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Insights

NOVATION, STEP-IN AND A POTENTIAL PROBLEM WITH CIGA 2020

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SUMMARY

Where the contractor has become insolvent, what obligations can an employer enforce when stepping-in to a previously novated professional consultant's appointment in a design and build scenario?

A question that routinely arises in practice, this scenario is perhaps more relevant now than ever, not only because of COVID-19 but also because of the **Corporate Insolvency and Governance Act 2020** (CIGA) that our colleague, Primrose Tay, blogged about.

This blog will take a closer look at this question. First, novation – what it is, what it does and what the novating party (here, the employer) needs to do when novating a contract to protect its position. Then step-in – how it works, what rights and obligations does the stepping-in party (here again, the employer) have and is it even possible now in the event of contractor insolvency?

Novation is the discharge of one contract (between A and B) and its replacement with a new contract (between B and C). The benefit **and** burden of the contract between A and B are transferred to the contract between B and C. You could say that C "steps in" to A's shoes.

Regularly used in the construction context, the most common scenario where it is seen is that envisaged by the question above: design and build procurement. Here, the employer appoints consultants initially during the early stages of the project before appointing the contractor. When the contractor is appointed, the consultants are "novated" to the contractor, the idea being that this facilitates the contractor taking single point responsibility for the design and build of the project.

Requirements for novation are few: it doesn't have to be in writing (although best practice is that it should be), consideration is required if a deed is not used and all parties must consent (consent doesn't need to be express, it can (somewhat alarmingly) be inferred from conduct). Again, best practice is to make sure it is in writing in a document signed by all relevant parties.

Potential problems

So, novation is simple to achieve. But it's a bit like saying that anyone can pilot a space shuttle – we all might be able to switch it on but that doesn't mean it's a good idea unless we know precisely what we are doing, or the fall out could be catastrophic. It's the same with novation – great care needs to be taken.

For example, if the employer in our scenario did nothing further than to agree with the contractor and consultant to novate the appointments to the contractor then not only would it not be able to step back into the appointments should the contractor become insolvent but a employer would find itself with no contractual recourse against the consultant for breaches in respect of the services.

Trouble shooting

Best practice is to ensure that the following express provisions are included.

In the building contract between the employer and contractor:

- Confirming that the contractor agrees to accept full responsibility for the novated consultants (who should be clearly identified in the contract) of their respective obligations under their appointments both before and after novation. This is important because the novation itself will not make the contractor responsible to the employer for the work that the consultant has carried out pre-novation. The contractor needs to expressly agree that it is responsible for this work in the contract between it and the employer;
- That the contractor will, within a specified timeframe, enter into a deed of novation with each of the novated consultants;
- We often expressly state that entry into the deeds of novation is a condition precedent to the performance by the employer of its obligations under the contract;
- You may also wish to include additional provisions making clear that:
  - the contractor will be entirely responsible for the payment of fees to the novated consultants post novation;
  - the contractor cannot terminate the novated appointments without the employer's consent and include additional provisions regarding appointment of replacement consultants; and
  - where novated consultants have been replaced, the contractor cannot claim any additional time, loss and expense and there shall be no adjustment to the Contract Sum due to replacements.
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- A provision that the consultant will enter into a deed of novation (the form should be appended to the appointment) within a specified time frame;
- Confirming that upon completion of the deed of novation that either third party rights or a collateral warranty (both in forms set out in a schedule to the appointment) shall be provided by the consultant in favour of the employer;
- Making clear that the consultant should have due regard to the contractor's obligations in the building contract and that when it performs the services it should ensure that no act, omission or default should contribute to any breach by the contractor of such obligations;
- The third party rights or collateral warranty should include step-in rights so the employer can step back into the appointment should the consultant terminate its engagement with the contractor; and
- Ensure that a unilateral right is included in the post novation collateral warranty or third party rights schedule for the employer to step-in to the appointment (more on this in a moment).

Let's now turn to see what happens to the employer's rights created by the above provisions in our scenario on step-in.

Step-in rights – how do they work?

Step-in is itself a quasi-form of novation.

