CONTRACTOR INSOLVENCY DURING A PROJECT

The insolvency of Carillion has put jobs and pensions at risk, as well as causing financial headaches for governments, developers, subcontractors, lenders and sureties of ongoing projects. It looks set to cast a shadow over infrastructure, construction, facilities management and maintenance markets for some time. Media estimates immediately following the collapse reckoned up to 30,000 businesses would be left owed £1billion and these numbers have only increased since then.

When most commentators had been anticipating a restructuring of Carillion, the sudden (and highly unusual) announcement of a compulsory liquidation, also acted as a reminder of the differences between insolvency procedures. As a result many projects (including even those construction projects which were nearly complete) found themselves reacting to the process and struggling to create effective remedial plans.

This briefing note is intended to give an insight into some of the legal and practical steps that a project developer will need to consider if its main contractor or a trade contractor pursues a restructuring strategy or is threatened with insolvency or becomes insolvent. As the individual circumstances for such restructuring and insolvencies may differ, it should not be relied upon as legal advice.

This briefing addresses the following areas:

- Early warnings signs
- Enforcement of performance security
- How to deal with formal insolvencies
- Dealing with subcontractors
- Strategies for completion of the works
- Understanding the restructuring process

Warning Signs

Insolvency situations can happen suddenly and without clear warning, but often there are early indicators to look out for:

- Rumours and trade gossip, such as murmurs of under-pricing, sub-contractors not being paid on time, withdrawing labour or not supplying deliveries due to payment disputes. It is important to ascertain whether the concerns are genuine - it is not uncommon for inaccurate rumours to spread and incorrect accusations can quickly erode confidence and goodwill. This has already been seen in the aftermath of the Carillion

liquidation with media and industry players alike openly wondering who might be next.

- Physical removal from site of materials by unpaid sub-contractors and suppliers.
- Sub-contractors seeking direct payment from the Employer[1] or a contractor pressing harder for quick payment following approval of an application.
- Sudden changes to on-site key personnel, labour or materials. Delay caused by cutbacks may set alarm bells ringing and justify additional monitoring.
- Suggestions of "pre-pack" arrangements with a contractor offering to move contracts to a new group company which will be sold on in the event of insolvency.

Stick or Twist

At the warning stage, those involved in managing the project should be advised to take a cautious approach. The temptation may be to delay or withhold payments, but, without more definitive information being obtained, the denial of cash-flow may lead to a self-fulfilling prophecy and push the Contractor over the edge into insolvency[2].

If it appears that an insolvency situation is imminent, the Employer will need to decide whether to stick with the failing Contractor and nurse it through the project or consider its options (if any) to terminate the contract and exercise contractual remedies.

In making its decision, the Employer should take the following relevant factors into account:

- The status of any construction works - what stage has been reached and are they near completion?
- If the project is externally financed, have any events of default or potential events of default arisen? The lenders may need to be appraised of and involved in any termination discussions.
- If the Contractor has provided a parent company guarantee, consider the financial position of that parent. Is the insolvency situation restricted to the Contractor or is the entire group threatened?
- Has the Contractor defaulted in performance and does this entitle a termination under the terms of the contract? Most construction contracts do not permit termination for a fall in financial status short of insolvency[3] (though this may be the case in highly leveraged schemes where the Contractor is also a project sponsor with an equity stake in a special purpose development vehicle). It is critical to analyse this question carefully. A wrongful termination will enable the Contractor to claim the contract has been repudiated and seek damages.

[1] There are important legal steps to check before agreeing this – see section 6(B) below. In some jurisdictions, sub-contractors may have rights to obtain direct payment or to impose liens.

[2] Depending on the jurisdiction and contract terms, the Contractor may also have suspension and/or termination rights and/or fast-track dispute remedies in the event of an improper withholding of payments (e.g. adjudication in the UK).

[3] In most construction contracts, insolvency events are defined widely, but with reference to an objective event such as the appointment of an insolvency practitioner, receivership, entry into an arrangement with creditors, etc.

- If the Employer is entitled to terminate the contract, would this require the consent of third parties such as lenders or public authorities?
- Does the Employer have the benefit of any guarantees or bonds that might enable it to recover the additional costs of completion? (See "Performance Security" section below).
- Does the Employer have the benefit of any step-in rights with subcontractors and service providers to enable it to complete works quickly/ maintain performance of services?

