

UK Supreme Court confirms an insolvent company can commence adjudication in construction disputes

25 June 2020



*On the back of the UK Supreme Court's recent decision in **Bresco, Latham & Watkins** partner Jessica Walker examines the interaction between adjudication and the insolvency set-off regime.*

She says the decision provides welcome clarification to enable companies in insolvency processes to continue using adjudication as a dispute resolution tool, but highlights that an award in favour of an insolvent company may not be enforced if it causes an unfair outcome for the defendant.

The Supreme Court's **judgment** in *Bresco Electrical Services Ltd (in Liquidation) v Michael J Lonsdale (Electrical) Ltd*, handed down on 17 June 2020, has confirmed that adjudication in construction disputes is not incompatible with the insolvency set-off regime. The judgment also recognised that adjudications should normally be permitted to continue even if the claimant is in an insolvency process, unless the defendant is able to demonstrate

exceptional circumstances. Demonstrating those circumstances would likely require factors other than those relating to the insolvency.

When is adjudication used?

Adjudication as an alternative dispute resolution process was introduced as a statutory right by the Housing Grants, Construction and Regeneration Act 1996 as a quick and cheap way to resolve disputes and facilitate continued cash flow during a construction project. An adjudicator provides a decision, which is binding on the parties only if they agree, and can be challenged by the losing party through the Technology and Construction Court (TCC). Adjudication is used throughout the construction industry to resolve disputes of varying levels of complexity, and the awards can be enforced through the TCC. The parties to a construction contract may not contract out of the right for each party to pursue arbitration to resolve any disputes arising under the contract at any time.

What is insolvency set-off?

The rationale for the insolvency set-off rules is that insolvency processes are collective proceedings, in which insolvency practitioners are appointed with one core aim: to collect the insolvent company's assets and distribute them to the company's creditors. Accordingly, a liquidator or administrator should not be forced to pursue a creditor for a debt owed to the insolvent company at the same time that the debtor is receiving dividends in the insolvency, in respect of a debt owed to it by the insolvent company.

The rules mean that if a company and any creditor have had "mutual credits, mutual debts, or mutual dealings" prior to a company's liquidation or administration, then any sums owed by each party to the other are set off against each other. In this scenario, only the balance, if any, is payable by the creditor to the company or provable in the liquidation or administration. Debts for this purpose may be payable at present or in the future, pursuant to certain or contingent obligations, fixed or unascertained (as long as they can be ascertained by fixed rules or opinions), but the debts must have arisen before the creditor received notice of the liquidation or administration.

The parties cannot contract out of this form of set-off, and it applies automatically if the company is in liquidation or administration. A company may also choose to incorporate insolvency set-off in a proposal for a company voluntary arrangement (CVA).

The *Bresco* Case

In *Bresco*, the UK Supreme Court was asked to consider how the adjudication regime and the insolvency set-off regime can interact and whether they are compatible.

Bresco Electrical Services Ltd (in Liquidation) (Bresco) was a contractor under a sub-sub-contract of electrical installation works for Michael J Lonsdale (Electrical) Ltd (Lonsdale) when it entered liquidation in March 2015. Bresco commenced adjudication and, though Lonsdale challenged the adjudicator's jurisdiction on the basis that Bresco was in liquidation, the adjudicator produced a non-binding decision.

Lonsdale then applied to the TCC for an injunction to prevent the adjudication continuing, on the ground of lack of jurisdiction. The TCC held that a company in liquidation cannot refer a dispute involving a counterclaim to adjudication for two reasons. It said that on the authorities, the adjudicator had no jurisdiction to deal with a claim by a company in liquidation. Secondly, the TCC said that it could not conceive that any decision in favour of a company in liquidation would be enforced by the courts.

On appeal, the Court of Appeal considered that insolvency set-off does not extinguish the underlying claims between a company in insolvency and its creditors; those claims still exist for the purpose of establishing the value of those claims and calculating the balance once all claims have been set off against each other — any litigation needed to settle the underlying claims is simply part of the calculation process. Accordingly, the appellate court held an adjudicator has jurisdiction to consider a claim by a company in liquidation.

However, the Court of Appeal questioned whether there could be any utility to the adjudicator's jurisdiction if the claimant company is in liquidation and the responding party has a cross-claim in light of the insolvency set-off rules. The court identified a basic incompatibility between adjudication and insolvency set-off because the adjudication process often only involves part of a claim and is temporary in nature, whereas insolvency set-off is a final accounting exercise involving all of the claims between two parties. Consequently, in the ordinary position, an adjudication award in favour of an insolvent company would not be enforced. As nothing took *Bresco* out of the ordinary position, the injunction stayed in place on the grounds of practical utility.

