



membership resources

Briefing 18-02

January 2018

Post Carillion: Contractor Insolvency and EU procurement rules. What is your room to manoeuvre?

This briefing considers the impact of the collapse of Carillion on local government contracts and considers how a process of managing new arrangements can be put into place to ensure service continuity. It is necessary to consider short term actions and longer term compliance issues with the EU Public Procurement rules.

It also provides a timely reminder to local authorities to consider the issues of risk when outsourcing contracts and in managing the ongoing risks associated with such contracts.

This briefing has been prepared with the kind assistance of APSE's legal partner Walker Morris LLP

1. Introduction

Throughout the era of New Public Management assumptions have been made about the involvement of the private sector in delivering public services; with arguments often cited as to the efficiencies of the private sector delivery model. However these savings have to be contextualized against the wider issues. Large contractors are often reliant upon sub-contractors; efficiencies may be delivered through operating models which are inconsistent with a public service ethos. Some larger contractors have few tangible assets, relying upon squeezing value out of the supply chain; this can leave contracts vulnerable both financially and in operational delivery terms; such contracts also potentially expose the sub-ordinate suppliers and contractors to debts, late payments or non-payments.

When a major supplier is unable to complete contracts, whether construction projects or service contracts such as school meals or building maintenance, through insolvency, this clearly leaves the public-sector client in a very difficult position. This briefing therefore considers possible action that could be taken by local authorities to ameliorate the impact of a contractor collapse. We also consider the merits of differing delivery models.

Accordingly, with the news of Carillion – a company responsible for delivering a large number of public infrastructure and services contracts from building HS2 to serving school

meals – entering into liquidation means many public sector organisations (as well as private) must work out how they deal with the collapse. This briefing therefore provides a timely reminder to local authorities to consider the risks associated with outsourced contracts and their contingency plans to deal with a similar situation.

The following information has been kindly provided by Walker Morris

a. Service continuity

Service continuity will be uppermost in the concerns of public sector clients and the solutions they adopt will need to balance this imperative with compliance and propriety concerns. For example how the authority's actions sit with EU procurement law and whether in solving one problem authorities create another problem in the form of a procurement challenge. David Lidington, Cabinet Office Minister, has publicly stated that some services will be taken in-house whereas others will be transferred over to other operators "in a managed, organised fashion". But how will this actually work in practice? This is a complex area and whilst this briefing looks at how termination and novation might work in practice, and what other issues local authorities should consider, advice should be sought in the context of the objectives of the local authority as a customer (client) and the status and rights arising under the contract as a result of the insolvency.

b. Termination and Step-In

Authorities need to understand their legal rights, remedies and responsibilities. Typically outsourcing, PPP and public services contracts will contain a right to terminate upon an insolvency event.

In more complex contracts the local authority may have rights to keep the suppliers and subcontractors to the insolvent company in place for a period of time to ensure continuity in service provision and allow it to make a decision as to whether it will either appoint a replacement contractor or perhaps take the services back in-house. These rights will flow from 'collateral warranties' or 'direct agreements'.

A key concern for the local authority is that the insolvent contractor may have accrued sizeable debts and liabilities to its sub-contractors, in which case the local authority may be required to take on these debts and liabilities (usually only those that have been fully disclosed by the sub-contractor prior to step-in). There is also a risk that the sub-contractor may look to re-negotiate the risk allocation in the contract and the authority will need to assess whether any modified terms comply with the EU Rules.

c. A new contractor or taking the service back in-house?

On termination or expiry of public contracts, the services will usually either be performed by a new contractor or provided in-house by the local authority. Public contracts should contain provisions covering termination consequences including the transfer of assets, employees (pursuant to TUPE), pensions, IP and data. However in situations like this the benefit of contract terms dealing with such matters (e.g. warranties and indemnities on accurate disclosure of liabilities) are as worthless as the insolvent company itself. For this

and other reasons the local authority may consider setting up a new company to provide the balance of the services and into which the staff and any assets transfer (assuming agreement with the insolvency practitioner).

