should insist on a payment guarantee – subject, of course, to the commercial realities of making a deal and being appointed on a specific contract."

Along a similar vein and coming to the aid of the contractors and subcontractors out there in terms of vital cash flow are the CIDB Prompt Payment Regulations and

Adjudication Standard, which appeared in the Government Gazette on 29 May 2015 (Notice 482 of 2015) and closed for comment at the end of July 2015. The regulations are expected to be signed into law within a couple of months, and will have far-reaching implications for cash flow in the construction industry.

These regulations introduce adjudication as a mandatory first step for resolution of disputes in both the public and private sector as well as a 30-day prompt payment provision. Given that the construction and civil engineering industries experience major problems related to non-payment of contractors and subcontractors, the regulations are expected to have a positive effect on the industry as a whole by ensuring better cash flow and quicker dispute resolution.

Van Deventer says that the new regulations will have profound consequences for the South African construction industry. "These regulations mean that payments cannot be withheld without going through a defined procedure," she says. "They give contractors a statutory right to suspend work and to charge interest on late payments. The regulations also introduce a form of statutory adjudication to resolve disputes.

"Issues such as withholding payment linked to performance or until completion of a project and delayed dispute resolution have resulted in contractors unwittingly financing projects themselves or "bank-rolling" projects in instances where they cannot afford to do so. The new regulations will compel parties to resolve disputes through adjudication far more expeditiously than any arbitration or court process, and the award will be immediately enforceable unless or until overturned in a subsequent court or arbitration process.

"These proposed interventions will have profound consequences for the South African construction industry and we look forward to the positive changes they will bring to the industry."