

26.1 INTRODUCTION

26.1.1 In most projects, the Contractor will need to use some type of IP in order to deliver the Service. The Contractor may use IP developed by a third party or by itself. Such IP may have a general application or may be specifically developed for the relevant Project. If the Contractor uses IP developed by and belonging to a third party, the Contractor will need a licence to use such IP¹.

26.1.2 The Contract must require the parties not to breach any terms of any licence to use IP and not to infringe the IPR of any owner of IP used. The Contract must set out what happens if any breach or infringement of IPR occurs.

26.1.3 In PFI there is a presumption that the Authority does not need to own the tangible assets created as a result of the Project. This should apply equally to intangible assets such as IPR, though the Authority may inherit free, or have an option to purchase IPR which is the core to the continuity of the Service (e.g. specially written software). Irrespective of who “owns” the IP, however, the Contract must ensure that the Authority is able to use any IP required to provide the Service if it takes over the Service or employs/procures a third party to perform the Service (e.g. on expiry or early termination of the Contract).

26.1.4 Where IP and IPR are of central importance to the Contract (e.g. in IT projects and certain defence projects, most notably equipment projects) further refinements and developments of the issues outlined in this Section may be appropriate².

26.2 INFRINGEMENT OF IPR BY THE CONTRACTOR

26.2.1 The general principle is that any costs resulting from infringement by the Contractor of IPR should be borne by the Contractor. It should be responsible for any costs of the owner of the IPR and the Authority. This will normally require the Contractor to offer an indemnity to the Authority.

26.2.2 If the infringement or related legal action threatens the delivery of the Service, the Authority should be notified as soon as possible. The Authority should be obliged to provide reasonable assistance to the Contractor in defending any legal action, but this should not extend to meeting any costs of the Contractor’s defence.

26.3 INFRINGEMENT OF IPR BY THE AUTHORITY

26.3.1 If the Authority infringes IPR (either during the course of the Contract, other than when using IPR for the purpose of the Contract or where the infringement results from the act or omission of the Contractor, or after expiry or termination, it should generally bear any resulting costs. The Authority should bear the owner’s costs and any costs incurred by the Contractor (e.g. if sued by the owner or if it has to procure a licence of different IPR from another party). This will normally require the Authority to offer an indemnity to the Contractor.

¹ If the Authority owns IPR that will be required by the Contractor in order to carry out the project, the Authority should consider how it intends to allow the Contractor to use such IPR during the term of the Contract.

² Reference should also be made to the “Decision Map Guidance for Procurement of IT-enabled Projects” published for consultation by the Office of Government Commerce.

26.3.2 The Authority may contribute IP to the Project for the Contractor to use. If it does not own the relevant IPR, it must ensure that it is entitled to pass it on to the Contractor (e.g. by way of sub-licence). If the Authority infringes the owner's IPR by passing the relevant IP on to the Contractor, the Authority should be liable for any resulting costs unless Section 26.3.3 applies.

26.3.3 If the Contractor uses any IP which the Authority has brought into the Project, it should ensure that it is entitled to do so. It will be liable for any infringement by it unless it is unable (acting reasonably) to verify such matter.

26.4 RIGHTS TO IPR ON EXPIRY OR TERMINATION

26.4.1 The Contract will also need to deal with what happens to IPR on a termination (whether early (see Section 20 (Early Termination)) or on expiry of the Contract (see Section 19 (Termination on Expiry of Service Period)), particularly in circumstances in which software or similar assets have been developed for the specific project. Examples of this would be an IT project or a similar project, where if the Project is to be transferred to the Authority on a termination then IPR should also be transferred as the Project would be unworkable without this.

26.4.2 Generally, the Authority should be entitled to a free and perpetual licence of IPR specifically developed for the Project (e.g. specially written software) for use in that project only (either by it or an alternative provider of the Service). The Authority should not usually attempt to extend its right to use such IPR in other projects but should be entitled to negotiate a price for its use on other projects³, having taken into account any development costs incurred in producing that software. Particular issues may arise on certain projects that make such licences impossible to obtain.

26.4.3 In respect of other IPR central to the Project such as third party software licences, the Contractor should ensure that the Authority is either entitled to a novation of such licences or has the right to obtain a licence of such software at commercial rates. It is for the Contractor to ensure that any licence it (or its Sub-contractors) enters into reflects these requirements. If the Contractor is unable to ensure that the Authority will have the benefit of all necessary IPR, it must indemnify the Authority against any costs incurred due to such non-availability. For example, if the Contractor chooses to use proprietary software, it must bear the risk if the owner will not agree to licence such software to the Authority or replacement Contractor. Similarly, the Contractor must bear the risk of the owner of the relevant IPR being prevented from licensing such IPR to the Authority or replacement Contractor due to trade restrictions imposed by its Government. If the Contractor does not want to bear such risks, it should find alternative IPR which is capable of being licensed to the Authority.

26.4.4 In addition to ensuring that the Authority has the right to use IPR required to continue provision of the Service (e.g. on expiry, early termination or Authority step-in), arrangements should wherever possible be put in place to ensure that the Authority has immediate access to such IPR and any information required to operate it. For example, source codes of IT products should be held in escrow by an independent party (e.g. the National Computer Centre). It should be noted that an additional or new service provider will need access to IPR in advance of the Expiry Date or the commencement of its service contract in order to acquaint itself with the Service and allow a smooth handover and such access rights should be negotiated in advance, rather than left to be resolved on termination.

³ If it is likely that the Contractor will be able to commercially exploit any IPR developed for the Project, the Authority should consider whether or not revenues from IPR exploitation are likely to be significant and whether it should require the Contractor share any such revenues with the Authority.

27.1 INTRODUCTION

The Contract must specify a procedure for handling disputes under the terms of the Contract.

27.2 DISPUTE RESOLUTION PROCEDURE

27.2.1 As going through the courts may not be appropriate for the disputes that can arise under a PFI contract, an alternative formal dispute resolution procedure may offer a more efficient and cost-effective method of resolving disputes.

27.2.2 A common form of dispute resolution involves a three stage process as follows:

- the Authority and Contractor consult with each other for a fixed time period (possibly involving different levels of internal consultation) in an attempt to come to a mutually satisfactory agreement;
- if consultation fails, the parties may then (except in the case of certain types of dispute) put their case before an expert to decide. The expert is appointed from a panel (e.g. of construction or operation experts) whose appointment is regulated by the Contract. It may be appropriate in certain circumstances to substitute other forms of Alternative Dispute Resolution (“ADR”)¹ for this type of expert determination. Disputes relating to the mechanics of price variations may go to a financial expert agreed between the parties at the time²; and
- if either party is dissatisfied with the expert’s decision, it may refer the matter either to arbitration (itself a form of ADR) or to the courts for a final and binding decision. The method of appointing the arbitrator should be set out in the Contract.

27.2.3 It is often proposed that a fast-track dispute resolution process is included in the contract to deal with certain pressing issues. The drafting included below reflects the procedure set out in the Housing Grants, Construction and Regeneration Act 1996, so is, by nature, fast track and construction related³.

¹ Other forms of ADR which may be considered include mediation, conciliation and neutral evaluation. These will not be appropriate where there are Project Documents which are subject to the Housing Grants, Construction and Regeneration Act 1996. Binding expert determination without recourse to the courts may also be appropriate in certain IT contracts where the dispute is about a technical matter.

² To enable the financial expert to reach an appropriate resolution (particularly where the dispute concerns the pricing of a change in accordance with Section 12 (Change in Service) which may result in the Contractor implementing a change at a price it considers too low) suitable terms of reference should be agreed in advance and provided to the expert in accordance with the relevant approach taken to such changes in the Contract (see Section 5.2.3 (Calculation of Compensation)). As Section 5.2.3 (Calculation of Compensation) makes clear, the agreed approach will depend on the risk profile of the Project, and the pricing approach adopted in the Contracts and sub-contracts. See also footnote 9 below.

³ The specifics of IT and defence projects may require particular treatment in defining a suitable dispute resolution procedure. See footnote 1 above.

27.3 JOINDER OF SUB-CONTRACT DISPUTES

27.3.1 The Contractor and its Sub-contractors may request the right to join their disputes into a dispute under the Contract if the same issues are involved. This should generally be resisted by the Authority as it will only increase the time and cost of the process for the Authority. The Authority should not automatically become embroiled in the Contractor's disputes with its Sub-contractors, particularly as the Contractor should in any case ensure that, as far as possible, decisions under the Contract flow down the contractual chain (although see Section 27.4.3 below). This is achieved through proper structuring of the sub-contracts and is an issue on which financiers will insist. It may, however, be possible to agree joinder in relation to certain limited matters (such as disputes arising out of the Tests referred to in Section 3.6 (Acceptance and Service Commencement)).

27.3.2 The Authority may, also, be willing to adopt a compromise position. This allows the Sub-contractors the right to make written representations to the arbitrator/adjudicator as part of the Contractor's case in a dispute under the Contract where that dispute relates to issues in dispute under the relevant sub-contract. The arbitrator/adjudicator will not determine the sub-contract dispute itself, so in order for his decision on the Contract dispute to be binding on the Contractor and the Sub-contractor, they must separately agree to be bound by the decision of the arbitrator/adjudicator in respect of that matter as between themselves.

