



**NOVATION:  
PRINCIPLES AND PITFALLS**

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It is necessary, although somewhat elementary, to distinguish between three concepts: sub-contracting, assignment and novation.

(a) Sub-contracting

In many contracts it is immaterial as to whether a party to the contract performs his obligations himself or those obligations are performed by someone else (the sub-contractor), vicariously on behalf of the original party. The original contractor remains liable for his obligations under the contract because the burden or performance of a contract may not be assigned.

(b) Assignment

This consists of the transfer from B to C of the benefit of one or more contractual obligations that A owes to B. It is not the obligation to perform which is assigned, but the benefit of the performance. The original contract between A and B remains in existence and is unchanged. Consent is not required to give effect to an assignment. Once A has received notice of the assignment, A is bound by it, therefore if the benefit B assigns to C is the money A owes to B for B's performance of the contract between A and B, then A is bound to make payment to C in respect of the notice of assignment.

(c) Novation

This is the process by which a contract between A and B is transformed into a contract between A and C. It can only be achieved by agreement between all three of them, A, B and C. Unless there is such an agreement, neither A nor B can rid himself of any obligation which he owes to the other under the contract. This is commonly expressed in the proposition that the burden of a contract cannot be assigned, unilaterally. If A is entitled to look to B for performance of the contract, he cannot be compelled to look to C for performance instead, unless there is a novation.

A novation is therefore a tripartite agreement by which an existing contract between A and B is discharged and a fresh contract is made between A and C, usually on the same terms as the first

contract. Upon novation B ceases to be liable to A and A discharges B from any further performance. The liabilities that B has accrued and from which A would benefit prior to the novation are transferred to C so that following the novation C enjoys the benefit of those liabilities and is entitled to require the performance of the obligation that remains for B to perform. If the terms of the contract are changed by agreement of the parties then the transaction is a "variation".

Unless the new contract is of a type which statute requires to be in writing or in a particular form, then the novation does not need to be in a particular format and need not be in writing - an oral novation is effective. As a novation is a contract, consent and intention to novate are essential, and unless the novation is by way of a deed, then it must be supported by consideration.

Novation was intended for straightforward situations such as the payment of a debt, where the obligations that are novated are not affected by the identity of the new party, and early case law on novation dealt with circumstances such as payment of debts, which are one-off obligations.

The sort of situation where novation in the classic sense may occur in the construction industry is where an employer transfers its interest in a project to an associated company or sells its interest in the project to another company in an arm's-length transaction. In these circumstances one of the parties is simply substituted by another.

In recent years, however, employers have attempted to have the best of both worlds by engaging their own consultants prior to the appointment of the design and build contractor. These consultants are then novated to the design and build contractor who accepts entire responsibility for the design including any design carried out by the consultants prior to their appointment. This gives rise to a situation which has obvious differences from the classic novation. The employer and the contractor have different interests in the development. The employer does not drop out of the picture, as in the classic novation, but instead retains its interest in the project. The obligations of the consultant change, even if the novation does not expressly state this. The services the consultant would have performed for the employer will differ from those required by the contractor.

A number of issues arise as a result:

- 1 What is being novated?
- 2 What is the consultant's liability?
- 3 Problems of conflict of interest.

Addressing each of these in turn:

- 1 *What is being novated?*

So far as performance is concerned, only the obligations under the original appointment that remain to be performed. You cannot novate obligations which have already been performed. For example, if A owes B £100, and B owes C £100, then A, B and C are entitled to agree that in consideration of B discharging the debt A owes to B, then B will agree to novate A's obligation to pay £100 to C. If, however, prior to the novation A pays B £50, then following the novation, C can only demand payment of the balance, £50.

In relation to the services that have been performed, there can be no retrospective change to them, or the scope of the consultant's duty to perform them. There is, however, inevitably a change in relation to the services that have yet to be performed, following novation. A consultant's duty is now owed to the contractor and the contractor's interests and concerns are different from those of the employer. This may not only affect the manner in which the consultant performs its duties, but may call into question the content of those duties. The services that the contractor requires may be different from those the employer would have required had there been no novation. Some services of the original appointment may not be appropriate for an engagement by a contractor. An obvious example would be to assist the employer if a dispute arises with the contractor. This obligation is found in most of the services contained in the standard forms of appointment for the respective building professions. Clearly a consultant could not now perform that service, but could he assist the contractor in a dispute with the employer? There is no reason in principle why the parties should not agree to a variation of the services that remain to be performed, and that indicates that the transaction ceases to be a novation and becomes a "variation".