Using the earlier A-B-C analogy, let's say that B and C are parties to a contract which provides that A has rights to step into B's shoes in certain circumstances. In the construction context, these circumstances typically arise where C has grounds to terminate its appointment with B. The step-in rights will sit in the collateral warranty or third party rights given in favour of the stepping in party (A).

The step-in rights typically provide that, before terminating the appointment, C will first serve a notice on A flagging that it plans to terminate and so giving A the option of stepping into the appointment and replacing B. If A chooses to step-in, it will take over B's obligations (principally the obligation to pay) and rights under the appointment.

So, the answer to our insolvent contractor scenario appears to be straightforward: our employer has the benefit of step-in rights, the contractor is insolvent, assuming the consultant plans to terminate and has served notice of its intention to the employer, the employer can step-in. The employer would then stand in the shoes of the contractor and take on all the rights and obligations of the contractor vis-a-vis the consultant. Job done. But not so fast… Houston, we have a (potential) problem.

The problem: CIGA

The problem, potentially, is CIGA.

As mentioned at the start, in June 2020 CIGA introduced a permanent extension to the UK's existing insolvency law provisions regarding "essential supplies" (which were designed to ensure that certain critical supplies such as gas, water, electricity and IT cannot be terminated solely as a result of the insolvency) that has the effect of prohibiting a supplier of goods and services (so here the consultant) from terminating its contract, or doing "any other thing", should the customer (here, the contractor) become insolvent.

In essence, CIGA automatically turns off the insolvency termination rights in an applicable contract, the intention being to assist an insolvent company in preserving the supply of critical goods and services to assist in a rescue of the business or to protect creditors' interests if a rescue cannot be achieved. What CIGA also does is prevent a supplier (the consultant) from terminating a contract based on existing breaches, which could be unconnected with the contractor's insolvency, where the right to terminate wasn't exercised before the contractor's insolvency process was commenced.

So unless the employer has taken the advice above and made provision for a unilateral step-in right in its post-novation collateral warranty or third party rights, it may not be able to step into the appointment if the consultant's only right to terminate is because the contractor is insolvent. This is because the consultant will not be able to serve a notice to start the step-in process.

CIGA vs step-in – work arounds

- **Termination for reasons other than insolvency**: The consultant may be able terminate for other reasons that have arisen post-insolvency (perhaps the contractor has not paid during the "relevant insolvency procedure") and then it can serve its notice and the employer can step-in.
- **Agree termination with insolvency practitioner**: CIGA makes express provision for the customer (so here the contractor) or its insolvency practitioner (depending on the relevant insolvency of the contractor) to agree to termination if they do not wish to continue the contract.
- **Assignment of contracts?**: Depending again on the building contract terms, the employer may be able to require an assignment of the consultant appointment under the building contract and this will give it rights in relation to the consultant appointment.

  But as our colleague Marcus Birch highlighted in his blog, this is not as effective a solution for the employer as step-in and the question becomes whether such an assignment can effectively be forced onto an insolvency practitioner of the contractor.
- **Temporary exclusions**: CIGA contains temporary exclusions to the prohibition on termination, permitting "small suppliers" to terminate contracts with customers that enter into

a “relevant insolvency procedure” at any time until 30 March 2021. Small suppliers must satisfy two of the following three conditions in relation to its most recent financial year:

- The supplier’s turnover is no more than £10.2m;
- The supplier’s balance sheet must be no more than £5.1m; and
- The supplier must have an “average number of employees” of no more than 50.

While there are some work arounds, you can see how CIGA will make it far more difficult for an employer to step-in if proper provision is not made. The lesson here for employers (and anyone else who has step-in rights) is make sure you have a unilateral right of step-in.

Final thoughts

So the answer to the question, rather predictably, is that all will depend on what the contracts say.

If the employer has a unilateral right of step-in, it will be able to step into the consultant appointment on insolvency of the contractor and, subject to the terms of the contracts, will take on the rights and responsibilities of the insolvent contractor.

If the employer does not have such a right, then it won’t be able to step into the consultant appointment unless one of the potential work arounds mentioned above applies.

Step-in is rarely utilised on construction projects but it will be interesting to see what happens in the coming months given the economic climate. CIGA causes yet more headaches in this regard – parties wishing to rely on step-in rights must make sure to take it into account.

This article first appeared on the Practical Law Construction blog dated 3 November 2020.

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