27.4 HOUSING GRANTS, CONSTRUCTION AND REGENERATION ACT 1996

27.4.1 This Act came into force in May 1998 and affects Contracts with construction-type obligations (including maintenance). It gives Construction Sub-contractors certain rights e.g. to receive staged payments according to work completed and sets out a fast track dispute resolution procedure.

27.4.2 It is not possible to contract out of the Act so its effect should be considered in relation to each contract in a PFI project. PFI contracts are specifically excluded, however, from the Act's application by virtue of Article 4 of the Construction Contracts (England and Wales) Exclusion Order 1998 (and Article 4 of the Construction Contracts (Scotland) Exclusion Order 1998) provided that they fulfil the conditions set out in that Article. For example, the Contract must state that it is entered into under the PFI (or, as the case may be, under a project applying similar principles). It may also be useful for the Contract to clarify which other conditions it fulfils to qualify as being excluded from the application of the Act.

27.4.3 This exclusion is not generally considered to extend to PFI sub-contracts. The result of this is that there is a risk that the Sub-contractors are entitled to rights as against the Contractor (under the Act) (e.g. to receive a staged payment) to which the Contractor is not entitled as against the Authority (as the Act does not apply). In order to avoid this situation, the Contractor must ensure its contractual arrangements are adequate (e.g. rights and entitlements under the sub-contracts are, without contravening the Act, sufficiently conditional on the operation of the Contract). One means (amongst a number) is to provide that Sub-contractors' rights to receive payment should only arise once certain criteria under the Contract itself have been satisfied (which would typically also trigger the Contractor's

right to receive payment). This is not (it is generally considered) the same as the Sub-contractor only receiving payment once the Contractor has been paid by the Authority. The Contract should not be amended (unless joinder is agreed⁴) simply to conform with the Project Documents which are governed by the Act as this is unnecessary. Moreover, the recommended dispute resolution procedure in the Contract is similar to the procedure set out in the Act, so some degree of conformity can be achieved without significant detriment to the Authority.

27.4.4 To the extent the Act applies to a PFI sub-contract⁵, the Authority may be asked to add particular provisions to deal with problems described in paragraph 27.4.3 above (e.g. provisions other than suggested above). The Authority should seek to accommodate reasonable approaches that are designed to deal with the effects of the Act, recognising that different Contractors and advisers will take different approaches to the issue. The Authority can, in most cases, accept one of a number of approaches already in operation in the market since they would not impact negatively on the position of the Authority (examples include the parallel loan structure). The Authority should, however, consider any suggested provisions that are Act driven in the context of the deal under negotiation to ensure that its position is commercially the same as it would be were the Act not to apply to the PFI sub-contract concerned.

27.5 DELAYS CAUSED BY DISPUTES

27.5.1 Contractors sometimes try to include disputes between the Authority and the Contractor under the Contract in the list of Relief Events on the basis that they cannot continue work until the dispute is resolved. This issue arises during the construction phase in particular. This is not standard practice and should be resisted. The Contractor (and the Sub-contractors) should not be permitted to “down tools” just because a dispute has arisen. If no other course of action can be taken (usually towards the end of the construction phase, but also at critical stages), then the issues involved can give rise to relief.

27.5.2 The Contractor must be under an obligation to carry on with the Service in accordance with the Authority’s wishes while any dispute is being carried on, even if this involves building or covering over construction works which may need rebuilding or opening up if the dispute is resolved in the Contractor’s favour. The Contractor must rely on the expert or arbitrator awarding adequate compensation if the dispute is resolved in the Contractor’s favour.

27.5.3 The Authority should recognise that if the dispute is resolved in the Contractor’s favour, the Authority will typically be liable for the Contractor’s costs. These could include any extra costs incurred in rebuilding (such as staff costs and materials costs) and any resulting costs incurred by the Contractor if a delay to Service Commencement results. Delays caused by the Authority failing to comply with the relevant dispute resolution procedure should be taken into account in the arbitrator’s determination.

⁴ See Section 27.3 above for reasons why the Authority should generally resist requests to include joinder of disputes.

⁵ See Section 104 of the Act for the definition of a “construction contract” to assess the extent to which the Act applies to a PFI sub-contract.

Required drafting is as follows:

27 Dispute Resolution⁶

- (a) Any dispute arising in relation to any aspect of the Contract shall be resolved in accordance with this Clause.
- (b) If a dispute arises in relation to any aspect of this Contract, the Contractor and the Authority shall first consult in good faith in an attempt to come to an agreement in relation to the disputed matter⁷.
- (c) If the Contractor and the Authority fail to resolve the dispute through such consultation within [7] days, either party may refer the matter to an Adjudicator selected in accordance with paragraph (d) below⁸.
- (d) The Adjudicator nominated to consider a dispute referred to him shall be selected on a strictly rotational basis from the relevant panel of experts appointed in accordance with the following:
 - (i) there shall be two panels of experts, one in respect of construction matters (**Construction Panel**) and one in respect of operational and maintenance matters (**Operational Panel**)⁹. All the experts on each panel shall be wholly independent of the Contractor, the Authority, the relevant Sub-contractor and any of the major competitors of the Contractor or relevant Sub-contractor;
 - (ii) the Construction Panel shall be comprised of [3] experts who shall be appointed jointly by the Contractor and the Authority. Such appointments shall take place within [28] days of the date of this Contract¹⁰;
 - (iii) the Operational Panel shall be comprised of [3] experts who shall be appointed jointly by the Contractor and the Authority. Such appointments shall take place on or before the Service Commencement Date¹¹;
 - (iv) if any member of a panel resigns during the term of the Contract, a replacement expert shall be appointed by the Contractor and the Authority as soon as practicable;
 - (v) if the Authority and the Contractor are unable to agree on the identity of the experts to be appointed to the panel(s), the President for the time being of the Chartered Institute of Arbitrators shall appoint such expert(s) within 30 days of any application for such appointment by either party.

⁶ The terminology in Scotland will be different to that used in this Clause.

⁷ The parties may wish to incorporate some form of Alternative Dispute Resolution – if this is the case, government policy should be followed and the Treasury Solicitor’s Department or the HMT should be consulted. Developments in the market on Alternative Dispute Resolution will be kept under review.

⁸ See footnote 3 above.

⁹ The parties shall consider how they wish to deal with disputes of a financial (rather than construction or operational) nature and ensure the Contract contains appropriate provisions. The parties may want to appoint a panel of financial experts in the way set out in Clause 27(d) or may prefer to appoint a financial expert by mutual agreement at the time of the dispute. As currently drafted, financial disputes could be referred straight to arbitration (see Clause 27(l)(i)) so parties may prefer to include an intermediate level of dispute resolution. The parties should also consider the likelihood of overlapping disputes arising of both a construction and operational nature. If such disputes are likely, a procedure will need to be developed for deciding which of the Construction Panel or Operational Panel should preside over the dispute’s resolution.

¹⁰ It is essential that such appointments are made as soon as possible after Contract signature so that the panel is in place in time to deal with any construction disputes arising.

¹¹ If operational disputes are capable of arising prior to the Services Commencement Date, an earlier date should be specified for such appointments.

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- (e) Within 7 days of appointment in relation to a particular dispute, the Adjudicator shall require the parties to submit in writing their respective arguments. The Adjudicator shall, in his absolute discretion, consider whether a hearing is necessary in order to resolve the dispute.
 - (f) In any event, the Adjudicator shall provide to both parties his written decision on the dispute, within 28 days of appointment (or such other period as the parties may agree after the reference, or 42 days from the date of reference if the party which referred the dispute agrees). The Adjudicator shall not state any reasons for his decision¹². Unless and until revised, cancelled or varied by the Arbitrator, the Adjudicator's decision shall be binding on both parties who shall forthwith give effect to the decision¹³.
 - (g) The Adjudicator's costs of any reference shall be borne as the Adjudicator shall specify or, in default, equally by the parties. Each party shall bear its own costs arising out of the reference, including legal costs and the costs and expenses of any witnesses.
 - (h) The Adjudicator shall be deemed not to be an arbitrator but shall render his decision as an expert and the provisions of the Arbitration Act 1996 and the law relating to arbitration shall not apply to the Adjudicator or his determination or the procedure by which he reached his determination.
 - (i) The Adjudicator shall act impartially and may take the initiative in ascertaining the facts and the law. The Adjudicator shall have the power to open up, review and revise any opinion, certificate, instruction, determination or decision of whatever nature given or made under this Contract¹⁴.
 - (j) All information, data or documentation disclosed or delivered by a party to the Adjudicator in consequence of or in connection with his appointment as Adjudicator shall be treated as confidential. The Adjudicator shall not, save as permitted by Clause 25 (Confidential Information), disclose to any person or company any such information, data or documentation and all such information, data or documentation shall remain the property of the party disclosing or delivering the same and all copies shall be returned to such party on completion of the Adjudicator's work.
 - (k) The Adjudicator is not liable for anything done or omitted in the discharge or purported discharge of his functions as Adjudicator unless the act or omission is in bad faith. Any employee or agent of the Adjudicator is similarly protected from liability.

¹² The parties should ensure that the relevant insurers and insurance policies will recognise the Adjudicator's decision and process claims accordingly if this is the case, as this could have important implications for both parties.

¹³ The timing of this process matches the fast track procedure set out in the Housing, Grants, Construction and Regeneration Act 1996. The fast track nature favours the claimant as the defendant will be under time pressure to prepare its case – see Clause 27(e). The parties should consider if the timing is appropriate for all types of dispute envisaged and adjust the standard drafting if required.