Insolvency Confirmed

First steps

Clear evidence that an insolvency situation has occurred usually comes from an official notification or, alternatively, this may become evident in the wake of an abandonment of the site and works. The details of the insolvency officeholder ("**IO**") appointed to oversee the affairs of the insolvent Contractor should be confirmed as soon as possible. There are key differences between insolvency processes[4] and it is important to identify which applies, for example:

- Is the IO a receiver or liquidator appointed by secured creditors, with the main duty of securing assets and value for that creditor alone and any other preferential creditors who have legal priority?
- Is the IO process an administration procedure where the intention is to continue trading and rescue the company or its business?
- Does the insolvent Contractor benefit from a protective moratorium, whereby proceedings cannot be brought and rights cannot be enforced against that company without the leave of the Court?

The Employer should therefore seek advice on the relevant process and carry out the following practical steps:

- Check on the Employer's health and safety obligations and put arrangements in place to ensure these are met.
- Secure the site, excluding the Contractor's employees, sub-contractors and suppliers (by changing the locks, if necessary). This is essential to ensure that equipment and materials needed to complete the works are not removed[5].
- Check that the site remains adequately insured. In particular, the Contractor's insurances (for example, all-risks, third party and transit insurance) may lapse due to unpaid premiums or determination of the contract.
- Arrange an immediate stop to payments, pending an assessment of the overall financial situation (which should include any other contracts between the Employer and the insolvent Contractor).
- Carry out a site and materials audit and make the site weatherproof, if necessary.

[4] A full briefing of the differences between insolvency procedures is beyond the scope of this note but we would be happy to provide further explanations on request.
[5] In the immediate aftermath of a main contractor insolvency situation, there is a high risk of vandalism and any legal analysis of who owns materials is rarely observed, with unpaid suppliers often seeking to remove items from site whether or not ownership has transferred to the Employer. In due course, materials and equipment belonging to others will need to be returned, absent agreement to the contrary, but there is a critical immediate need for site security in these situations.

- As Contractor insolvency, abandonment and loss of insurance are all likely to constitute events of default under any funding arrangements (as could any additional delay or costs resulting from insolvency), the Employer should consider early consultation with its lenders in order to try and forge a consistent approach.
- Check whether any default has arisen or is likely to arise in contracts with other third parties (e.g. purchasers or occupiers) and manage as appropriate.

Next steps

Once the initial practical steps have been carried out, the Employer should consider the following:

- The Employer should procure a schedule of the overall financial position, as it is likely that a request will shortly be received for any outstanding payments. This schedule should cover all contracts between the Employer and the Contractor as it may be possible to set-off between unconnected contracts.

  Depending on the terms of the contract, it may also be appropriate for the Employer to procure a detailed record and valuation of the works carried out and materials on-site as at the date of determination[6]. This is likely to be relevant for the purpose of accounting exercises following any termination of the construction contract and completion of the works.
- The Employer should move quickly to secure possession of any off-site materials and equipment for which it has paid and where title has transferred to it. In practice it may be hard to identify and claim possession of materials, especially in the context of an English law administration, where the administration moratorium prevents repossession without the consent of the administrator or the approval of the court. If the relevant supplier has not been paid by the Contractor, the materials may be subject to retention of title claims.

  It is common in large engineering plant projects for major pieces of key equipment to be manufactured off-site and, if this is a relevant factor on the project, it will require specific and close attention. It may not be possible to have partly-manufactured equipment completed by others (due to proprietary technology issues), in which case there may be significant additional delay and there may be an impact on the on-going viability of the project[7].
- Depending on market conditions, lead-in times for replacing unique or key equipment or materials may be very long. Consideration will need to be given as to whether such items can be obtained by others in sufficient time.
- Certain insolvency procedures (such as "administration" in the UK and "Chapter 11" in the USA) protect the insolvent Contractor from its creditors and, as a general rule, will prevent the Employer from taking legal proceedings against the Contractor or enforcing other legal processes without the consent of the Court or IO. In administration the

[6] This may need to take into account site materials that are subject to retention of title claims by unpaid sub-contractors and suppliers (which may be enforceable even where the Employer has paid the insolvent Contractor in respect of such items).

[7] In principle, this risk should have been factored into the performance security package for the project at the outset. In practice, commercial exigencies of the transaction may leave the Employer with inadequate security.

moratorium extends to secured creditors who may not take any steps to enforce their security without the consent of the administrator or the approval of the court.

