

UK SUPREME COURT CLARIFIES AVAILABILITY OF CONSTRUCTION ADJUDICATION REGIME IN INSOLVENCY

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Legal Briefings

In what is likely to be one of this year's landmark insolvency decisions, the Supreme Court in *Bresco v Lonsdale* has considered the interaction between insolvency set-off and adjudication, though the judgment is likely to have application to other dispute resolution processes including litigation and arbitration. The Supreme Court, unlike the High Court and Court of Appeal, permitted the adjudication to continue and, in doing so, dismissed the suggestion that insolvency set-off always results in the extinction of cross-claims to be replaced by a single claim for the balance. The claim which was the subject of adjudication continued to exist and could be pursued in adjudication.

It is important to note that the decision concerns an adjudication claim *by* a company in liquidation. The judgment confirms that any claim *against* that company would also continue to exist though pursuit of that claim (or enforcement of any adjudication award made on that claim) would potentially be subject to an insolvency stay or moratorium.

SUMMARY

Bresco Electrical Services Ltd (in Liquidation) v Michael J Lonsdale (Electrical) Ltd [2020] UKSC 25 concerns the ability of liquidators and administrators to refer claims of the insolvent company to the construction dispute adjudication regime codified in section 108 of the Housing Grants, Construction and Regeneration Act 1996 (the “**1996 Act**”) in circumstances where the respondent to that adjudication has a cross-claim against the insolvent company.

Previous authority suggested that the respondent in such circumstances would be entitled to injunctive relief restraining the adjudication, on account of the purported incompatibility of the construction adjudication regime and the set-off regime arising under Rule 14.25 of the Insolvency (England and Wales) Rules 2016 (SI 2016/1024)) (the “**IR**”^[1]). This incompatibility has in the past been commonly put on two grounds:

1. The set-off regime has the effect of replacing the claims and cross-claims with a single claim for the balance which cannot be said to arise under the construction contract, such that the adjudicator does not have jurisdiction because there was no longer any claim to refer to adjudication; and
2. Even if the adjudicator has jurisdiction, adjudication would be an “exercise in futility” on the basis that the adjudicator’s decision could not normally be enforced by the court, because enforcement of that decision against a creditor who had a cross-claim would be unfair, making the creditor pay in full when it would be entitled to only a distribution from the insolvent company in respect of the cross-claim.

This purported incompatibility had functioned as a strong deterrent against liquidators and administrators seeking to commence adjudications in such circumstances, effectively limiting the options of the officeholder to enforce the insolvent company’s rights via an adjudication process which is generally much quicker and less expensive than litigation or arbitration.

In a decisive judgment, Lord Briggs (with whom the other Justices agreed) found there was no incompatibility between the regimes and accordingly that liquidators and administrators have the unfettered right to refer claims to the construction adjudication regime even where the respondent to adjudication has or asserts a cross-claim.

The immediate upshot of this decision will be obvious, in that parties can expect liquidators and administrators to refer construction disputes entailing cross-claims to adjudication in greater frequency. Other potential consequences include:

- Liquidators and administrators may be more likely to take advantage of a company’s rights to pursue other dispute resolution procedures, particularly arbitration, in order to

obtain a determination of the company's claim.

- Though beyond the scope of the *Bresco* decision, given the commentary provided by the Supreme Court, it is possible that adjudication claims *against* a company in administration or liquidation will be given permission to proceed via a lifting of the liquidation stay or administration moratorium. That would potentially permit the quantum of the claim against the company to be determined but would not impact on the *pari passu* distribution of the insolvent company's assets if the court stayed enforcement of the adjudication award (which, outside the insolvency context, would commonly be enforced via the summary judgment procedure). Against that, there is already a quick and efficient process for quantifying a creditor's claims against the company – the proof process – so that the rationale for permitting a creditor to lift the stay or moratorium so as to quantify its claim is not as strong as the rationale for permitting the company to refer its claim to adjudication (rather than the insolvency company being deprived of a quick and efficient dispute resolution process).
- There is likely to be uncertainty as to the purposes for which cross-claims continue to exist and those for which they do not. Previous House of Lords authority (*Stein v Blake* [1995] UKHL 11) confirmed that the separate cross-claims do not continue to exist for the purposes of one of them being assigned.

FACTS AND PROCEDURAL HISTORY

In August 2014 Bresco Electrical Services Ltd ("**Bresco**") agreed to perform electrical works for Michael J Lonsdale (Electrical) Ltd ("**Lonsdale**") at a site in London. The sub-contract governing the provision of these services (the "**Contract**") made express provision for the adjudication of such disputes arising under the Contract which complied with the requirements in the 1996 Act.