¹⁴ This should be the case unless the parties agree that any relevant opinion, certificate etc. should be binding and conclusive on the parties.

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- (l) If:
- (i) there is any dispute in respect of matters referred to in Clauses 12 (Change in Service), Clause 13 (Change in Law), [Clause 14 (Price Variation)], Clause 20.1.3 (Compensation on Authority Default, [Section 20.2.5 (Compensation on Termination for Contractor Default)], Clause 20.3.4 (Compensation on Termination for Force Majeure), [Section 20.4.3 (Compensation on Termination for Corrupt Gifts and Fraud)] or Clause 20.5.2 (Compensation on Voluntary Termination); or
 - (ii) either party is dissatisfied with or otherwise wishes to challenge the Adjudicator's decision made in accordance with Clause []; or
 - (iii) both parties agree,

then either party may (within [28] days of receipt of the Adjudicator's decision, where appropriate), notify the other party of its intention to refer the dispute to arbitration¹⁵. Such notification shall invite the other party to concur in the appointment of a sole arbitrator who shall be a solicitor, barrister or arbitrator recognised by the Chartered Institute of Arbitrators of not less than 10 years' standing (the Arbitrator). If the parties are unable within 14 days to agree the identity of the Arbitrator either party may request the President of the Law Society to make the appointment.

- (m) The Arbitrator shall have the power to open up, review and revise any opinion, certificate, instruction, determination or decision of whatever nature given or made under this Contract, to vary or cancel the decision of the Adjudicator and, where appropriate, to order financial compensation to be paid by one party to the other. The arbitration shall take place in London.
- (n) The Arbitrator shall in his absolute discretion, make such procedural directions as he considers necessary such as ordering the parties to provide written submissions within such time period as he considers appropriate and/or to attend such hearings as he deems necessary.
- (o) The Arbitrator shall deliver his decision on any matter referred to him within 28 days of concluding any hearings which may have been held in connection with the matter and in any event within 3 months (or such other period as the parties may agree) of his appointment. The Arbitrator's decision shall be in writing and shall state his reasons for his decision. The decision of the Arbitrator shall be final and binding on both parties. The costs of the arbitration will be in the discretion of the Arbitrator.
- (p) The parties shall continue to comply with, observe and perform all their obligations hereunder regardless of the nature of the dispute and notwithstanding the referral of the dispute for resolution under this Clause and shall give effect forthwith to every decision of the Adjudicator and the Arbitrator delivered under this Clause.

¹⁵ Either party may agree to go to court at this stage instead of arbitration. In addition, the parties may wish to address expressly the right to apply to the courts for interlocutory relief at any stage in support of the adjudication or arbitration (assuming the arbitrator does not have such powers). If so, the need to appoint agents for service of process on overseas parties will arise.

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- (q) If any dispute arising under this Contract raises issues which relate to:
- (i) any dispute between the Contractor and the Construction Sub-contractor arising under the Construction Sub-contract or otherwise affects the relationship or rights of the Contractor and/or the Construction Sub-contractor under the Construction Sub-Contract (the “Construction Sub-contract Dispute”); or
 - (ii) any dispute between the Contractor and the Operating Sub-contractor arising under the Operating Sub-contract or otherwise affects the relationship or rights of the Contractor and/or the Operating Sub-contractor under the Operating Sub-contract (the “Operating Sub-contract Dispute”), then the Contractor may include as part of its submissions made to the Adjudicator or to the Arbitrator, where the dispute is referred to arbitration, submissions made by the Construction Sub-contractor or by the Operating Sub-contractor as appropriate.
- (r) The Adjudicator or the Arbitrator, as appropriate, shall not have jurisdiction to determine the Construction Sub-contract Dispute or the Operating Sub-contract Dispute but the decision of the Adjudicator or the Arbitrator shall, subject to Clause 27(1), be binding on the Contractor and the Construction Sub- Contractor insofar as it determines the issues relating to the Construction Sub-contract Dispute and on the Contractor and the Operating Sub-contractor insofar as it determines the issues relating to the Operating Sub-contract Dispute.
- (s) Any submissions made by the Construction Sub-contractor or the Operating Sub-contractor shall:
- (i) be made within the time limits applicable to the delivery of submissions by the Contractor; and
 - (ii) concern only those matters which relate to the dispute between the Authority and the Contractor under this Contract.
- (t) Where the Construction Sub-contractor or the Operating Sub-contractor makes submissions in any reference before:
- (i) the Adjudicator, the Adjudicator’s costs of such reference shall be borne as the Adjudicator shall specify, or in default, one-third by the Authority and two-thirds by the Contractor; and
 - (ii) the Arbitrator, the costs of the arbitration shall be in the discretion of the Arbitrator.
- (u) The Authority shall have no liability to the Construction Sub-contractor or the Operating Sub-contractor arising out of or in connection with any decision of the Adjudicator or Arbitrator or in respect of the costs of the Construction Sub-contractor or the Operating Sub-contractor in participating in the resolution of any dispute under this Contract.

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- (v) The Contractor shall not allow the Construction Sub-contractor or the Operating Sub-contractor access to any document relevant to the issues in dispute between the Authority and the Contractor save where:
 - (i) the document is relevant also to the issues relating to the Construction Sub-contract Dispute or the Operating Sub-contract Dispute as the case may be; and
 - (ii) the Contractor has first delivered to the Authority a written undertaking from the Construction Sub-contractor and/or the Operating Sub-contractor (as appropriate) addressed to the Authority that they shall not use any such document otherwise than for the purpose of the dispute resolution proceedings under this Contract and that they shall not disclose such documents or any information contained therein to any third party other than the Adjudicator or Arbitrator or any professional adviser engaged by the Construction Sub-contractor or the Operating Sub-contractor (as appropriate) to advise in connection with the dispute.

28.1 INTRODUCTION

28.1.1 In some circumstances, the Authority may wish to take action itself in relation to the Service if there is a need to prevent or mitigate a serious risk to health, safety (person or property) or the environment to discharge a statutory duty. Such a right may arise due to matters outside the scope of the work of the Contractor or may arise due to the Contractor being in breach of certain of its obligations under the Contract.

28.1.2 Such a right of the Authority is often referred to as “step-in” (and this is the terminology used here for that reason), as it involves the Authority taking over some or all of the obligations of the Contractor for a period. It should, however, be viewed as being entirely different in nature and purpose from a step-in by Senior Lenders under a direct agreement (see Section 30 (Direct Agreement)) and separate from the Contractor Default provisions (see Section 20.2 (Termination on Contractor Default)). Essentially, the focus of the right is a serious short term problem that can or must be solved quickly, where the Authority is in a better position to do this than the Contractor. The Authority should not in any situation be obliged to step-in.

28.2 STEP-IN – GENERAL

Required drafting for such a right of step-in is as follows:

28 Authority Step-In

- (a) If the Authority reasonably believes that it needs to take action in connection with the Service:
- (i) because a serious risk exists to the health or safety of persons or property or to the environment¹; and/or
 - (ii) to discharge a statutory duty,
- then the Authority shall be entitled to take action in accordance with paragraphs (b) to (e) below.
- (b) If paragraph (a) applies and the Authority wishes to take action, the Authority shall notify the Contractor in writing of the following:
- (i) the action it wishes to take;
 - (ii) the reason for such action;
 - (iii) the date it wishes to commence such action;
 - (iv) the time period which it believes will be necessary for such action; and
 - (vi) to the extent practicable, the effect on the Contractor and its obligation to provide the Service during the period such action is being taken.

¹ Other considerations may be important in other projects, such as those involving national security. In any event, the MOD will normally require a similar right to step-in during “a period of tension, transition to war, or hostilities or where it is directed to respond to any national or international emergency, disaster or other unforeseen risk”.

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- (c) Following service of such notice, the Authority shall take such action as notified under paragraph (b) above and any consequential additional action as it reasonably believes is necessary (together, the “**Required Action**”) and the Contractor shall give all reasonable assistance to the Authority while it is taking such the Required Action.

28.3 STEP-IN WITHOUT CONTRACTOR BREACH

28.3.1 If there has been no breach, in the circumstances set out above (i.e. those set out in Clause 28(a) (Authority Step-In)) the Authority should notify the Contractor that it plans to step-in and the extent of such step-in. To the extent the Authority steps in, it will be effectively removing any obligations affected by such step-in from the Contractor and performing them itself.

28.3.2 During its step-in, as the Authority needs to act for reasons external to the Contract, the Authority should pay for the Service as if the Service had been fully performed, subject only to any deductions to be made in respect of parts of the Service still provided by the Contractor (e.g. to reflect performance on that part) and unaffected by the Authority’s step-in². To the extent aspects of the Service are affected by the Authority’s step-in, the Authority should make full payment in respect of such aspects and its right to terminate for non-performance should be suspended. Payment should also be conditional upon the Contractor agreeing to provide reasonable assistance to the Authority at this time (provided the Authority reimburses the Contractor for any extra costs it incurs).

28.3.3 The Authority should bear all its own costs incurred by stepping in, in this circumstance.

Required drafting for the circumstances in which Clause 28 (a) above applies is as follows:

- (d) If the Contractor is not in breach of its obligations under the Contract, then for so long as and to the extent that the Required Action is taken, and this prevents the Contractor from providing any part of the Service:
- (i) the Contractor shall be relieved from its obligations to provide such part of the Service; and
 - (ii) in respect of the period in which the Authority is taking the Required Action and provided that the Contractor provides the Authority with reasonable assistance (such assistance to be at the expense of the Authority to the extent incremental costs are incurred), the Unitary Charge due from the Authority to the Contractor shall equal the amount the Contractor would receive if it were satisfying all its obligations and providing the Service affected by the Required Action in full over that period³.