- Certain insolvency procedures may entitle the IO to 'disclaim' contracts, effectively bringing them to an end. The remedial strategy should be tested against this as it may impact on the ability to 'step-in' on sub-contracts, as well as on what can be claimed under guarantees and bonds.
- A further complication arises where the law governing the contract is different from that governing the insolvency (i.e. because the Contractor is established in a different jurisdiction). In many countries termination based upon an insolvency event is prohibited irrespective of any express provisions in the contract which give the Employer the right to terminate. In these cases, the IO usually has the right to elect to continue with the contract and the termination right only resurrects if it does not so elect or fails to proceed with the work. Specialist advice should therefore be obtained regarding whether the law relating to the insolvency might impinge on the exercise of contractual remedies.
- The Employer will wish to consider the impact of the loss of the Contractor's warranty on the project. In some cases it may be possible to place latent defect insurance to mitigate the impact of this, although such insurance is likely to be more expensive once works have commenced.

Completion of Works

A decision will need to be made regarding completion of the works, the usual options being (subject to any overriding legal restraints – see above):

- Contract termination and appointment of replacement contractor(s).
- IO arranges for completion of the works - this is relatively unusual.
- Novation/transfer of the existing contract to a new contractor by arrangement with the IO.
- A decision to not complete the works, usually because it is no longer economically viable, practicable or possible to do so.

In deciding which option is best, the Employer must consider the impact on its funding and other third party arrangements, as termination or other actions and the resulting additional delay and costs may constitute events of default.

Contract termination and appointment of replacement contractor(s)

Where the Employer is able and wishes to terminate the contract and appoint a new contractor, it should be aware of the following:

- Typically, the construction contract will provide that if the Employer terminates the Contractor's engagement due to its insolvency, it need not make any further payment to the Contractor until completion of the works. At that stage a balancing exercise is usually carried out and any balance remaining to the Contractor (after deducting additional costs and expenses incurred in completing the works) will become due.

If the balancing exercise leaves an outstanding balance due to the Employer, the Employer will usually be an unsecured creditor of the

Contractor for the purposes of recovery although it may have a claim on any guarantor or bondsman (assuming the relevant performance security is unexpired and enforceable).

- In certain market sectors, it will be usual for the Contractor's termination liabilities to be capped in amount and for liability for specific losses to be excluded[8]. Whilst there may be little prospect of recovery against the insolvent Contractor in any event, this will still need to be checked as it may impact on recoveries available against any guarantor (provided it is not also affected by the insolvency) or under a performance bond.
- It will be similarly important to check on the timing of the termination accounting process. Many standard form contracts defer any accounting until after the works have been completed, which may create a cash-flow issue (and impact on cost-overrun provisions in finance agreements) as the Employer has to meet additional costs as they arise. Again, this may delay crystallisation of claims under guarantees and bonds. Bespoke or modified standard construction contracts may contain termination provisions triggering earlier liabilities on the part of the Contractor (for example, for the additional costs of replacement contractors) in order to enable earlier claims on the bond.
- Completion of the works can take several different routes: (i) the remaining works could be re-tendered; (ii) the Employer may seek to revert to the runner-up in any original tender for the works (if not subject to any compulsory re-tendering requirement); or (iii) an experienced Employer may complete the works itself by engaging the sub-contractors directly (possibly by utilising the standstill period in or exercising step-in rights in collateral warranties/direct agreements) and acting as, or separately engaging, a construction manager. Needless to say, such decisions will almost inevitably require funder and other interested party consents.

IO arranges for completion of the works (rarely occurs)

In dealing with any offer by an IO to carry on with and complete the works, the Employer should consider:

- The resources and expertise of the IO (or any replacement contractor proposed by the IO, although usually the IO if he has elected to continue the contract will often seek to employ the current workforce) and whether these are sufficient to take on and complete the works with minimum disruption.
- The IO's motives. If it is simply to release value for secured creditors, the Employer will weigh whether there is adequate motivation to complete the job, to the requisite standards and without sub-contractor disputes endangering the project? In addition, would it be preferable to engage a new contractor to provide an ongoing covenant in respect of existing as well as new work (as an IO will seek to avoid personal liability and the insolvent company's covenant will, in all probability, be worthless)?
- The IO's ability to deal with health and safety responsibilities, as in many jurisdictions criminal liability (including at director level) may arise

[8] A common trap is where termination liabilities only cover the additional costs of completion but do not permit recovery of losses arising from delay (whether inherent in the programme at the time of termination or arising as a result of the insolvency and need to re-tender the works).

if these matters are not given due regard(although generally speaking IO's take compliance with these issues very seriously).

