CONSTRUCTION & ENGINEERING GUIDE

December 2013

Novation in engineering and construction projects

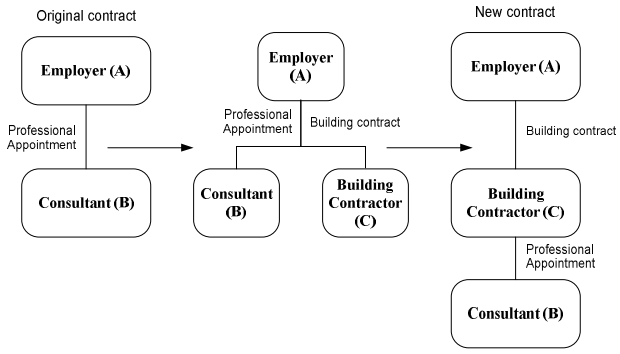
Assignment and novation are important legal topics with real ramifications for parties if they are not dealt with properly. The idea behind them is simple and easier to grasp when having an understanding of the way in which they work.

NOVATION

Novation is an important feature of engineering and construction projects, particularly in relation to design and build procurement. The novation of the design consultants' appointments to the main building contractor is a common example. Novation must be executed properly and achieved correctly; 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. So, for example, if a contract entered into between A and B is "novated" to C, the result is that C has "stepped into the shoes" of B. The original contract is extinguished and is 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 between all three parties - A, B and C, as shown in the diagram below.



NOVATION IN DESIGN AND BUILD PROCUREMENT

Novation is an important feature of design and build procurement. It is the icing on the cake when it comes to transferring risk of the design and the construction of the project to a single point of responsibility i.e. to the main building contractor. Typically, the developer appoints its design consultants, such as the architect, under professional appointments and, separately, its main contractor under a design and build 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 the appointments of its design consultants to the main contractor (although, for example, sometimes this does 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. In addition, it is common for the developer to receive a separate collateral warranty agreement back from each design consultant so that he is able to retain a direct route of claim against the consultant, if necessary.

NOVATION CONTRASTED WITH ASSIGNMENT

Novation and assignment are separate and distinct legal concepts:

- Novation transfers both the rights and obligations under a contract to a new party. Assignment, on the other hand, enables a party to transfer the benefit of a contract, i.e. 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, whereas a contract may be assigned without consent (unless the contract expressly requires it).
- Following an assignment, the original contract is not extinguished and, consequentially, the party assigning the benefit of the contract remains liable under it. Novation creates a new contract in place of the original contract.

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 has 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 a novation agreement are usually set out in writing in a separate contract called a novation agreement or deed of novation. It is important that the terms of the novation 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.

WARNING: BLYTH & BLYTH V CARILLION CONSTRUCTION LIMITED

The employer appointed Blyth & Blyth as engineers and novated the appointment across to Carillion, the main contractor. While still appointed by the employer, Blyth & Blyth underestimated the amount of steel reinforcement which was required in the works. The underestimated figure was included as part of the bill of quantities in the building contractor's tender and subsequent building contract. Following the novation, the building contractor could not make a claim against the employer for its loss due to the undervalue because it had accepted full responsibility for design.

The building contractor sought to recover its loss under the novation agreement. However, the court ruled that this was not possible. The novation agreement meant that Blyth & Blyth had agreed to perform future obligations for the building contractor but the building contractor could not claim losses arising from Blyth & Blyth's breach of the appointment before it had been novated. It was decided that the employer had incurred "no loss" arising from Blyth & Blyth's breach, as Carillion had assumed all the risk under the building contract. 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. Carillion was therefore liable to the employer for problems caused by pre-novation work carried out by Blyth & Blyth and Carillion had no effective remedy against Blyth & Blyth, who had actually carried out the work.

This decision caused much debate in the construction industry. Industry organisations such as the Construction Industry Council (**"CIC"**), the City of London Law Society (**"CLLS"**) and the British Property Federation (**"BPF"**) have published standard form novation agreements in response to *Blyth & Blyth*. However, each of these organisations approached the issues raised by *Blyth & Blyth* in a different way, as a result, two types of novation agreements are now available to a design and build contractor, these are known as the "switch" novation and the "ab initio" novation. Whilst both forms

are "novation agreements", the legal effect of the two is very different. The standard novation produced by the CIC and the BPF is a "switch" type of agreement, whilst the CLLS has produced an "ab initio" type agreement. All such standard forms should be amended as required if they are to be used.

