CONSTRUCTION & ENGINEERING TOOLKIT

August 2015

Novation in construction and engineering projects

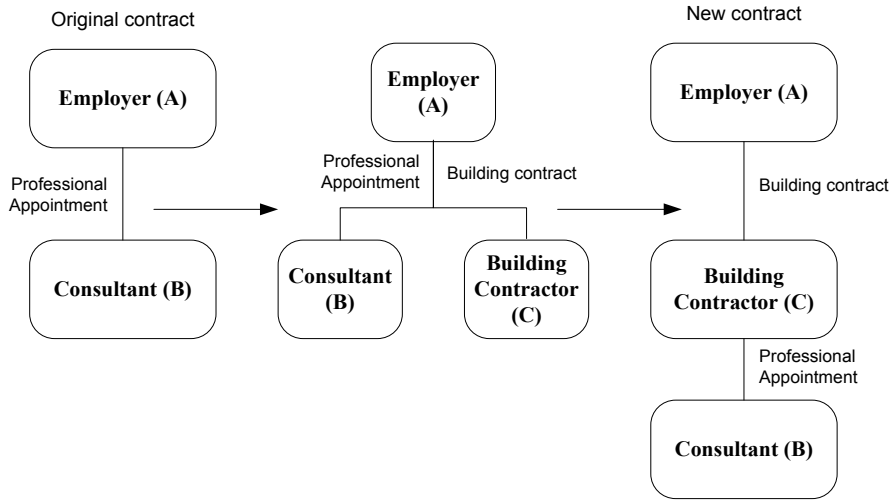
Novation is the cornerstone of design and build procurement. It is the novation of the design consultants' appointments to the main building contractor that effects the risk transfer that developer employers seek. The novation must be executed properly; if this does not happen, the effect can be the loss of a party's legal rights altogether.

MEANING OF 'NOVATION'

Novation is the legal name given to the mechanism by which contractual rights and obligations are transferred from one party to another. The process can also be viewed as a substitution.

Example

If a contract entered into between A and B is "novated" to C, C is considered to have "stepped into the shoes" of B; the original contract is extinguished and replaced by a new contract between A and C. C takes on the rights and obligations of B under the original contract. The substitution takes place by a novation executed all three parties.



NOVATION IN DESIGN AND BUILD PROCUREMENT

Novation is the icing on the cake when it comes to transferring the risk of the design and the construction of a project to a single point of responsibility (namely, the main building contractor).

Typically, the developer appoints its design consultants (architect and engineers) under professional appointments and, separately, engages its main contractor under a design and build construction contract.

At some point during the project (usually when the building contract is entered into, or where the design has reached a certain stage) the developer novates its design consultants' appointments to its main contractor. Sometimes, this may not affect the whole design team; the mechanical and electrical engineer may remain appointed by the developer.

As the consent of all parties is required, the novation is effected by each party entering into a novation agreement. It is also common for the developer to receive a separate collateral warranty back from each design consultant so that it can retain a direct route of claim against each design consultant, if necessary.

NOVATION CONTRASTED WITH ASSIGNMENT

Novation and assignment are separate and distinct legal concepts:

Novation	**Assignment**
Novation transfers both the rights and obligations under a contract to a new party	Assignment only enables a party to transfer the benefit of a contract (the rights under that contract) to a new party; it is not possible to assign contractual obligations (or "burdens") to another party
Novation requires the consent of all of the parties	A contract may be assigned without consent (unless the contract expressly requires it)
Novation creates a new contract in place of the original contract	Following an assignment, the original contract is not extinguished; consequentially, the party assigning the benefit of the contract remains liable under it

In Scotland, the position is slightly different. Assignment is termed "assignation" and, under Scots law, obligations can be assigned (as well as rights) unless there is an element of *delectus personae*. *Delectus personae* means "choice of person": where a consultant is selected because he possesses a specific skill or particular expertise and/or experience, there will be an element of *delectus personae* and it will not be possible to assign his obligations.

NOVATION AGREEMENTS

The terms of the novation are set out in a separate contract called the novation agreement or deed of novation. It is important that the terms of the agreement are clear and unambiguous. The Scottish case of *Blyth & Blyth v Carillion Construction Limited (2001)* demonstrated how issues with a novation agreement can result in difficulties over whether a novation or an assignment was intended and may have quite unexpected and inadvertent consequences.

BLYTH & BLYTH

The employer appointed Blyth & Blyth as engineers and novated their appointment across to Carillion, the main contractor.

While still appointed by the employer, Blyth & Blyth underestimated the amount of steel reinforcement required in the works. The underestimated figure was included as part of the bill of quantities in the contractor's tender and subsequent building contract. Following the novation, the contractor was unable to make a claim against the employer for its loss due to the undervalue as it had accepted full responsibility for the design.