28.4 STEP-IN ON CONTRACTOR BREACH

28.4.1 If the Contractor is in breach of an obligation under the Contract, the Authority should notify the Contractor of such breach. This will generally occur through the monitoring arrangements and, in such circumstances, it is then up to the Contractor to rectify the breach within the agreed timetable.

² The parties will need to consider appropriate alternative arrangements for projects involving usage-based payment schemes based on third party revenue. See also footnote 3 below.

³ The parties will, to the extent relevant, need to consider how an appropriate forecast for any third party income can be made.

28.4.2 If the breach gives rise to a need for the Authority to step-in in the circumstances set out above (i.e. those set out in Clause 28 (a) (Authority Step-In)) and the Contractor has failed to remedy the breach within the agreed time period, the Authority should have the right to step-in and carry out such rectification itself (for example, using a third party) at the Contractor's expense.

28.4.3 Where the Authority steps-in upon Contractor breach, the Authority should continue to pay the Contractor as where there is no breach (see Section 28.3.2). In addition, the full Unitary Charge should be paid for all aspects of the Service that are affected by the Authority's step-in which were not previously affected by the Authority's step-in, the Authority should make full payment in respect of such aspects, subject again here to the obligation on the Contractor to provide reasonable assistance to the Authority. Its right to terminate for non-performance should be similarly suspended unless the step-in is coterminous with the breach by the Contractor in which case this is not necessary.

28.4.4 The Authority should, however, be entitled to set off any costs it incurs in stepping in such circumstances (i.e. for both costs of work and advice and for time devoted to running the operations) against the Unitary Charge payable to the Contractor. The Contractor should be relieved of its obligations to continue the running of the relevant part of the operation concerned while the Authority has stepped in.

Suitable drafting is as follows:

- (e) If the Required Action is taken as a result of a breach of the obligations of the Contractor under the Contract, then for so long as and to the extent that the Required Action is taken, and this prevents the Contractor from providing any part of the service:
 - (i) the Contractor shall be relieved of its obligations to provide such part of the Service; and
 - (ii) in respect of the period in which the Authority is taking Required Action, the Unitary Charge due from the Authority to the Contractor shall equal the amount the Contractor would receive if it were satisfying all its obligations and providing the Service affected by the Required Action in full over that period, less an amount equal to all the Authority's costs of operation in taking the Required Action.

28.4.5 The Authority should be obliged to behave in a reasonable manner, taking into account the relevant circumstances (e.g. it should try to avoid action which would detrimentally affect any compensation payable to the Contractor on a termination).

28.4.6 The rights referred to here should not be used as a means to undermine the carefully structured termination arrangements and should tie in with such arrangements. If the breach subsists following the Authority's step-in, the Authority should be entitled to terminate for Contractor Default (see Section 20.2 (Termination on Contractor Default)) subject to any rights the Senior Lenders may have under the direct agreement (see Section 30 (Direct Agreement)).

28.5 RELATED ISSUES

28.5.1 Having stepped-in, the Authority should act in accordance with good industry practice and to the extent there is a failure to do so, then it should indemnify the Contractor for any effects (including for any detrimental effect on any termination payment). Liability amounts should be outside any indemnity cap (for both parties).

28.5.2 The Authority should not be particularly concerned about such an indemnity being required as the price for a right of step-in. This is because to the extent the Contractor is not in breach the Authority should honour the contractual structure and risk allocation in the Contract. If the Contractor is in breach, then the termination provisions should be drafted in a manner that is ordinarily sufficient to protect the Authority (with no indemnity) without any additional involvement of the Authority through step-in.

28.6 RIGHTS OF ACCESS

28.6.1 An issue related to step-in rights (and at times confused with them) is that of rights of access of the Authority to the facilities.

28.6.2 This right exists in part to give the Authority the ability to monitor performance (see Section 9 (Performance Monitoring)) and carry out spot checks, to the extent required by the Contract.

Required drafting to deal with this is as follows:

Rights of access

- (a) The Authority or a representative of the Authority may enter upon any property used by the Contractor to perform the Service, to inspect the construction, operation and maintenance of the Project and to monitor compliance by the Contractor with its obligations.
- (b) The Authority and a representative of the Authority may at all times enter upon any property used by the Contractor as training or workshop facilities and places where work is being prepared or materials being obtained for the Project.
- (c) The Contractor shall procure that satisfactory facilities are made available to the Authority and any representative of the Authority and that reasonable assistance is given for the purposes of paragraphs (a) and (b) above, subject to the Contractors and Sub-contractors construction or operational requirements not being adversely affected and to reimbursement of any reasonable costs or expenses of the Contractor.
- (d) If the Authority is or becomes aware of a breach by the Contractor of its obligations under Clause 8.1 (Maintenance) then the Authority may exercise its right of access and remedy such breach and shall be entitled to recover any costs or expenses incurred from the Contractor as a debt⁴.
- (e) The Authority and its representative shall at all times comply with any health and safety requirements when exercising its rights under this Clause.
- (f) If the Authority or its representative causes material damage to any asset⁵ in exercising any right under this Clause, then the Authority shall be liable to the Contractor for the reasonable costs directly caused by such damage.

⁴ The Authority should be careful in exercising this right owing to paragraph (f) and should not interfere with the obligations of the Contractor but instead rely on its other rights under the Contract.

⁵ These are the physical assets referred to in the definition of "Assets".

The Contract will also contain a number of relatively standard positions. The following suggests how some of these should be drafted:

“DPA”

means the Data Protection Act 1998.

“Personal Data”

means personal data as defined in the DPA which is supplied to the Contractor by the Authority or obtained by the Contractor in the course of performing the Service.

29.1 Data Protection

- (a) In relation to all Personal Data, the Contractor shall at all times comply with the DPA as a data controller if necessary, including maintaining a valid and up to date registration or notification under the DPA covering the data processing to be performed in connection with the Service.
- (b) The Contractor and any Sub-contractor shall only undertake processing of Personal Data reasonably required in connection with the Service and shall not transfer any Personal Data to any country or territory outside the European Economic Area.
- (c) The Contractor shall not disclose Personal Data to any third parties other than:
 - (i) to employees and Sub-contractors to whom such disclosure is reasonably necessary in order for the Contractor to carry out the Service; or
 - (ii) to the extent required under a court order,provided that disclosure under paragraph (i) is made subject to written terms substantially the same as, and no less stringent than, the terms contained in this Clause 29.1 and that the Contractor shall give notice in writing to the Authority of any disclosure of Personal Data it or a Sub- Contractor is required to make under paragraph (ii) immediately it is aware of such a requirement.
- (d) The Contractor shall bring into effect and maintain all technical and organisational measures to prevent unauthorised or unlawful processing of Personal Data and accidental loss or destruction of, or damage to, Personal Data including but not limited to take reasonable steps to ensure the reliability of staff having access to the Personal Data.
- (e) The Authority may, at reasonable intervals, request a written description of the technical and organisational methods employed by the Contractor the Sub-contractors referred to in paragraph (d). Within [30] days of such a request, the Contractor shall supply written particulars of all such measures detailed to a reasonable level such that the Authority can determine whether or not, in connection with the Personal Data, it is compliant with the DPA.

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- (f) The Contractor shall indemnify and keep indemnified the Authority against all losses, claims, damages, liabilities, costs and expense (including reasonable legal costs) incurred by it in respect of any breach of this Clause 29.1 by the Contractor and/or any act or omission of any Sub-contractor¹.

29.2 Public Relations and Publicity

- (a) The Contractor shall not by itself, its employees or agents and procure that its Sub-contractors shall not communicate with representatives of the press, television, radio or other communications media on any matter concerning the Contract without the prior written approval of the Authority.
- (b) No facilities to photograph or film in or upon any property used in relation to the Project shall be given or permitted by the Contractor unless the Authority has given its prior written approval.

29.3 Waiver

- (a) No term or provision of this Contract shall be considered as waived by any party to this Contract unless a waiver is given in writing by that party.
- (b) No waiver under paragraph (a) shall be a waiver of a past or future default or breach, nor shall it amend, delete or add to the terms, conditions or provisions of this Contract unless (and then only to the extent) expressly stated in that waiver.

29.4 Severability

If any term, condition or provision contained in this Contract shall be held to be invalid, unlawful or unenforceable to any extent, such term, condition or provision shall not affect the validity, legality or enforceability of the remaining parts of this Contract.

29.5 Counterparts

This Contract may be executed in any number of counterparts, all of which when taken together shall constitute one and the same instrument.

29.6 Law of the Contract and Jurisdiction

The Contract shall be governed by the laws of England and Wales² [and subject to Clause 27 (Dispute Resolution), the parties submit to the exclusive jurisdiction of the courts of England and Wales³].

29.7 Third Party Rights

No term of this Contract is enforceable under the Contracts (Rights of Third Parties) Act, 1999 by a person who is not a party to this Contract.⁴

29.8 Contractor's Records

- (a) The Contractor shall at all times:
- (i) maintain a full record of particulars of the costs of performing the Service, including those relating to the design, construction, maintenance, operation and finance⁵;

¹ See Section 23.3 (Indemnity).

² This may require amendment for Scottish and Northern Ireland projects.