SWITCH

A "switch" novation provides for the realities of a situation - it details the fact that the consultant worked for the employer at the outset of a project and then, from a certain stage of the works, the consultant worked for the contractor. The legal effect of the "switch" type of agreement is that the consultant will remain liable to the employer for the work carried out prior to him being employed by the contractor, and, after the novation is entered into, the consultant will be liable to the contractor for all future work carried out. The contractor will accept responsibility for any design work done by the consultant prior to the novation when entering into the building contract with the employer. 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 employer in accordance with the terms of the appointment. This provides a safeguard to the contractor, as, if the consultant has breached his duty to the employer, resulting in the contractor becoming liable for loss, then the contractor will have redress to the consultant.

As a consequence of the case of *Blyth & Blyth Limited v Carillion Construction Limited* (detailed above) the CIC agreement provides the following caveat: "*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 prevents the consultant from raising a "no loss" argument, i.e. the consultant cannot argue that because the developer suffered no loss, the contractor is not entitled to recover its loss from the consultant following the novation.

AB INITIO

An "ab initio" (meaning - *from the outset*) novation creates the fictional scenario that the consultant has always, from the outset, worked for the contractor. The ab initio novation agreement is based on the traditional type of novation, whereby an original employer transfers all his rights and obligations to another employer, who steps into the shoes of the original employer. The second employer, from the moment of novation, is treated as if it he has always been the employer. A new contract, which is on identical terms as 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 notated from the employer to the contractor at a particular stage of the works.

The legal effect of the ab initio novation is for the contractor to be treated as though it has always been the employer of the consultant, therefore all obligations that are owed, performed or discharged by the consultant to the original employer before the novation will be transferred to the contractor. This means if a problem with any pre-novation work arises, then the contractor will be able to pursue the consultants, as it can rely on the fictional scenario that it has always been in contract with the consultant.

The City of London Law Society (CLLS) has produced a standard form of novation based on the ab initio format. The CLLS form 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.

KEY POINTS TO CONSIDER

- To enable the novation to take place, a formal written novation agreement should be executed. Where the original contract (eg 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 agreement or deed of 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.

NOVATION IN OTHER CONTEXTS

Novation is not limited to the "traditional sense" of design and build procurements. An express novation clause may be included in engineering and construction contracts, because even if novation is not planned, a novation clause may prove useful. For example, the novation clause could specify that novation by the employer and/or contractor is permitted to another company in its group. 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.

POST-NOVATION

The situation post-novation should also be carefully considered. In some situations obligations may need to continue directly to the original employer and this should be assessed, for example in relation to a consultant it may be that there is a demarcation between pre and post novation services.

OUR APPROACH

Our approach is to create certainty in construction and engineering projects by specifying and seeking the parties' agreement to the novation arrangements and the forms of novation agreement early on in the project. Contract terms need to be clear, unambiguous and drafted in simple English. The parties need to understand their rights and obligations and the implications of acting outside the scope of their contractual agreements or of failing to perform. We give bespoke advice tailored to the needs of our client.

CONTACTS

Elspeth Christie
Senior Associate
Construction & Engineering Group
T +44 (0)151 237 4858
elspeth.christie@dlapiper.com

HOW WE CAN HELP

With specialists across the UK, our **Construction & Engineering Group** is uniquely placed to advise our clients in relation to all types of construction, development, engineering and infrastructure project and dispute resolution procedure - wherever they are and wherever their projects are. Find out more about our Construction & Engineering UK and global practices.

We also have a page on *LinkedIn*

We also have one of the largest global Litigation & Arbitration practices comprising of a team of experienced litigators able to represent a varied range of interests on an international basis.

REALWORLD

Construction & Engineering is part of our wider Real Estate practice - the largest group of Real Estate lawyers in the world.

REALWORLD is our interactive online guide to real estate that provides answers to the key questions that arise when entering foreign real estate markets.

The site covers questions related to sale and purchase, real estate finance, leases, construction, planning and zoning, real estate taxes and corporate vehicles. It allows users to compare the way in which issues in any two (or more) different countries are dealt with and help evaluate the possible options.

WHAT IN HOUSE LAWYERS NEED (WIN)

Knowledge, support and networking for the in-house lawyer community

WIN is the DLA Piper programme for in-house lawyers. The aim of the programme is to listen to our clients and identify the key legal and commercial issues in-house lawyers face on a day to day basis so we can tailor our services to meet their changing needs and priorities.

Many of our in-house clients are helping us shape the agenda so that it remains topical and relevant. Clients can join the discussion at www.dlapiperwin.com and tell us what topic areas are of interest for access to a master-class programme of targeted updates and educational networking events.

For more information or to request additional information on WIN please contact Richard Norman or Bethany Jennings via www.dlapiperwin.com.