- The status of the project. If the work is very near completion (or in its warranty or defects period) and monies are due to the Contractor that are not required to cover any Employer costs, there may appear to be advantages in the IO completing the works, but this will almost certainly require lender consent. However, the IO will probably seek advance payment to fund the works and the Employer may struggle to obtain any enforceable assurance that the works will be executed.
- Whether the IO is organising a sale of the whole business. If so, the Employer may wish to defer any termination decision pending the sale, as it may be more attractive to the Employer than finding its own replacement[9].

Novation/Transfer to a new contractor

In certain circumstances, it may be preferable to agree to a novation/ transfer by the IO to a new substitute contractor. This may arise where the contract termination provisions restrict the assignment of key sub-contracts or licensed processes to the Employer, effectively forcing the Employer to deal with the IO. When considering whether to transfer the works to a new contractor, the Employer should take the following into account:

- Ideally, from the Employer's perspective, any transfer would be on the basis of a full novation to the substitute contractor - with the substitute contractor adopting the same contractual rights and liabilities as the insolvent Contractor, as if it had always been appointed as the contractor from the outset. In practice, this is unlikely to happen, as the incoming substitute contractor may not wish to take on full responsibility for work it cannot check before stepping into the contract and there may need to be adjustments to completion dates and pricing.
- The Employer needs to consider required consents from lenders and other third parties to the transfer and whether it should retain remedies against the Contractor and/or bring claims under any performance security to cover additional costs and losses arising.
- Works may be suspended whilst negotiations take place to organise a transfer. It is important not to inadvertently trip over any default thresholds or events of default in funding or other project documentation whilst this takes place.

Decision not to complete the works

The Employer may decide to cancel the project where it is no longer economically viable as a result of the Contractor's insolvency. This may be, for example, due to the additional costs or the resultant delay that would arise if the project were completed by another entity (which may, in turn, lead to the inevitable termination of key project contracts or loss of consents or triggering of defaults under financing documents).

If the Employer (or project funder) decides to cancel a project, it will naturally first wish to consider the potential recoveries available on termination and under the performance security[10].

[9] A whole business sale may still require replacement of guarantees and bonds.

[10] A contractual termination regime that only covers the additional costs to complete and delay liabilities will not provide compensation for project cancellation; this should be considered when negotiating the contract.

Performance Security

The Employer should check the position and give any notices required by any performance bond or parent company guarantee provided by the Contractor (of course, if the Contractor's parent company is also insolvent, any guarantee may prove to be worthless). Where the works are financed, enforcement of performance security will probably require lender consent.

If the Employer has a conditional performance bond, it should review whether a call can be made on the grounds of the insolvency alone or only where there has been a default[11]. If the latter applies, it may be preferable to delay determination until an independent event of default permitting determination occurs (assuming other agreements do not require immediate action). That said, any such delay will need to be balanced against the risks of continuing even temporarily with an insolvent Contractor. The Employer should also check whether a claim under the bond can be established prior to resolution of the termination account at completion of the works.[12]

Where bonding has taken the form of a letter of credit or an "on-demand" bond, it is sometimes supposed that these can be called at any juncture without requiring any proof of default or loss. This right tends to be overstated. Courts in some legal regimes have been more willing to interfere in calls on such instruments and even where there are no barriers to the initial call and payment, there is usually some duty to account for any amounts over-claimed that do not represent true losses.

In the event of an IO 'disclaimer' of the underlying contract, there will be a need to carefully check the implications for bond demands. Notwithstanding that the disclaimer will determine the contract, it may still have a half-life to the extent bond liabilities refer back to the contract.

Third Parties

Third party consents

The Employer will invariably need to consider whether notice of the insolvency and/or any termination and change in the Contractor needs to be given to any third party with an interest in the construction process (e.g. lenders and purchasers of interests or product) under the terms of the agreement between them and whether consents need to be obtained. Contractor insolvency is likely to trigger events of default and step-in rights and create cost overruns and delays. Accordingly, it will be important to keep all relevant parties informed and manage any approvals required, noting that lenders, in particular, may exercise discretionary rights to control this decision process.