## 2 *What is the consultant's liability?*

Obligations performed prior to the novation were performed by the consultant for the benefit of the employer not the contractor. The liability of the consultant for the performance of the pre-novation obligations must therefore be measured against the consultant's duty owed to the employer not the contractor who was not a party to the contract at the time.

## 3 *Problems of conflicts of interest*

There is a potential for the consultant to find itself in a conflict of interest situation, particularly in relation to the services that remain to be performed. It is therefore vital to distinguish between the situation prior to novation and the situation after novation, and avoid any attempt to make the consultant answerable to both the employer and the contractor during either stage as there is a risk that the consultant may not be able to perform the appointment without breaching it. When originally appointed, the consultant may agree that the appointment will eventually be novated to the contractor this is quite usual, as the proposed deed of novation is frequently attached to the appointment. This may give rise to duties of care in tort, but in contract the consultant should not owe a duty to the contractor until it is actually engaged by the contractor and released from its contractual obligations to the employer.

All the above problems are amply illustrated in the case of *Blyth & Blyth Limited v Carillion Construction Ltd*<sup>(1)</sup>.

In this case, involving the design and construction of a leisure development in Edinburgh, a novation agreement, which purported to place upon the consultant responsibility for all services performed prior to the novation as services performed for the contractor. The consultant commenced proceedings against the contractor for non-payment of fees. The contractor counter-claimed for breaches of contract which occurred prior to the novation. The court

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<sup>(1)</sup> [2001] 79 Con LR 142

decided that the contractor could not bring proceedings against the consultant, because the contractor had suffered no loss for which the consultant owed a duty to the contractor.

This principle the court applied in *Blyth & Blyth* was stated by Lord Hoffman in the case of *South Australia Asset Management Corporation v York Montague Ltd*<sup>(2)</sup> as follows:

A duty of care such as the valuer owes does not exist in the abstract. A plaintiff who sues for breach of a duty imposed by law (whether in contract or under tort or under statute) must do more than prove that the defendant has failed to comply. He must show that the duty was owed to him and that it was a duty in respect of the kind of loss which he has suffered.

The novation agreement in *Blyth & Blyth* contained, and *Carillion* relied upon, the following clauses to argue that the scope of the consultant's duty was owed to them rather than the original employer :

The liability of the Consultant under the Appointment whether accruing before or after the date of this Novation shall be to the Contractor and the Consultant agrees to perform the Appointment and be bound by the terms of the Appointment in all respects as if the Contractor had always been named as a party to the Appointment in place of the Employer.

Without prejudice to the generality of clause 3 of this Novation the Consultant agrees that any services performed under the appointment by the Consultant or payments made pursuant to the Appointment by the Employer to the Consultant before the date of this Novation will be treated as services performed for or payments made by the Contractor and the Consultant agrees to be liable to the Contractor in respect of all such services and in respect of any breach of the Appointment occurring before the date of this Novation as if the Contractor had always been named as a party to the Appointment in place of the Employer.

*Carillion's* claims based on the above clauses were firstly that the contract was in effect re-written with the word "Employer" being substituted for "Contractor". This, as the Judge pointed out, led to nonsensical results, and conflicts of interest would arise advising on the one hand an employer and on the other hand a contractor. As a consequence the Judge considered it inherently unlikely that the intention was to "*re-cast the duty owed and performed to the employer as being a duty owed to the contractor retrospectively*".

*Carillion's* counsel accepted this must be so, and therefore *Carillion* relied upon their second argument namely that the consultant had breached the terms of its appointment by failing in duties that it owed to the Employer, these breaches being deficiencies in the Employer's Requirements which led to *Carillion's* tender being too low, and as *Carillion* had accepted responsibility for the design of the Employer's Requirements they had to bear this loss. For the reason stated in the South Australian case above this argument was doomed if the consultant's duties were not re-cast retrospectively.