³ This is not strictly necessary where no foreign element exists (it rarely does in a PFI contract).

⁴ This may require amendment for Scottish and Northern Ireland projects.

⁵ Their records should include details of any commitments made by the Contractor for future expenditure and details of any funds held by the Contractor.

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- (ii) when requested by the Authority, provide a summary of any of the costs referred to in paragraph (i), including details of any funds held by the Contractor specifically to cover such costs, in such form and detail as the Authority may reasonably require to enable the Authority to monitor the performance by the Contractor of its obligations under this Contract;
 - (iii) provide such facilities as the Authority may reasonably require for its representatives to visit any place where the records are held and examine the records maintained under this Clause⁶; and
 - (iv) at the request of the Authority, provide to the Authority any information provided by it to the Senior Lenders during the term of the Contract⁷.
- (b) Compliance with the above shall require the Contractor to keep (and where appropriate shall procure that the Sub-contractors shall keep) books of account in accordance with best accountancy practice with respect to the Contract showing in detail:
- (i) administrative overheads;
 - (ii) payments made to Sub-contractors;
 - (iii) capital and revenue expenditure;
 - (iv) such other items as the Authority may reasonably require to conduct cost audits for verification of cost expenditure or estimated expenditure, for the purpose of Clause 5.2 (Delays Due to Compensation Events), Clause 12.4 (Authority Changes), Clause 13.8 (Qualifying Change in Law), [Section 14.4 (Benchmarking)] and Clause 14.5 (Market Testing).

and the Contractor shall have (and procure that the Sub-contractors shall have) the books of account evidencing the items listed in paragraphs (i) to (iv) available for inspection by the Authority (and any expert) upon reasonable notice, and shall present a report of these to the Authority as and when requested.

- (c) The Contractor shall maintain or procure that the following are maintained⁸:
- (i) a full record of all incidents relating to health, safety and security which occur during the term of the Contract; and
 - (ii) full records of all maintenance procedures carried out during the term of the Contract,
- and the Contractor shall have the items referred to in paragraphs (i) and (ii) available for inspection by the Authority upon reasonable notice, and shall present a report of them to the Authority as and when requested.
- (d) The Contractor shall permit records referred to in this Clause to be examined and copied by the Controller and other representatives of the Authority, and by [the Comptroller and Auditor General and his representatives⁹].

⁶ See Section 28.6 (Rights of Access).

⁷ This enables financial information such as audited accounts to be obtained. Alternatively, the precise financial information required can be listed. The “regular basis” qualification is required as the Authority should not be permitted access to all confidential communications between the Contractor and its financiers.

⁸ Others may be needed depending on the project.

⁹ Local authorities and Scotland have their own equivalent bodies.

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- (e) The records referred to in this Clause shall be retained for a period of at least [5] years after the Contractor's obligations under the Contract have come to an end.
 - (f) Upon termination of the Contract, and in the event that the Authority wishes to enter into another contract for the operation and management of the Project the Contractor shall (and shall ensure that the Sub-contractors will) comply with all reasonable requests of the Authority to provide information relating to the Contractor's costs of operating and maintaining the Project.
 - (g) All information referred to in this Clause is subject to the obligations set out in Clause 25 (Information and Confidentiality).

29.9 Interest on Late Payments

The parties will pay interest on any amount payable under this Contract not paid on the due date, from the period from that date to the date of payment at a rate equal to []% above []¹⁰.

29.10 Continuing Obligations

Save as otherwise expressly provided in this Contract:

- (a) termination of the Service Period shall be without prejudice to any accrued rights and obligations under this Contract as at the Termination Date; and
- (b) termination of the Service Period shall not affect the continuing rights of the Authority and the Contractor under Clauses []¹¹ or under any other provision of this Contract which is expressed to survive termination or which is required to give effect to such termination or the consequences of such termination.

¹⁰ This will relate to both disputed and undisputed amounts and should, where relevant, take into account the Late Payments of Commercial Debt (Interest) Act 1998 provisions (see Section 10.2.5 above) and the costs of the Senior Debt at that time.

¹¹ The parties will need to specify those Contract provisions intended to survive termination or expiry of the Contract. Usually, these will include the provisions relating to restrictions on Authority assignment (Clause 16.3), information and confidentiality (Clause 25), dispute resolution (Clause 27), indemnities, guarantees and contractual claims (Clause 23), data protection (Clause 29.1), public relations and publicity (Clause 29.2), law of the contract and jurisdiction (Clause 29.6) and Contractor's records (Clause 29.7).

30.1 INTRODUCTION

30.1.1 A direct agreement referred to in this guidance is an agreement between the Authority and Senior Lenders that deals with the relationship between these interested parties following a termination or threatened termination for Contractor Default (see Section 20.2 (Termination on Contractor Default)). As stated in Section 28 (Authority Step-In), it is entirely different to the rights described in that Section.

30.1.2 The concern of the Senior Lenders is that they have financed the Project on the basis of projected cash flows and if the Contract (under which these cash flows are agreed to be paid) is terminated, they will only have rights against the Sub-contractors and to amounts in the bank accounts of the Contractor as security for their financing. They will not, typically, have any rights to sell the Assets, as would be the case in many types of secured financings. In many projects, recovery of amounts by the Senior Lenders making claims under the Project Documents will not lead to full repayment. To the extent that the financiers are protected, for example, by corporate guarantees, or there is a possibility of their realising some kind of return from an alternative use of the Assets, then there may be no need for such a document (or if one is needed it can deal simply with opportunities to rectify).

30.1.3 Where direct agreements are required, however, such documents are increasingly seen as advantageous to the public sector, in that they give Senior Lenders an opportunity to “revive” the Project and, therefore, to avoid the disruption that invariably follows termination. If the Project can be restored with minimal disruption to the Service and there is no need for the Authority to get involved to ensure that this occurs, then both the Authority and the Senior Lenders benefit.

30.1.4 The key issues are when the Senior Lenders should be permitted to step-in; the extent to which the Senior Lenders should be obliged to assume liabilities that have been or are being incurred by the Contractor and the extent to which they are given the opportunity to rectify a breach on behalf of the Contractor. The approach taken in this guidance is very closely related to the approach taken in Section 20.2 (Termination on Contractor Default).

30.1.5 Other issues relating to this arise, such as for how long any liability of the Senior Lenders should continue; what rights of termination exist on a step-in and what rights of “sale” or replacement of Sub-contractors the Senior Lenders should have.

30.2 LIABILITY OF SENIOR LENDERS

30.2.1 It can be argued that to the extent the Senior Lenders “step in” (i.e. obtain rights under the Contract) then they should be liable for obligations to the same extent as the Contractor. This has led to the development in certain sectors of “step-in undertakings”, under which Senior Lenders agree to accept a degree of liability (invariably capped) as the price of their attempt to save the Project.

30.2.2 Other projects take the view that the approach to be taken should aim to follow more closely the existing structure for insolvencies and work-outs in the UK, namely that of an administrative receivership appointment and sale. That is, the interests of all parties are best served by following a well established procedure that allows an entity to be appointed to take over the decision making rights of the Contractor without immediately being forced to sign up to either a limited quantified or unlimited liability.

30.2.3 The recommended approach is that the Senior Lenders should be given an opportunity to rectify any defaults and maximise any realisation without having to provide a “step-in undertaking” to the Authority. This recommendation is very closely linked to the approach recommended in Section 20.2 (Termination on Contractor Default) as if the situation worsens to a sufficient degree (e.g. claims arise) during the Senior Lenders’ period of “step-in”, the Authority may terminate the Contract and such liability will be reflected in the termination compensation payable to the Contractor.

30.3 RECOMMENDED APPROACH

30.3.1 The approach recommended here distinguishes between the Contractor and the Senior Lenders even on step-in. The Senior Lenders must agree to sign up and pay for any liability (e.g. any amounts owing to the Authority) at the time of step-in and take steps to rectify breaches. In implementing rectification of breaches under the Contract some time and flexibility should be given. Nevertheless, the Contractor will always remain liable under the Contract and, to the extent a new breach occurs during the period of step-in, then termination can still occur.

30.3.2 Following, or simultaneously with, the issue of a Termination Notice under the Contract, the Authority will issue a Termination Notice to the Agent. This will trigger the running of a period which, if the Senior Lenders decide not to step-in, will allow the Contract to terminate. Within 30 days of issuing the Termination Notice, the Authority must also notify the Agent of the liabilities to be discharged by the Senior Lenders on step-in. If the Senior Lenders wish to step-in, then the liability to be discharged must be paid to allow step-in to occur (see Clause 6(b) of the Direct Agreement for the detail of this approach).

30.3.3 A similar procedure can apply if no Termination Notice is in fact issued, but the Senior Lenders have accelerated the maturity of their debt and demanded repayment. These provisions are set out in Clauses 3 (No Termination Without Notice), 5 (Representative) and 6(b) of the Direct Agreement.

30.3.4 During the step-in period, the Senior Lenders are incentivised to ensure that a remedial programme is implemented in relation to antecedent breaches and that no new breaches occur. If antecedent breaches are not remedied or new breaches occur, then a right to termination can arise again.

30.3.5 The Direct Agreement also provides that the effects of the step-in can come to an end if the Senior Lenders step-out or a novation occurs. If the Contract continues by way of a novation, this does not mean that the parties will not amend the Contract in certain respects. For example, the parties may agree that the performance and payment mechanism are not incentivising the parties correctly (see Section 9.2 (Setting the Performance Level)) and so require it to be amended. This will depend in part on the extent to which the mechanism concerned is untested and/or capable of automatic recalibration (see Section 9.2.5).

