Novation in construction contracts – what does it really mean?

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Novation is a significant feature of building and construction projects, particularly in relation to design and construct (D&C) procurement.

It is important for construction industry participants (particularly principals, head contractors and consultants) to have a sound understanding of the concept, a failure of which can have unintended consequences.

What is novation?

Novation is a legal concept that, at its core, aims to achieve a process of substitution. It is a transaction by which, with the consent of all the parties concerned, a new contract is substituted for one that already exists.

The effect of a novation is to discharge the original contract between two parties (the continuing party and the outgoing party) and substitute it with a new contract between the continuing party and a new party (the incoming party). The incoming party must perform the contractual obligations (under the new contract) that were formerly owed by the outgoing party under the original contract.

For example, it is common under a D&C arrangement for the principal to engage a consultant to carry out design works prior to the principal engaging a head contractor to carry out the construction works. At some point during the project (for example when the design has reached a particular stage) the principal may novate the appointments of its design consultants to the head contractor. Novation fundamentally changes the risk allocation in the project, as the head contractor generally then assumes responsibility for the entire design (including the prior design work).
Novation vs assignment

Novation is often confused with the concept of assignment, however these are two distinct concepts:

- Novation transfers both the rights and obligations of the outgoing party to the incoming party, whereas assignment is a transfer of rights only. It is not possible to assign contractual obligations to another party.
- Novation requires the consent of all parties in order for it to be valid (i.e. by way of tripartite agreement). Conversely, a contract may be assigned without consent (unless there is a contractual provision to the contrary).
- Novation gives rise to a new agreement on the same terms as the original agreement, with the original agreement being discharged. Once an assignment occurs, the original contract is not extinguished and, consequentially, the assignor will remain bound by any prospective obligations and liabilities under it.

Novated consultants beware

Most standard forms of D&C contract provide for novation as well as including standard novation deeds (for example, Annexure Part D of AS4902-2000) (standard deed of novation).

Issues that should be considered and addressed by parties to a deed of novation include:

Release

The provisions of the standard novation deed include a general release, whereby the outgoing party and continuing party release each other from all claims in connection with the original contract.

It is important to be clear about the scope of the release and its timing, and to tailor the drafting of the novation accordingly. A ‘first principles’ understanding of the concept of novation is essential. A lack of understanding can lead to unintended consequences.
For example, in MWH Australia Pty Ltd v Wynton Stone Australia Pty Ltd (in liq) the Victorian Court of Appeal was scathing about a poorly drafted “Transfer Agreement”, saying:[1]

“Insofar as it uses the nomenclature of transfer, it has clearly been drafted and executed by individuals without a complete understanding of the law of novation.”

Therefore, parties should seek to clarify the effect of the novation on accrued rights, claims and demands in connection with the original contract as well as all future rights, claims and demands.

Warranty

The provisions of the standard deed of novation include a warranty by the outgoing party and the continuing party that the continuing party’s work performed under the original contract is in accordance with the provisions of the original contract.

Beware of the risks of such a seemingly benign promise. The novated consultant has now given a stand-alone contractual warranty that its services complied with the original contract. Many professional indemnity policies exclude indemnity for “contractually assumed liability” where that liability doesn’t also arise in the absence of the contract (for example a claim in negligence). Spot the potential black hole, which insurance might not cover in the event of a claim.

Manage the risk

Therefore, the key point is that the consultant’s insurance program needs to be carefully tailored to address this potential hole. Don’t let your expensive insurance program be an “umbrella for a sunny day”.

In next month’s update, we will provide a summary of a recent case that illuminates some practical consequences of a failure to properly manage this risk.
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