The contractor sought to recover its loss under the novation agreement. The court, however, ruled this was not possible: the novation agreement meant that Blyth & Blyth had agreed to perform future obligations for the building contractor but the contractor could not claim losses arising from Blyth & Blyth's breach of the appointment before it had been novated.

The wording of the novation agreement was to assign to Carillion any claim which was available to the employer for services carried out pre-novation by Blyth & Blyth. However, it was decided that the employer had incurred "no loss" from Blyth & Blyth's breach, as Carillion had assumed all the risk under the building contract.

The result was that Carillion was left liable to the employer for problems caused by the pre-novation services (performed by Blyth & Blyth) and Carillion had no effective remedy against the engineers.

The decision caused much concern. In response to *Blyth & Blyth,* industry organisations such as the Construction Industry Council ("CIC"), the City of London Law Society ("CLLS") and the British Property Federation ("BPF") published their own standard form novation agreements.

Each of these organisations approached the issues raised by *Blyth & Blyth* in a different way. As a result, two types of novation agreement are now available to design and build contractors, the "switch" novation and the "ab initio" novation. Whilst both are novation agreements, the legal effect of each is very different; the novation produced by the CIC and the BPF is a "switch" type of contract, whilst the CLLS has produced an "ab initio" type agreement. If one is to be used, an industry standard novation agreement must be reviewed and amended, as required.

SWITCH

The "switch" novation aims to reflect what happens in reality; it details the fact that the consultant began to work for the employer at the outset of the project and then, from a certain stage of the works, worked for the contractor.

The legal effect of this type of novation is that the consultant remains liable to the employer for the work carried out prior to being employed by the contractor. After the novation is entered into, the consultant becomes liable to the contractor for all future services it performs.

By entering into the design and build contract with the developer, the contractor accepts responsibility for any design work done by the consultant prior to the novation. For this reason, the contractor will require the consultant to enter into a warranty for all services carried out prior to the novation, warranting that all services have been performed for the developer in accordance with the terms of its appointment. This provides a safeguard to the contractor, as, if the consultant breaches its duty to the developer, resulting in the contractor becoming liable for loss, then the contractor will have redress against the consultant.

As a consequence of *Blyth & Blyth Limited,* the CIC agreement provides the following wording: "*...Save that the Consultant shall not be absolved from liability to the Contractor for such loss merely by virtue of the fact that the loss has not been suffered by the Employer*".

This important caveat prevents the consultant from raising a "no loss" argument that, as the developer suffered no loss, the contractor is not entitled to recover from the consultant following the novation.

AB INITIO

Ab initio can be translated as "*from the outset*". Unlike the switch novation, this type of novation creates the fictional scenario that the consultant has always worked for the contractor from the very outset of the project.

The *ab initio* agreement is based on the traditional type of novation whereby the original employer transfers all its rights and obligations to another employer who steps into the shoes of the original employer. From the moment the novation is effected, the second employer is treated as if he had always been the employer. A new contract, on identical terms to the original contract, is entered into between the second employer and the consultant.

Based on this traditional type of novation, it has become common practice for the consultant's appointment to be novated from the developer to the contractor at a particular stage of the works.

The legal effect of this type of novation is that all obligations owed, performed or discharged by the consultant to the developer before the novation are transferred to the contractor. Accordingly, if a problem with any pre-novation work arises, the contractor will be able to pursue the consultants as he can rely on the fictional scenario that he has always been in contract with the consultant.

The CLLS standard novation is based on the *ab initio* form. It clarifies that the consultant is liable for losses suffered as a result of the consultant's breach of the appointment before the novation took place.

POST-NOVATION

In relation to the professional services each design consultant should perform and for whom, it is fundamentally important to consider what happens post-novation. In some situations, certain obligations may need to continue and be owed directly to the original employer. This needs to be considered carefully and dealt with on a case by case basis. For example, in relation to each design consultant, it may be that there is a demarcation between pre- and post-novation services.

NOVATION IN OTHER CONTEXTS

Novation is not limited to design and build procurement. A novation provision may be included in construction and engineering contracts on the basis that, even if novation is not planned for, an express novation clause may prove useful.

By way of example, the novation clause could specify that novation by the employer and/or contractor is permitted to another company within the same group of companies. It may be that novation is required from one contractor to another.

In any event, it is prudent to have the parties' prior agreement to novation via an express clause, should circumstances arise during the project where novation is required.

KEY POINTS TO CONSIDER

- To effect a novation, a formal written novation agreement needs to be executed.
- Where the original contract (building contract, professional appointment) has been executed as a deed, a deed of novation should be entered into between all three parties.
- The terms of the novation must be clear and unambiguous in order that it is not mistaken for an assignment. A failed novation could lead to a deemed assignment whereby the assignor would still be liable under the original contract.
- Ideally, the form of novation agreement or deed of novation should be appended to the underlying contract to create certainty.

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