30.3.6 If the Senior Lenders cannot rectify the default or save the Project, then termination will occur in accordance with Clauses 20.2.8 (Retendering Procedure) or 20.2.9 (No Retendering Procedure) of the Contract, depending on what steps have been taken by Senior Lenders to realise a value from the project. If any undischarged claims are owing from the Contractor, then they can be set off under Clause 11 (Set-off).

30.3.7 The advantage of the above approach is that the Senior Lenders are clearly aware when they make the decision whether or not to step-in what liabilities are being accepted¹. At the same time, the Authority retains the right to terminate if any breach occurs or the Senior Lenders are not making sufficient effort to rectify the antecedent breaches and so it is in substantially the same position after step-in as it was before.

30.3.8 In return for a payment being made to the Contractor (whether under Clause 20.2.8 (Retendering Procedure) or Clause 20.2.9 (No Retendering Procedure)), the Senior Lenders should agree to release any security over the Assets (other than charges over bank accounts and counterparty claims (including claims against the Authority under the Contract and the Sub-contractors under the Sub-Contracts)).

30.4 PERFORMANCE POINT ACCRUAL WHEN STEPPED IN

30.4.1 One key point is the extent to which performance points can continue to accrue when the Senior Lenders have stepped in.

30.4.2 The recommended approach depends in part on the issues referred to in Section 23.6 (Claims for Damages) and the likelihood of any claims arising. To the extent the performance points accrual rate reflects the loss to the Authority, then by performance points being incurred, the Authority is protected. Its main concern in such circumstances is to ensure that it is not paying for the Service if it is not being provided.

30.4.3 To the extent this is the case, then relief from termination should be given for an extended period to allow rectification to occur, so that a significant period can be given to allow implementation of the rectification programme. Sufficient flexibility should be included in the Step-In Period so that default is not an inevitable consequence (for example, if one more penalty point triggers a termination, the Senior Lenders will be reluctant to step-in) and time is given to rectify, so allowing the Senior Lenders the opportunity to rectify.

30.4.4 The recommended approach is that performance points should continue to accrue during the Step-In Period but that during any Step-In Period there should be a suspension (but not cancellation) of any performance points that accrued prior to the Step-In Date, but only for the purposes of triggering a termination (i.e. not in accruing deductions from the Unitary Charge). Although performance points will accrue during the Step-In Period, the Authority should not be able to terminate the Contract if the Senior Lenders are using reasonable endeavours to rectify any breach that arose prior to the Step-In Date but which is continuing. If the Senior Lenders subsequently step-out, the suspension of those performance points should be lifted, unless the Authority is satisfied that the event giving rise

¹ Unlike in some models of Direct Agreement, the Senior Lenders have no liability to the Authority during the step-in period (but the step-in period may end and the Contract may be terminated if new payment or other defaults arise during the step-in period, or if “post notified” debts are not paid – see Clause 6(b)). Similarly, the Senior Lenders can step out at any time without having any liability to the Authority. This does not prejudice the Authority as it is protected in the knowledge that if the situation worsens (e.g. claims arise) as a result, then this will be reflected in compensation payable on Contractor Default.

to termination has been remedied by the Senior Lenders, in which case those performance points should be cancelled (for the purposes of both termination and deductions)². If the Authority does not have this protection and the Senior Lenders step-out because they no longer wish to rescue the Project, the Authority will need those points that accrued prior to the Step-In Date to be taken into account so as to ensure that the Authority has the ability to terminate the Contract. If the Step-In Period ends because of a transfer of the Contract to a Suitable Substitute Contractor, any accrued performance points will be cancelled.

30.4.5 To the extent that a rectification programme is being implemented (and so no termination right exists) it is possible that a refinancing may be required to incorporate, for example, new working capital. If this results in an increased level of Senior Debt then the Authority should show flexibility in the context of limits contained in Section 21.4 (Compensation Payments Following a Refinancing).

30.5 LIABILITY FOR INDEMNITY CLAIMS OR CLAIMS FOR DAMAGES

30.5.1 It is argued in some cases that the Authority should at least retain the right to recover against the Senior Lenders (when stepped-in) for any damages the Senior Lenders caused when stepped-in. To the extent that any damage or claims (e.g. from third parties) arise in relation to the Contract, then the damage or claims concerned will, in most cases be reflected in the termination compensation payable.

Required minimum drafting for a direct agreement is set out below. Much of the explanatory guidance is set out in the footnotes.

THIS AGREEMENT³ IS MADE ON [], []

BETWEEN:

- (1) [RELEVANT DEPARTMENT OR GOVERNMENT BODY] (the “Authority”);
- (2) [] (the “Agent” for the Senior Lenders⁴); and
- (3) [PROJECT COMPANY] (the “Contractor”).

IT IS AGREED AS FOLLOWS:

1 INTERPRETATION

In this Agreement, unless the context otherwise requires:

“Appointed Representative”

means a Representative that has assumed the Contractor’s rights under the Contract under Clause 5(a).

² Cancellation of penalty points in these circumstances needs to be addressed by way of an objective test in the Direct Agreement.

³ This draft deals with the step-in mechanics and novation. Other issues may also require inclusion in Direct Agreements if appropriate (such as specific detail relating to specific accounts into which payments are to be made and insurance provisions (see Section 24 (Insurance)). The practice of including wholesale amendments to the Contract required as a result of issues being addressed too late in the negotiation of the Contract is to be discouraged.

⁴ The reference to “Senior Lenders” is intended to track the definition in the Financing Agreements. To the extent bonds are used, minor drafting changes will be needed (for example to refer to the “Trustee” rather than the “Agent” and to “Bondholders” rather than “Senior Lenders”). The approach taken will not otherwise differ. When a monoline insurer is involved as part of the Project, key decisions taken will be taken by the monoline insurer, rather than the bondholders and the drafting should reflect this. Similarly, it may be that the security is held by a trustee for the financiers (usually called the “Security Trustee”). If so, then the drafting will require conforming.

[“Credit Agreement”

means the [] credit agreement dated [] between the Contractor, the Agent and various Senior Lenders and financial institutions.]

“Contract”⁵

“Enforcement Event”

means any acceleration of all outstanding amounts owed to the Senior Lenders under the Senior Financing Agreements.

“Fair Value”

means the amount at which an asset or liability could be exchanged in an arm’s length transaction between informed and willing parties, other than in a forced liquidation or sale.

“Liquid Market”

means that there are sufficient willing parties (being at least two parties, each of whom is capable of being a Suitable Substitute Contractor) in the market for PFI contracts or similar contracts for the provision of services (in each case the same as or similar to the Contract) for the price that is likely to be achieved through a tender to be a reliable indicator of Fair Value.

“Representative”⁶

means

- (a) the Agent, any Senior Lender and/or any of their Affiliates⁷;
- (b) an administrative receiver⁸, receiver or receiver and manager of the Contractor appointed under the [Security Documents⁹];
- (c) an administrator of the Contractor;
- (d) a person directly or indirectly owned or controlled by the Agent and/or any Senior Lender(s); or
- (e) any other person approved by the Authority (such approval not to be unreasonably withheld or delayed).

“Required Period”

means¹⁰, subject to Clause 4 (No Liquid Market) the period starting on the date of a Termination Notice and:

⁵ As defined in Section 1.7 (Terminology).

⁶ Certain Authorities have taken the view that it is inappropriate to have an administrator, receiver, manager or an administrative receiver over the Contractor or its assets. Provided that the right to terminate the Contract for non-performance is preserved during this period any such concern is misplaced.

⁷ See the definition in Clause 1.8.1 (Definitions).

⁸ This assumes the Senior Lenders have valid security over all or substantially all of the assets of the Contractor, entitling them to appoint an administrative receiver.

⁹ To be defined, but Senior Lenders will expect the security referred to in footnote 8 above.

¹⁰ The time periods will be subject to the specific requirements of particular projects, but these are likely to be appropriate for many projects that have a split between these phases. In practical terms, since the Senior Lenders will be funding the Project while they are making the decision whether or not to step-in and the liability of the Senior Lenders while stepped-in is clearly limited in this agreement, provided the Project is not technically complex or does not involve a large banking syndicate 90 days may be sufficient even during the construction phase.

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- (a) during the construction phase ending [120] days later; and
 - (b) during the operating phase ending [90] days later.

“Step-In Date”

means the date on which the Agent takes any action under Clause 5(a).

“Step-In Period”

means the period from the Step-In Date up to and including the earlier of:

- (a) the Step-Out Date;
- (b) the date of any transfer under Clause 8;
- (c) the date of any termination for breach under Clause 6; and
- (d) the date of expiry of the Contract.

“Step-Out Date”

means the date falling [30]¹¹ days after the date of the notice given under Clause 7 (Step-Out).

“Suitable Substitute Contractor”

means a person approved by the Authority (such approval not to be unreasonably withheld or delayed) as¹²:

- (a) having the legal capacity, power and authority to become a party to and perform the obligations of the Contractor under the Contract; and
- (b) employing persons having the appropriate qualifications, experience and technical competence and having the resources available to it (including committed financial resources and sub-contracts) which are sufficient to enable it to perform the obligations of the Contractor under the Contract.

“Termination Notice”

means a notice given by the Authority to the Agent under Clause 3(a).