In March 2015 Bresco went into creditors' voluntary liquidation (in which there is not an automatic liquidation stay on proceedings against the company). In late 2017 each party accused the other of repudiatory breach of the Contract. The substance of the claims is not significant to the appeal, save for the fact that the claims on both sides arose entirely under the Contract and were therefore *prima facie* referable to the adjudication regime if they survived insolvency set-off.

In June 2015 Bresco commenced the adjudication process, including by appointing an adjudicator. Immediately thereafter Lonsdale issued proceedings in the Technology and Construction Court ("**TCC**") seeking a declaration that the adjudicator lacked jurisdiction (on the basis set out above) and an injunction restraining the further conduct of the adjudication.

Fraser J accepted the jurisdiction argument raised by Lonsdale and granted the injunction sought. Bresco appealed, and was successful in the Court of Appeal against the jurisdiction point but the injunction was continued on the basis that the adjudication would be an "exercise in futility" and a waste of resources. Bresco appealed the so-called "futility" point to the Supreme Court, while Lonsdale cross-appealed on the jurisdiction point.

JUDGMENT

Prior to setting out his reasoning, Lord Briggs spent some time reviewing the key traits of the adjudication and set-off regimes. Lord Briggs' comparison of the two regimes sets the scene for his subsequent dismissal of the notion that the regimes are incompatible, and is therefore worth summarising.

Adjudication:

- While the regime was initially adopted by statute to improve/preserve the cash flow of construction counterparties as disputes arise, it has since evolved into a dispute resolution process in its own right which is commonly used to settle disputes on a near-final basis (in the sense that adjudication decisions are rarely challenged in court), at any stage of the project life-cycle (or beyond).
- Importantly, the 1996 Act includes no express limitations on the rights of parties as to when adjudication can be commenced. Contrast the position in certain other jurisdictions, including New South Wales, where special provision is made in respect of insolvent companies and adjudication.
- The process is much cheaper and faster than arbitration or litigation, but is less reliable in that adjudicated disputes are not finally determined and can be re-determined in arbitration or litigation (though in the significant majority of cases, the adjudication award is not challenged).

Set-off:

- The set-off regime arising under the IR identifies a net balance between the solvent company's claims against the insolvent company and the insolvent company's cross-claims against the creditor where there have been mutual dealings. Any net balance in favour of the insolvent company may be pursued by proof of debt, while that owing to the insolvent company may be pursued by the liquidator by exercise of any available remedies (including litigation, arbitration or ADR). Insolvency set-off acts as a defence to any claim other than for the balance.
- The proof process is designed to operate speedily and relatively cheaply, and therefore shares some features of adjudication.
- The set-off regime applies to all types of pre-liquidation dealing. It is mandatory and self-executing (i.e., taking effect on at the commencement of insolvency).

- If any of the claims and cross-claims are in dispute, then those disputes will need first to be resolved by reference to their individual merits before set-off can occur. The insolvency framework is inherently flexible as to the best means for their resolution.

Jurisdiction

Lonsdale argued that the adjudicator lacked jurisdiction because, from the moment of insolvency, Lonsdale's claim against Bresco (and Bresco's cross-claim against Lonsdale) ceased to exist and were replaced by a single claim for the balance against the relevant party. This single claim was not under the Contract, but "under the insolvency" and therefore could not be heard by the adjudicator. Lonsdale relied on *Stein v Blake*, which Lonsdale said established as a general rule, without exception, that insolvency set-off extinguished cross-claims so that only a claim in respect of the balance continued to exist. That claim was not under the Contract and could not be pursued in adjudication, asserted Lonsdale.

This argument was rejected by Lord Briggs. The mere existence of cross-claims did not mean that they simply "melted away" in insolvency. If it did, a *de minimis* cross-claim could deprive the adjudicator of jurisdiction over a substantially larger claim arising squarely under the contract, which would seem to defeat the general purpose of the adjudication regime. Further:

- Lord Briggs pointed to some examples where claims and cross-claims retain their separate identity after insolvency, and where the owner of a claim retains certain ancillary rights after insolvency (such as a secured creditor retaining its rights as regards the security even in the set-off regime).
- A liquidator retains his or her right to refer the company's claims to arbitration after insolvency, and there is no basis for treating adjudication differently.

Futility

Lord Briggs then considered the "futility" argument in favour of an injunction. The Court of Appeal had held that the decision of an adjudicator in favour of an insolvent company, in circumstances where there is a cross-claim, would not ordinarily be enforced by the courts (see above). For this reason adjudication was "futile" (in the sense of being without consequence to the legal position of either party) and therefore wasteful of the resources of the liquidator and the courts. Further, it would expose the respondent to the insolvent company's adjudication to irrecoverable costs.