The decision leaves contractors in a difficult position as they are being required to take liability for the design of the works without having recourse to the designers who have prepared the design. The problem can be overcome by the designer acknowledging that it knew the contractor would rely upon its design in the preparation of its tender prices, but potentially this

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<sup>(2)</sup> [1996] 3 WLR 87, 80 BLR 1

exposes the consultant to a conflict of interest and is, in any event, resisted by the Professional Indemnity insurers.

This case has now led to the publication of two standard forms. The first is the City of London Law Society (Construction Committee) standard form which has been published with its guidance notes which include a broad discussion of the need, timing and content of a Deed of Novation. It also includes a clause similar to Clause 4 which deals with Blyth & Blyth issues. The second is issued by the CIC which has moved away from a novation *ab initio* which the CIC think is a fiction, to an arrangement where the consultant warrants the pre-novation services to the Contractor, as well as promising to perform the post-novation services.

### Implied novation

Consent to novation may be inferred from conduct without express words.

A number of cases are authority for this proposition, for example, in *Re Towns Drainage and Sewerage Utilisation Company* (Morton's case),<sup>(3)</sup> the facts are described in the head note as follows:

M agreed to take shares in the company incorporated by an Act of Parliament, providing that the company should not issue any share nor should any share vest in the person accepting the same, unless and until a sum not being less than one-fifth of the amount of such share had been paid in respect thereof. M transferred his shares without paying one-fifth of the amount thereof; the transfer was duly registered, and M's name removed from the register of shareholders. More than a year afterwards the company commenced to be wound up.

The action was brought by the liquidator of the company being wound up against Morton, who had been placed on the list of contributories as a shareholder. Morton denied that he was liable to contribute. In his judgment, the Lord Chancellor, Lord Selborne said:

Either a payment of £100 was made in respect of these shares or it was not. If the payment was made, the transfer was valid, and the liquidator's case wholly fails. If the payment was not made, the transfer was invalid, for these shares did not vest; but if the shares did not vest the liquidator must fall back on an agreement to take shares. That agreement rested in fieri, and was capable of being discharged by a fresh agreement, as was decided in *ex parte Beresford*; and the transfer which has been executed and registered operated as a new Contract between the company, Morton and Gladstone [the transferee]. Gladstone, in effect, came in and said, 'I will take the shares instead of Morton' and both the company and Morton agreed to that. Unless the new contract is vitiated by fraud, of which I have heard nothing, the old contract with Morton is discharged, and he cannot be placed on the list of contributories.

Just how far the courts are prepared to go in inferring a novation is exemplified by the surprising decision of the Court of Appeal in *Chatsworth Investments Limited v Cussins (Contractors) Limited*.<sup>(4)</sup> In that case, the plaintiffs arranged for a building firm to undertake the erection of a building. The building firm, in turn, arranged for part of the work to be undertaken by sub-contractors. The building was completed in 1962. In 1963 the building firm assigned its assets to the defendants who undertook to discharge all the firm's liabilities. The defendants then assumed the original name of the building firm. Subsequently, in August 1966 the plaintiffs issued a writ

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<sup>(3)</sup> [1873] LR 16 Eq 104

<sup>(4)</sup> [1969] a All ER 143

claiming damages for defects which had appeared in the building. This was served on the defendants in 1967. In January 1968, the defendants put in a defence to the effect that they were not parties to the original contract. In April, the plaintiffs applied to amend their statement of claim to allege that there was a novation to be implied from the circumstances of the case whereby the defendants made a new contract with the plaintiffs to take over the liabilities of the original building firm. On the question of whether the amendment should be allowed Lord Denning paraphrased the defendants' arguments against the plaintiffs as follows:

We are not the people with whom you contracted in 1960, although we bear the self-same name. We are a different company. We did not take over until 1963. We took an assignment of the assets and we agreed to discharge the liabilities. But we did not make that contract with you.

Lord Denning went on to say that:

On the face of it, that looked like a complete defence. To overcome the difficulty, the plaintiffs applied for leave to amend their claim. They wished to allege that there was a novation whereby the second company, if I may call it so, Cussins (Contractors) Limited (No. 2) made a new agreement with them to take over and to be responsible to the plaintiffs for the liability of Cussins (Contractors) Limited (No. 1). They said that this novation was to be implied from all the circumstances of the case. The defendants objected to the proposed amendment. They said that the alleged novation was too tenuous and was wanting in particularity. There is nothing in this objection. It would be very easy to infer a novation from the circumstances of this case.