Sub-contracts

The position of sub-contractors and suppliers must also be considered, as the Employer may be dependent upon them for the smooth completion of the project. The treatment of sub-contractor claims may impact sub-contractors availability and willingness to complete the works. Factors to consider include the following:

[11] Most modern conditional bonds should be drafted to avoid this issue arising.

[12] The conditional bond market has responded to some of the criticisms aimed at it by offering, albeit at an increased premium, bonds which will respond to fast-track dispute resolution awards in certain jurisdictions and may even be on-demand in the event of an insolvency (though this is likely to be subject to reconciliation accounting mechanics). These bonding options should be considered at the outset of a project.

- Sub-contractors may have already terminated their sub-contracts by reason of the insolvency event or notified that they intend to do so under any collateral warranties or direct agreements. Alternatively, the sub-contract may provide for automatic termination upon termination of the main contract. The result is that commonly a decision on whether or not to step-in will need to be exercised within a short time-frame or new arrangements will need to be entered into with the sub-contractors by the Employer or its chosen substitute contractor.
- Some standard form contracts do not allow the Employer to procure the assignment of sub-contracts at the termination of the main contract, requiring the Employer to deal with the IO.

The Employer is likely to receive numerous requests for direct payment from sub-contractors and suppliers in respect of work carried out or goods supplied which have not been paid for by the Contractor[13]. The Employer may be tempted simply to pay the sub-contractors to complete the project. Although this may be attractive commercially, for example, to avoid further delay and costs, there is a risk of double payment (i.e. the payment to the sub-contractor does not relieve the Employer of the debt to the Contractor).

Claims by sub-contractors may be complicated by the following:

- Notwithstanding prior payment by the Employer to the Contractor, an unpaid sub-contractor may have a valid retention of title claim over materials and goods supplied by it. Retention of title claims are complex and need to be examined on a case-by-case basis.
- The sub-contractor may seek to argue that the Employer has no right to use its intellectual property rights in its designs, which will depend on the nature of licences expressly granted or implied. Specialists and plant suppliers will, in particular, be concerned if the Employer appoints a rival business competitor as the substitute contractor.
- Depending on the contractual terms and governing law, there may be liens over documents or over the work itself.
- Sub-contractors might act to prevent the Employer claiming title over off-site materials unless they have their outstanding claims met or are re-engaged to complete their contracts.
- Sub-contractors might argue they were nominated by the Employer to the Contractor and are entitled to protection in the event of the Contractor's insolvency.

Claims by other contractors and consultants

The Employer should be prepared for claims from its other contractors and consultants in respect of any delay caused by or additional costs arising from the insolvency. Their entitlement to recovery will depend on the terms of their contracts and appointments.

If the Employer is liable to meet these claims, it should check whether these liabilities can be passed on and either included in its account with the insolvent Contractor and/or form the basis of a call under any performance security. This will depend on whether the governing law, the contract and the performance security permits or restricts recovery of such liabilities.

[13] The Employers' obligations to make such payments to a sub-contractor may differ between jurisdictions and should be checked.

Be Prepared

There are a number of steps an Employer can take to better safeguard its position in advance, ranging from better credit checks to contractual upgrades including, in particular, consideration at the contracting stage of early termination accounts; provision for offsite materials and equipment; the performance security package; use of third party rights (to mitigate the all-too-familiar problem of incomplete collateral warranty/direct agreement packages) and internal guidance for managers. In the event of a contractor or subcontractor insolvency, the Employer and other interested parties should seek legal advice as soon as possible to establish its rights and obligations.

Restructuring

Of course it's not all doom and gloom and over the last decade there has generally been a trend away from formal insolvencies and a focus on restructuring (which is why Carillion has been a notable exception).

The trend towards restructuring may in part be attributable to a number of different factors, for example a benign economy, reluctance in some cases to lenders wanting to crystallise their losses due to increased pressures on their own capital adequacy and very low interest rates. It may also be the result of it being recognised that by restructuring distressed businesses, value is preserved. A restructuring will often produce a better result for all stakeholders.

In the UK most restructurings take place outside of the formal process, but where there are complex group structures, with complicated debt arrangements, and often cross border activities, the restructuring process needs to be carefully managed. The business needs to continue to operate, whilst at the same time resources are devoted to the restructuring process itself. This may often lead to a chief restructuring officer (or nowadays called a "transformation officer") being appointed in the more significant cases.

Managing the process is often key to facilitating an agreement to refinance or restructure. The process can be divided into three main stages: (i) the coordination; (ii) stabilisation; and (iii) implementation.