Bresco subsequently appealed to the Supreme Court. Lord Briggs, in his leading judgment, did not regard adjudication to be incompatible with the operation of the insolvency code in general, or with insolvency set-off in particular, or to be an exercise in futility, and so allowed the appeal and removed the injunction.

Lord Briggs observed substantial similarities between adjudication and the process of proving for debts in an insolvency: they are both designed to be relatively quick, cheap, and provisionally binding (a dissatisfied creditor may challenge either ruling by application to court). In the majority of cases, however, the decision will be accepted by the parties and become binding.

There was no basis for the argument that either an adjudicator or a liquidator is required to combine all disputes with a party into one proceeding, and the underlying claims did not fall away on the operation of insolvency set-off. The Supreme Court considered that injunctive relief would only be granted to prevent a party exercising a contractual right or statutory right very exceptionally, and Lonsdale had not demonstrated in this case that these were very exceptional circumstances.

That is not to say that an insolvency would have no impact on the adjudication process; the Supreme Court was clear that summary enforcement of adjudicators' decisions will frequently be unavailable. If allowing an enforcement would mean that the respondent would effectively lose its right to claim against the company, for example by being unable to recover from the company in liquidation once the cross-claim had been determined, then that would be unfair. But the reasoning does not follow that the adjudication should not run its course as summary enforcement may, on occasion, be appropriate, for example if the cross-claim is not in dispute or is found to be of no substance, or if the adjudicator has determined the net balance of the whole dispute.

Therefore, adjudication clearly will be permitted to proceed in normal circumstances, and the time for a defendant to object will usually be at the enforcement stage.

Challenges to enforcement of adjudication awards

The Supreme Court declined to give further guidance on when an award in favour of an insolvent party might be enforced. There have, however, been a limited number of cases that have considered the basis on which a court should prevent summary enforcement of an adjudication award if the claimant is in an insolvency process, and from which some principles have emerged.

In the Court of Appeal, *Bresco* was heard in conjunction with *Cannon Corporate Limited v Primus Build Limited*, in which Primus Build Ltd (Primus) was in a CVA and brought a claim in adjudication against Cannon Corporate Ltd (Cannon). Cannon had a counterclaim, but Primus was awarded summary judgment in respect of the adjudicator's decision, and Cannon's application to stay enforcement was refused. On appeal, the Court of Appeal decided the fact that a claimant is in a CVA does not create an automatic bar to summary judgment or require that there must be a stay of execution.

The Court of Appeal found that each case will be judged on its own facts, taking into consideration three things. First, any decision must bear in mind that adjudication is designed to be quick and easy to get a temporary result, and that adjudication decisions are designed to be enforced summarily so that the claimant is not kept out of its money. Secondly, a claimant's inability to pay at the end of the substantive process may justify a stay, and the claimant's formal

insolvency is likely to do so. And finally, the claimant's probable inability to repay any award will not be sufficient to justify a stay if the company's finances have not changed since the contract was entered into. Equally, if the company's financial problems are caused in whole or a significant part by the respondent, this will not be sufficient to justify a stay.

The supervisor of Primus' CVA had adopted the result of the adjudication for the purposes of the insolvency set-off to be applied under the CVA, so the Court was satisfied that summary judgment would not interfere with the CVA process. It was, therefore, appropriate to uphold the summary judgment and deny a stay of enforcement.

In another case before the High Court, *Indigo Projects London Ltd v Razin*, Indigo obtained an adjudication award against Razin and subsequently applied for summary judgment. Razin later raised a number of counterclaims and Indigo entered into a CVA, under which all recoveries made were to be given to the supervisors and subsequently distributed to creditors. The CVA contained an insolvency set-off clause and a moratorium against legal proceedings.

The Court of Appeal decided that, as the CVA had already commenced, Razin's payment of the award would result in a windfall for creditors at Razin's expense, which would be an unfair outcome for Razin. Further, payment of the award would not provide any assistance to the CVA supervisor in respect of the calculation of the parties' claims for the purpose of set-off, as it amounted only to an interim payment on account and not a calculation of the underlying liability. Accordingly, the court considered that allowing the award to be enforced would not be fair and refused to grant summary judgment.

Conclusion

The decision in *Bresco* is to be welcomed, as it is rarely in parties' interests for the courts to narrow the resolution methods available to parties in dispute, and adjudication can be a useful tool for an insolvency practitioner when determining creditors' claims.

However, it is important that the target of an adjudication award is not left in an unfair position by the financial status of the successful party. As such, parties will appreciate the courts taking a pragmatic approach to ensure that defendants are protected from having to contribute to a pool of assets in an insolvency before they can access it for dividend purposes.