- (a) [Relevant parts of Clause 1.8.2 (Interpretation) of the Contract should be included here with suitable amendments where necessary].
- (b) Capitalised terms defined in the Credit Agreement have the same meaning in this Agreement.

¹¹ This will depend on the time required by the Authority to put in place alternative measures to provide the Service.

¹² This definition applies to the criteria required for a new Contractor. To the extent there are rights of veto for the Authority in the Contract on replacements to Sub-Contractors and transfers of shares (see Sections 15.1 (Control over Sub-Contractors) and 17 (Change of Ownership)), Senior Lenders will seek to impose criteria (such as the above). Thought should always be given to including any such criteria in the Contract and, to the extent they are included, these are appropriate limits. Criteria that are not objective are very unlikely to be “bankable”. Other criteria may be appropriate in particular cases (for instance, if security or national security is an issue). Departments may require, for example, that directors of the Contractor have not committed a criminal offence. These requirements should focus on key requirements for a Contractor in that project (as, for example, a road traffic offence or a spent conviction may have little or no relevance). Similar considerations apply to those in Section 15 (Sub-Contractors and Employees).

2 CONSENT TO SECURITY

- (a) The Authority acknowledges notice of, and consents to, the security interest granted over the Contractor's rights under the Contract effected by the Contractor in favour of the Senior Lenders under the Security Document¹³.
- (b) The Authority confirms that it has not received notice of any other security interest granted over the Contractor's rights under the Contract¹⁴.

3 NOTICE OF TERMINATION AND EXISTING LIABILITIES

The Authority shall not terminate or give notice terminating the Contract¹⁵ without giving to the Agent:

- (a) at least the Required Period of prior written notice stating:
 - (i) the proposed Termination Date; and
 - (ii) the grounds for termination in reasonable detail, and
- (b) not later than the date falling 30 days after the date of a Termination Notice or (if earlier) the date falling 30 days after the date on which the Agent informs the Authority that an Event of Default¹⁶ has occurred, a notice containing details of any amount owed by the Contractor to the Authority, and any other existing liabilities or unperformed obligations¹⁷ of which the Authority is aware (having made reasonable enquiry):
 - (i) at the time of the Termination Notice or the notification of an Event of Default; and/or
 - (ii) which will fall due on or prior to the end of the Required Period, under the Contract¹⁸.

¹³ This should restrict the ability of the Senior Lenders to transfer in breach of Clause 8 (Novation).

¹⁴ Departments will sometimes argue that they may not be aware of such notices. The correct view is that they should be and so should be able to make this confirmation.

¹⁵ The termination events in the Contract can be distinguished between for these purposes (for example, treating an insolvency default differently from a performance default), but if the Project can be rescued by the Senior Lenders then there is no good reason to draw such a distinction. This agreement also assumes that if the Contract is to be terminated in circumstances in which the Senior Lenders will be repaid in full (e.g. for corrupt gifts or force majeure) then the Senior Lenders will not want to exercise their rights under this Agreement. The Direct Agreement should also restrict the Authority's right to terminate other agreements ancillary to this Agreement (e.g. a lease of land on which the Project is built). Authorities may consider whether or not to allow additional restrictions on the exercise of its rights under collateral warranties with sub-contractors during the step-in period.

¹⁶ See footnote 22, as this may be at a later date.

¹⁷ Both parties should have a clear understanding of what these liabilities are, as it is likely that an increase in debt facilities will be needed to rectify defaults or cover interest that accrues. Care should be taken to ensure that the Authority does not intervene to specify how unperformed liabilities should be performed (e.g. following a request for conditions surveys), but instead give information on the default that led to termination and any other breaches of which it is reasonably aware.

¹⁸ This method is used as an alternative to requiring a step-in undertaking, which is currently used in many (but not all) PFI projects. A step-in undertaking is an undertaking from the Senior Lenders or other financiers to meet certain obligations, usually existing as at the date of step-in (and in some cases those that arise later). Even a capped liability during the Step-In Period could discourage the Senior Lenders or other financiers from stepping-in and for that reason this approach is not taken here.

4 NO LIQUID MARKET

- (a) At any time during the Required Period¹⁹ the Agent may issue a written notice (the “No Liquid Market Notice”) to the Authority setting out the reasons why the Agent does not believe that a Liquid Market exists.
- (b) On or before the date falling 14 days after the date on which a No Liquid Market Notice is received by the Authority, the Authority shall notify the Agent of its opinion as to whether or not a Liquid Market exists. Where the Authority believes that a Liquid Market does exist, such notice shall set out the reasons for the Authority’s belief. If the parties do not agree whether or not a Liquid Market exists, then either party may refer the dispute to be determined in accordance with Clause 27 (Dispute Resolution)²⁰.
- (c) If the parties agree or it is determined in accordance with Clause 27 (Dispute Resolution) that no Liquid Market exists, the Contract shall automatically terminate and the provisions of Clause 20.2.9 (No Retendering Procedure) shall apply²¹.
- (d) If any dispute relating to this Clause 4 is determined under Clause 27 (Dispute Resolution), the Required Period shall be extended by the period of time spent determining such dispute under Clause 27 (Dispute Resolution).

5 REPRESENTATIVE

- (a) Without prejudice to the Agent’s rights under the Security Documents, at any time:
 - (i) during which an Event of Default²² is subsisting (whether or not a Termination Notice has been served); or
 - (ii) during the Required Period²³,

the Agent may procure that a Representative assumes, jointly and severally with the Contractor, all of the Contractor’s rights under the Contract.

- (b) The Agent shall give the Authority [5]²⁴ days prior notice of any action to be taken by it referred to in this Clause 5.

¹⁹ The Agent should only be permitted to issue a No Liquid Market Notice to the Authority during the Required Period. Any dispute as to whether or not a Liquid Market exists after the last day of the Required Period should be determined in accordance with Clause 20.2.7 (Retendering Election) of the Contract.

²⁰ Any dispute should be determined under the fast-track dispute resolution procedure (see Section 27.2.3). The dispute resolution procedure in the Contract will need to apply *mutatis mutandis* to the Direct Agreement.

²¹ The compensation payable to the Contractor in such circumstances will be determined in accordance with the procedure set out in Clause 20.2.9 (No Retendering Procedure).

²² This should be defined in the Credit Agreement and this drafting assumes that the occurrence of an Event of Default will allow the Senior Lenders to enforce their security. If the Contractor has negotiated that the security is not enforced until the debt is actually accelerated, the Contractor should be permitted to change references from Event of Default to “Enforcement Event”. It is, in any event, unlikely that Senior Lenders will wish to step-in unless the Project is in serious difficulties.

²³ The Authority should ensure that during this period it has preserved the right in the Contract to enter on the property and restore problems that need an emergency fix (through rights of access). Its rights of termination against the contractor with the Senior Lenders “stepped-in” are sufficient to protect it during the “step-in” period (provided the Contract has been negotiated correctly).

²⁴ It is unlikely that a longer period will be needed.

6 STEP-IN PERIOD

(a) Without prejudice to Clause 3 (No Termination Without Notice), but subject to paragraph (b) below, the Authority shall not terminate the Contract during the Step-In Period on grounds:

- (i) that the Agent has taken any action referred to in Clause 5 (Representative) or enforced any Security Document(s); or
- (ii) arising prior to the Step-In Date²⁵ of which the Authority is aware (having made reasonable enquiry and whether or not continuing at the Step-In Date); or
- (iii) arising solely in relation to the Contractor²⁶,

unless, in the case of paragraph (ii) above:

(A) the grounds arose during the [construction phase]²⁷, and construction is not completed on or before the date falling [12]²⁸ months after the date on which the Authority would have been entitled to terminate the Contract for non-completion²⁹; or

(B) the grounds arose during the [operation phase], and neither the Appointed Representative nor the Contractor is using all reasonable endeavours (including implementation of any remedial programme³⁰) to remedy any breach of the Contract that:

- (1) arose prior to the Step-In Date; and
- (2) is continuing (and capable of remedy); and
- (3) would have entitled the Authority to terminate the Contract.

(b) The Authority shall be entitled to terminate the Contract by written notice to the Contractor and the Appointed Representative:

- (i) if any amount referred to in Clause 3(b)(i) above has not been paid to the Authority on or before the Step-In Date;

²⁵ To the extent a right to terminate would otherwise arise, a right to terminate should arise for a 'latent defect' (i.e. one that could not reasonably be expected to have been discovered) becoming an 'actual defect'. That is, notwithstanding the discovery of a latent defect that existed prior to the Step-In Date, it should be treated as arising after that date. Latent defects are likely to be dealt with in the Contract (see Section 6.5 (Latent Defects Risk)) and are project specific.

²⁶ For example, insolvency of the Contractor.

²⁷ It is acknowledged that in the provision of the Service it is not always clear when the construction phase ends as the construction of an asset will be to facilitate the provision of the Service and without the ancillary support (for example, in a prison the regime being set up and approved) the Service will not be ready to start. Similarly in a phased development, the two phases will usually overlap. The key determinant will, of course, be the extent to which failure to complete construction of either phase will lead to termination (thereby preventing Service Commencement), in which case paragraph (aa) will apply. If the failure is in the delivery of the Service from a completed facility then paragraph (bb) will apply.

²⁸ Time periods will depend on a number of issues, including the nature of the Project and the length of the construction phase. If there is no critical need for the project to commence by a certain date or parties believe the financial incentives are sufficiently strong, then (B) can also apply to terminations in the construction phase.