Taking each stage in turn:

- The coordination stage recognises that it is essential to approach often disparate groups of stakeholders in a coordinated way. This can be done by appointing coordinators who are representatives of the different stakeholder constituents. The coordinators act as a conduit for information and negotiations between the distressed business and the different stakeholders, they can be more efficient in terms of time and cost compared to dealing with individual stakeholders. They can also assist in providing some momentum for the negotiations, of course coordinators are not required in every case, especially those that are less complex.
- The next stage of a restructuring is the stabilisation stage, this is where the distressed business needs to secure sufficient time and breathing space to allow the restructuring options to be explored and negotiated. Whilst some contractual arrangements have a mechanism for

forbearance, or the nature of the arrangement gives the distressed business some time to work out its issues, in many cases a formal standstill arrangement is agreed with key stakeholders. The standstill is a voluntary moratorium, which usually ensures that the debtor's counterparties are not able to take individual enforcement steps, limits the use of banking facilities and determines how any new monies may be dealt with. The agreement will also restrict the distressed business from paying any dividends, limit CAPEX, limit acquisitions/disposals and, limit new security being granted.

- Once the business has a stable platform, the restructuring can move to the implementation stage. The implementation stage will very much depend upon the particular circumstances of the case, it could be delivered in a consensual manner, but often this requires everyone involved to agree. When consensus cannot be achieved a number of non-consensual avenues exist as a matter of English law and practice. For smaller, less complex cases, a company voluntary arrangement may be used. This allows a company to agree an arrangement/compromise with its creditors, and provided all the secured and preferential creditors agree and 75% of unsecured creditors vote in favour of arrangement, the compromise/arrangement will bind all creditors.
- For more complex situations, schemes of arrangement may be used as a mechanism to implement a restructuring. They are not an insolvency process at all but are used in a restructuring context. They have been used to simply extend the maturity dates of loan arrangements or effect a balance sheet restructuring. A scheme facilitates a restructuring where at least 75% in value of creditors voting in each class of creditors and a majority in number vote in favour of a scheme. The scheme must also be approved by the court. The classes are determined on a case by case basis, but essentially the classes group together creditors with similar rights and interests e.g. secured senior creditors; junior secured creditors; unsecured creditors.
- In addition to company voluntary arrangements and schemes, formal insolvency techniques may be used to deliver a restructuring such as an administration. Administration for example may seek to preserve the value of the business by facilitating a pre-packaged sale to a new company, which essentially allows the business and assets to be transferred for value paid by the purchaser without the liabilities of the business. The proceeds from the sale are then available for distribution according to the relevant priorities amongst the company's creditors in the administration. (See above for the impact of a formal insolvency in the construction contracts more generally).

Dealing with contractors in distress is often complex especially understanding all the stakeholders involved and their differing interests. It will also be unfamiliar ground for most contracting parties, especially where a formal process ensues. In our experience, those projects that plan speedily and pro-actively, taking into account the contractual framework and available performance security, tend to fare better.

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If you would like to know more about Clifford Chance's Construction Group in London or across our network, please contact David Metzger (david.metzger@cliffordchance.com).

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Authors – Restructuring & Insolvency

Adrian Cohen
Partner

T +44 207006 1627
E adrian.cohen
@cliffordchance.com

Philip Hertz
Partner

T +44 20 7006 1666
E philip.hertz
@cliffordchance.com

John MacLennan
Partner

T +44 207006 1642
E john.maclennan
@cliffordchance.com

David Towers
Partner

T +44 207006 8036
E david.towers
@cliffordchance.com

Iain White
Partner

T +44 207006 2825
E Iain.White
@CliffordChance.com

Gabrielle Ruiz
Senior PSL

T +44 20 7006 1615
E gabrielle.ruiz
@cliffordchance.com

CONTACTS

Authors – Construction

David Metzger
Partner, Head of International Construction Group

T +44 20 7006 4240
E david.metzger@cliffordchance.com

Sandy Hall
Partner

T +44 20 7006 6806
E sandy.hall@cliffordchance.com

Tim Steadman
Head of Construction, Middle East

T +971 2 613 2327
E tim.steadman@cliffordchance.com

Marianne Toghill
Head of UK Real Estate Construction

T +44 20 7006 4373
E marianne.toghill@cliffordchance.com

Matthew Buchanan
Partner

T +65 91773126
E matthew.buchanan@cliffordchance.com