Lord Briggs disagreed. He started from the position that it would be entirely inappropriate for the court to interfere with the exercise of a contractual (still less statutory) right, such as the right to adjudicate. Lonsdale had not shown any good reason why the Court should depart from this starting point:

- Adjudication is a “*useful means of ADR in its own right*”, which could assist parties in resolving disputes regardless of the enforceability (or otherwise) of the adjudicator’s decision by the courts. The award could have value to the liquidator in the assessment of proofs, even if the liquidator could not enforce it.
- Enforcement would require judgment by the court. The court was well-placed to determine whether to enforce the award having regard to the effect on both the insolvent company and the creditor with a cross-claim. Enforcement would often be refused where it would require the creditor to pay the claim in full but would only receive a distribution, generally as an unsecured creditor, from the insolvent company.
- Adjudication is (necessarily, by statute) a costs-neutral process, and therefore always presents some risk of irrecoverable costs being incurred. The fact that some costs may be incurred which are irrecoverable did not justify an injunction preventing adjudication.
- Adjudication helps to relieve the burden on the courts, as adjudication will likely be completed before any opposed injunction application could be determined by the court.

COMMENT

As explained above, the most obvious implication of the judgment is that adjudications commenced by insolvent companies are likely to increase. Many practitioners in the construction sector had considered that an insolvent company could not refer disputes to adjudication, so this decision will likely support a radical shift in practice and have a potentially significant effect on the conduct of the insolvencies of construction companies.

For insolvency practitioners, it is the wider implications which are likely to be of more interest. There is no reason in principle why the decision should be confined to adjudication. It supports also the exercise of contractual rights to refer disputes to non-judicial determination by liquidators and administrators. The most obvious such contractual dispute resolution mechanism is arbitration.

It is possible that there are gaps in the judgment which may require clarification in due course. For example, does it make any difference whether the cross-claims arise under the same contract?

More generally, the Supreme Court judgment contains useful support for alternative dispute resolution, particularly by insolvency practitioners seeking quick and orderly determination of disputes so as to speed up and maximise any distribution to creditors. That said, the availability of adjudication and the ever expanding litigation funding market, put together with increased flexibility in fee structures for lawyers, may mean that ADR which is proving fruitless is quickly abandoned in favour of relatively inexpensive adjudication which, while not conclusive, is likely greatly to inform the parties' assessments of their respective positions. Where a liquidator or administrator refers a dispute to adjudication, the adjudicator's fees will generally constitute insolvency expenses. Adjudicators and respondents may well seek clarity that funds will be set aside by the insolvency practitioner to ensure that the fees of the adjudicator are paid (if they are not, the respondent may otherwise be liable for the entirety of the fees).

What will this mean for adjudication claims *against* the insolvent company? Those would ordinarily be caught by a liquidation stay or administration moratorium, but the judgment in *Bresco* might potentially encourage the courts to lift a stay or moratorium so as to permit a creditor to seek to obtain an adjudication award. Doing so may assist in clarifying the quantum of the creditor's claim - which could ultimately be of benefit to the insolvency process - and would not necessarily cut across the *pari passu* distribution of the insolvent company's assets provided that the adjudication award is not enforced. Against that, however, the rationale in *Bresco* cannot be applied neatly to adjudication claims *against* an insolvent company. Where an insolvent company was (based on the earlier law) prevented from commencing adjudication, a quick and efficient means of quantifying its claim was effectively shut off. The liquidator or administrator therefore had no option but to commence a more formal dispute resolution process in respect of the insolvent company's claim or, after insolvency set-off, the balance in its favour. By contrast, where the prospective adjudication is *against* the insolvent company, the relevant claim will already be the subject of another quick and efficient dispute resolution process - proofs of debt - and that can deal with both the underlying cross-claims and any balance in favour of the creditor without any threat to the orderly conduct of the broader insolvency process.

For insolvency lawyers, the decision in *Bresco* presents a conundrum - in certain circumstances, as confirmed in *Stein v Blake*, the application of insolvency set-off will prevent dealings with cross-claims as separate claims because they are merged into the single claim for the balance after set-off, yet *Bresco* confirms that the cross-claims are not extinguished for all purposes. *Stein v Blake* confirms that the original cross-claims cannot be assigned. *Bresco* confirms that they can be pursued separately (though they may effectively merge at the enforcement stage). The courts may in due course have to apply these apparently contradictory results to novel situations and it is unclear which approach the courts will prefer.

[1] Or, in the case of administrations, Rule 14.24. Note that Lord Briggs expressly stated that "substantially the same" regime governs liquidations and administrations, suggesting his judgment is applicable to both insolvency processes. This briefing refers primarily to liquidations solely for the sake of convenience.

KEY CONTACTS

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