²⁹ See footnote 27 above.

³⁰ Prior to any step-in by the Senior Lenders, it is likely that the Authority will be asked to approve a remedial programme in respect of rectification works that the Senior Lenders are proposing in an attempt to rescue the Project. Such an approach is only acceptable provided that the Authority does not assume any additional risk by virtue of giving such approval, i.e. the purpose of the remedial programme should be purely to assist the Senior Lenders in a defence of a claim by the Authority that the Senior Lenders are in breach of Clause 6(a)(iii)(bb) as they are not using reasonable endeavours to rectify the relevant breach of the Contract.

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- (ii) if any amount referred to in Clause 3(b)(ii) has not been paid on or before the last day of the Required Period;
 - (iii) if amounts, of which the Authority was not aware (having made reasonable enquiry) at the time of the Termination Notice or the Event of Default, subsequently become payable and are not discharged on or before the date falling [30] days after the date on which the liability for these amounts is notified to the Agent; or
 - (iv) on grounds arising after the Step-In Date in accordance with the terms of the Contract provided that for the purposes of termination under the Contract, [warning notices, deductions and/or penalty points] that arose prior to the Step-In Date shall not be taken into account during the Step-In Period but shall be taken into account after the Step-Out Date³¹.
- (c) The Authority shall deal with the Appointed Representative and not the Contractor during the Step-In Period.

7 STEP-OUT

- (a) The Appointed Representative will, on [30] days' prior written notice from the Agent or the Appointed Representative to the Authority, be released from all of its obligations and liabilities to the Authority under the Contract arising prior to the Step-Out Date and rights of the Appointed Representative against the Authority will be cancelled³².
- (b) The Contractor shall continue to be bound by the terms of the Contract, notwithstanding the occurrence of the Step-Out Date³³.

8 NOVATION

- (a) Subject to Clause 8 (b), at any time:
 - (i) during which an Event of Default³⁴ is subsisting; or
 - (ii) during the Step-In Period,

the Agent may, on [30] days' prior written notice to the Authority and any Appointed Representative, procure the transfer of the Contractor's rights and liabilities under the Contract to a Suitable Substitute Contractor.

- (b) The Authority shall notify the Agent as to whether any person to whom the Agent proposes to transfer the Contractor's rights and liabilities under the Contract is a Suitable Substitute Contractor, on or before the date falling [30] days after the date of receipt of all information reasonably required by the Authority to decide whether the proposed transferee is a Suitable Substitute Contractor³⁵.

³¹ See Section 30.4.4 (Performance Point Accrual when Stepped-In).

³² Any undischarged liabilities are reflected in the payments under Clause 20.2.8 (Retendering Procedure) and Clause 20.2.9 (No Retendering Procedure).

³³ See Section 30.4.4 (Performance Point Accrual when Stepped-In).

³⁴ See footnote 22 above. The same point applies here.

³⁵ The Authority would be reasonable in withholding its consent if there are outstanding unremedied breaches with no proposed remedial programme.

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- (c) The Authority shall not unreasonably withhold or delay its decision on whether the proposed transferee is a Suitable Substitute Contractor³⁶.
 - (d) On any transfer referred to in Clause 8(a) becoming effective:
 - (i) the Contractor shall be released from any obligations arising under or in connection with the Contract from that date and the new Contractor shall become liable for obligations arising on or after that date;
 - (ii) any accrued [performance points] shall be cancelled;
 - (iii) any then subsisting ground for termination of the Contract by the Authority shall be deemed to have no effect and any subsisting Termination Notice shall be automatically revoked; and
 - (iv) the Authority shall enter into a direct agreement with the Senior Lenders lending to the new Contractor on substantially the same terms as this Agreement.

9 INSURANCE PROCEEDS

Notwithstanding the other provisions of this Agreement and the terms and conditions of the Senior Financing Agreements, the Agent shall only permit amounts to be released from the Joint Insurance Account in accordance with the requirements of [Clause 24.6 (Reinstatement)] of the Contract³⁷ and shall not exercise any rights under the Senior Financing Agreements or take any other steps to prevent amounts being released from the Joint Insurance Account in accordance with [clause 24.6 (Reinstatement)] of the Contract.

10 MISCELLANEOUS

- (a) The Authority shall at the Contractor's expense, take whatever action the Agent, an Appointed Representative or a Representative taking a transfer in accordance with Clause 8(a) may require for perfecting any transfer or release under Clauses 5 (Representative), 7 (Step-Out) and 8 (Novation) including the execution of any transfer or assignment, and the giving of any notice, order or direction and the making of any registration which, in each case, the Agent, Appointed Representative or Representative reasonably requires.
- (b) The Authority shall not take any action to wind up, appoint an administrator or sanction a voluntary arrangement (or similar) in relation to the Contractor.

³⁶ At the time of any proposed novation, the Authority should ensure that it is a condition of the novation that any unpaid amounts owed to it by the Contractor (e.g. amounts claimed under the indemnity provision) are satisfied in full.

³⁷ Under the terms of the Senior Financing Agreements, the Senior Lenders will take security over all of the assets of the Contractor, including the Contractor's interests in the Joint Insurance Account. However, the Senior Lenders should accept that any proceeds standing to the credit of the Joint Insurance Account should be applied in reinstatement of the assets except where no reinstatement is required as a result of Section 24.7 (even if the Contract has terminated) and accordingly the Authority should not agree to any request from the Senior Lenders for the Authority to grant security to the Senior Lenders over its interests in the Joint Insurance Account.

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- (c) This Agreement shall remain in effect until the date on which all amounts which may be or become owing by the Authority to the Contractor under [Section 20 (Early Termination)] of the Contract have been irrevocably paid in full, [whereupon the Agent agrees on behalf of itself and the Senior Lenders to release any security granted in their favour over the Assets which has not previously been assigned to the Authority]³⁸.
- (d) The Agent, in respect of paragraphs (i), (ii) and (iii), and the Contractor in respect of paragraph (iv), shall promptly notify the Authority of:
- (i) any decisions to accelerate the maturity of any amounts owing by the Contractor to the Senior Lenders under the Credit Agreement and/or demand repayment³⁹;
 - (ii) the date referred to in paragraph (c) above on or before the date falling 30 days after its occurrence;
 - (iii) the details and amount of any proposed Additional Permitted Borrowing, including:
 - (a) the circumstances giving rise to it and reasons for it; and
 - (b) the terms on which it will be borrowed; and
 - (iv) on the first Business Day of each calendar month during which any Additional Permitted Borrowing is, or may be, subsisting, the amount outstanding under the Senior Financing Agreements, and, to the extent it is aware (having made reasonable and proper enquiry):
 - (a) the amount of any Distribution made by the Contractor; and
 - (b) the amount of any credit balance on any account of the Contractor⁴⁰
- (e) The Contractor joins in this Agreement to acknowledge and consent to the arrangements set out and agrees not knowingly to do or omit to do anything that may prevent any party from enforcing its rights under this Agreement⁴¹.
- (f) For the avoidance of doubt, if there is any conflict or inconsistency between the provisions of this Agreement and the Contract, the provisions of this Agreement shall prevail⁴².
- (g) The Agent agrees on behalf of itself and the Senior Lenders that [include relevant “boiler plate” from the Contract⁴³].

³⁸ If the Assets revert to the Authority on early termination of the Contract and the Authority has the right and elects to pay early termination compensation amounts in instalments, the Senior Lenders should release any security held over the Assets on termination so as to allow the unencumbered Assets to be transferred to the Authority. See Section 30.3.8 in relation to which Assets the Senior Lenders should not be required to release their security over.

³⁹ See footnote 22 above. Even if the trigger for step-in is demand for the repayment of Senior Debt, earlier enforcement steps should be notified.

⁴⁰ For a Bond transaction, 10(d)(iv) may be replaced by a new clause as follows if the Authority thinks this appropriate:

⁴¹ It is also good practice for the Contractor to appoint the Authority as its attorney to sign any required novation documentation so that, if novation occurs, it does so as smoothly as possible.

⁴² For example, provisions relating to termination and compensation will cut across the provisions of this Agreement.

⁴³ These provisions should be consistent with the provisions of the Contract and impose an equivalent but separate liability on the Senior Lenders to that to which the Contractor is subject.

11 ASSIGNMENT

- (a) No party to this Agreement may assign or transfer any part of its rights or obligations under the Agreement, save that:
 - (i) the Agent may assign or transfer its rights and obligations under this Agreement to a successor Agent in accordance with the Senior Financing Agreements without the consent of the Authority;
 - (ii) any Senior Lender may assign or transfer its rights under the Senior Financing Agreements in accordance with the terms of the Senior Financing Agreements; and
 - (iii) the Authority may assign, novate or otherwise transfer its rights and/or obligations under this Agreement to any person that the Authority assigns, novates or otherwise transfer its rights and/or obligations under the Contract in accordance with Clause 16.3 of the Contract.
- (b) If paragraph (a)(i) applies then the Authority shall enter into a direct agreement with the new Agent on substantially the same terms as this Agreement.

12 GOVERNING LAW

This Agreement is governed by the laws of England and Wales⁴⁴.

⁴⁴ Scottish PFI projects will have direct agreements governed by Scottish law since they are widely regarded as operating in parallel with Scottish law governed Contracts (even if the Financing Agreements are English law governed). Northern Ireland projects will also normally be governed by local law.

