Liberty Technical Update 5 - Novated Contracts

Novated Contracts And Their Insurance Implications

What are "novated contracts" and when do they take place? Importantly, from an insured's point of view, what are the insurance and financial risk exposures that have to be managed in relation to novated contracts? These issues will be discussed in this Technical Update.

Novation is a legal term used usually to describe the act of replacing a party to a contract with a new party. A contract that is transferred by the novation process transfers all rights and obligations from the original party to the new party. Agreement between all parties concerned is necessary in order to effect a novation.

When are Contracts Novated?

There are many instances in which contracts are novated. The novation process may be used for instance, in car leasing arrangements, in mortgages or as a financial option to transfer risks in and out of insurance captives. For present purposes, however, we will focus on the following instances in which contracts may be novated:

Sale of Business

When a vendor of a business sells its business, a novation agreement is usually entered into between the vendor and the purchaser so that the vendor's contractual rights and obligations to its customers are transferred to the purchaser - with the agreement of the customers. The contract usually creates an obligation on the purchaser to perform the contract with the customers in place of the vendor. In agreeing to the novation, the purchaser is agreeing to be liable to the customers for any breaches of contract carried out by the vendor prior to the novation ("antecedent breach"). Typically, however, a purchaser of a business would seek an indemnity from the vendor in relation to liability incurred by the vendor against any costs, loss or damage arising from such antecedent breach.

Novation of Consultancy Agreements in D&C Contracts

The "traditional" method of procurement for a construction project is one whereby the contractor is responsible only for the construction works. Design & Construct ("D&C") contracts have, however, become a common and indeed preferred method of procurement these days. They have been widely used on large scale, complex engineering and infrastructure projects for many years. In the last decade or so, D&C contracts have also gained widespread acceptance in the property development market.

Under these contracts, the contractor is responsible for both the design and the construction works. In reality however, whilst the appointed contractors are responsible for the design and the construction works, most principals of projects or property developers would have appointed design consultants even before the appointment of the contractor.

In the case of large infrastructure projects, a principal is likely to engage design consultants early on in the project to prepare, design or detail the project requirements prior to the engagement of a contractor to carry out the works. This early planning process may be necessary, for example, for planning permission or financing purposes. Similarly, in the case of property development, property developers engage project designers and consultants before the appointment of the D&C contractor so that they can prepare preliminary design documentation for the purposes of marketing the development to prospective purchasers or lessees.

In both cases, once a D&C contractor has been appointed, the contractor then agrees to take over the engagement of the design consultant from the principal/developer in its D&C contract. In that event, the design service contract between the principal/developer and the design consultant is extinguished and, with the consent of all parties concerned, a new contract is formed between the contractor and the design consultant. All the rights and obligations under the first contract are novated to the new D&C contract.

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Early Contractor Involvement (ECI) Delivery

In some of the major projects, an ECI delivery model is used. The ECI model can best be described as a negotiated D&C contract involving a two-stage process. The D&C contractor is engaged, under a service agreement, very early in the process (Stage 1) to develop the design of the project to a stage where it can be accurately priced. Stage 1 finishes with the contractor submitting a Stage 2 offer. If accepted, Stage 2 is similar to a D&C contract whereby the contractor completes the design and constructs the works. If another contractor is successful in relation to Stage 2, the contract with the first contractor is then novated to the second contractor who would then assume all responsibility for the design documentation prepared by the first contractor prior to the date of novation.

Risk Exposures and Insurance Implications

Generally, most novation agreements provide for mutual release and discharge of liabilities by the original two parties to the first contract. The original two parties may also provide warranties and indemnities to protect the new contracting party from liabilities arising from work the original parties performed prior to the novation. For instance, in the case of design consultants, the new contract may contain additional requirements such as an obligation to indemnify the previous principal and the contractor for any costs, loss or damage arising from the design work carried out prior to the date of novation. Consultants need to understand their rights and obligations under the original contract and, where possible, maintain that risk profile in the subsequent contract created by the novation.

Conversely, the new contract may also impose obligations and liabilities on the new contracting parties that would not otherwise have existed but for that contractual agreement. For example, in the case of novated business contracts, whilst there may be indemnities in place to protect the purchaser, the indemnity may not be sufficiently exhaustive or it may be limited. Similarly, for contractors, they may bear the risk of design defects when they accept the design works carried out by design consultants that they had not originally retained. Some contracts require the contractor to warrant that they can comply with their obligations under the D&C contract without the need to change the existing design.

As far as managing risk exposures is concerned, insureds (be they purchasers of a business, contractors or design consultants) should be aware that, when contracts are being novated, they may be assuming liabilities by virtue of the agreement – liabilities which may not have existed at law but for the agreement.

It is crucial to note that most professional indemnity liability (PI) policies do not cover insureds for "liability which the insured has assumed under a contract unless liability would have attached in the absence of such contract". This contractual liability exclusion is typically found in most PI policies. Such policy wordings may result in the above liabilities being excluded from cover.

LIU has designed an extension which offers protection to insureds who may have assumed liabilities by virtue of novated contracts. In our new Australian Construction PI policies we offer an optional extension called "Novated Contracts" which, subject to the wording of the extension and the policy exclusions, covers claims for contractual liability assumed by the insured by virtue of novated contracts, provided those contracts are specifically noted in the policy. You can click here to see the extension.

It is clearly important for an insured to appreciate their risk exposures when novation of contract takes place and to read their policy wording very carefully to ensure that they know where they stand in the event of a claim.

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