What is extremely surprising about this case is that when, in 1963, the original firm assigned its assets to the defendants who undertook to discharge all that firm's liabilities, the plaintiff was unaware that this had taken place. Accordingly, it is difficult to see how it could have possibly consented to a novation even by inference.

### **Step-in, Novation or Quasi-Novation Provisions**

Collateral warranties contain step-in, novation or quasi-novation provisions of the kind familiar to users of the BPF funder warranty. The clauses usually contain a provision which applies if the agreement between the funder and the employer for financing the works (the "finance agreement") has been terminated. The funder gives notice of this to the contractor.

The contractor is entitled (and should perhaps be required) to rely on the funder's notice as evidence of termination of the finance agreement. Typically the grounds for termination of a finance agreement by the funder are the failure to fulfil any precondition, serious and uncorrected breaches by the employer, and the employer's insolvency.

The second provision applies if the contractor wishes to determine his employment under the building contract, or to treat the building contract as having been repudiated by the employer. In either case the contractor must give notice to the funder, who may (within an agreed period) give a counter-notice to the contractor; and meanwhile the contractor must stay his hand.

In either case, that is, whether the funder gives the contractor (a) notice of termination of the finance agreement or (b) a counter-notice in response to the contractor's notice of intention to determine or to treat the building contract as repudiated, the funder's notice or counter-notice will require the contractor to accept the instructions of the funder "or its appointee" to the exclusion of the employer in respect of the works upon the terms and conditions of the building contract.

It is debatable whether or not this mechanism constitutes a novation of the building contract. Under a straightforward novation, a new building contract would come into being in place of the original one; the new contract would be between the funder and the contractor, and would be deemed to have existed *ab initio*. However, the funder's notice does not appear to bring about any such new contract; nor does it discharge the original contract. In fact there are frequently provisions which preserve the contractor's liability to the employer for any breach of the original building contract, and make it clear that the original building contract continues in full force and effect.

To complicate matters further, there is frequently a proviso which says that nothing shall relieve the contractor of any liability he may have to the employer for any breach by the contractor of the building contract while at the same time making it clear that upon the issue of any notice by the funder the contractor shall be liable to the funder under the building contract in lieu of its liability to the employer. The intention appears to be that the contractor remains liable to the employer for any loss occasioned to the employer by the contractor's breaches of the building contract occurring before the funder's notice or counter-notice; and that the contractor becomes liable to the funder for breaches occurring after the notice or counter-notice.

What then happens if the funder's notice does not lead to a straightforward novation? Analysing the position, it would appear that the original building contract continues in force on the basis that the employer and contractor have given the funder, vis-à-vis all parties, full and irrevocable authority to issue instructions to the contractor as permitted by the contract, directly or via the architect or contract administrator. The contractor remains liable to the employer for any loss occasioned to the employer by the contractor's prior breaches. The contractor becomes liable to the funder, but not to the employer, for future breaches. The funder becomes liable to the contractor for all sums owed to the contractor by the employer, including sums outstanding at the moment of step-in.

The funder's warranty therefore becomes supplemental (as well as collateral) to the building contract, and for interpretation of the building contract both agreements must be read together. The step-in rights in the warranty are thus not a true novation, which would involve the discharge of one contract and the formation of a new contract, but a quasi novation.

## **Conclusion**

Novation only gives limited protection to the contractor against the risks that it takes when being responsible for the design prepared by the employer's consultant.

The employer loses the benefit of the services of its consultant following novation and, indeed, the consultant may be required to act against the employer's interests.

Novation should, in theory, cause no problems for the consultant, providing the novation agreement does not cause any retrospective variation in the scope of its duties or conflicts of interests.

Following the *Blyth & Blyth* case, it is important for the parties to consider carefully the lists of services to be inserted in the appointment and exclude services or limit services to the pre-novation period which cannot be regarded as being performed for the contractor.

Novation of consultants and design and build contracts is now an accepted practice, and appears to benefit both the employer and the contractor provided its limitations are recognised and the novation is properly drafted.

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