If having taken the contract in-house, the local authority wishes to outsource then this will likely involve an OJEU compliant tender process under the EU Rules. This may make some local authorities query whether it wouldn't be better simply to transfer the contract to another (solvent) contractor at the outset.

d. Transferring the Contract to a New Contractor

Cabinet Office has suggested that contracts will be transferred to other providers "in a managed and organised fashion" and the Guardian reported that "contracts were drawn up so that if Carillion failed, other contractors would take over its responsibilities." However, transferring to a new contractor is not particularly straightforward under the EU Rules.

EU Rules state that a change of contractor is a substantial modification that requires a new tender process. There is an exemption to this rule where a new contractor replaces the old one if:

- i. The replacement follows corporate restructuring, including takeover, merger, acquisition or insolvency; and*
- ii. The new contractor fulfils the criteria for qualitative selection in the original tender process; and*
- iii. There are no other substantial modifications to the contract.*

These conditions do not make a transfer to a new contractor particularly straightforward. First, the recitals to the EU directive suggest that the contractor should be able to undergo structural changes (including those arising from insolvency) during the currency of the contract. This suggests that the drafters of the EU Directive had more in mind changes to the contractor driven by the administrator, rather than the authority selecting an alternative contractor. However, local authorities should bear in mind these second and third conditions if an administrator is seeking to change the contractor. The second condition will require the local authority to perform "a qualification stage" with this alternative contractor using the original qualification questions. Lastly, the alternative contractor may be reluctant to take on the risk allocation in the existing contract but a modification to this to make it more palatable may well fall foul of EU Rules as a substantial modification to the original contract.

e. What about a joint venture partner insolvency?

If the insolvent contractor is delivering the contract in a joint venture then the local authority may want to explore whether it could transfer the entire contract to the remaining contractor. This is likely to be more straightforward. The Court of Justice decided in 2014 that a bidding consortium could be replaced with a single entity that was part of the consortium provided that the single entity met the qualification criteria for the contract. It

therefore seems arguable that competition would not be distorted if the contracting parties were reduced in number provided the initial qualification criteria were met and there were no other material modifications such as the level of guarantees and similar surety obligations.

f. Contract novation

If an authority were to drive a novation of the contract to an alternative contractor outside of the above exemption without an OJEU advertised procurement then the next question would be whether it complied with one of the grounds for direct awards in particular, whether this was "strictly necessary where, for reasons of extreme urgency brought about by events unforeseeable by the contracting authority, the time limits for the open or restricted or competitive procedure with negotiation cannot be complied with".

Some public contracts may contain provisions which permit the funders to auction off PFI contracts where the existing contractor is subject to insolvency. However, it will require a review of the exact drafting to determine whether or not these provisions would meet the requirements of the EU Rules for "clear, precise and unequivocal review clauses".

Insolvency may seem an obvious unforeseeable event and there may be circumstances where local authorities could use this argument but it is far from clear cut. One might imagine different judicial views depending on whether the novated contract had 6-9 months left to run or whether it as PFI contract with another 15 years left. At the core of the EU Rules is the principle objective of ensuring the free movement of services and the opening-up to undistorted competition in all the Member States. The distortion of competition is likely to be a key consideration in determining whether a novation complies with the EU Rules or not.

g. Concluding remarks

The right course of action for any local authority will ultimately be to balance commercial pressures and the need to continue delivering services within the regulatory requirement of the EU rules on procurement. While Authorities directly affected by the Carillion collapse take urgent advice, its insolvency is a reminder to all Authorities to check and take expert advice on their existing contracts as well as their plans for future contract awards and procurements and ensure they are prepared for the unexpected.

APSE Comment

The Carillion insolvency situation once again highlights the risks associated with outsourcing of public services. As major contractors become often too big to fail the concept of 'risk' transferring to the contractor is often illusory. The public sector will still need to pick up the pieces to ensure service continuity. Moreover the public sector remains accountable for service failures, even if delivery has been delegated to a third party under a contract; this can often undermine democratic representatives being able to intervene when a service proves to be less than satisfactory to citizens and service users.

APSE has previously produced reports on insourcing, within local government, with a third report due in the spring. These reports have consistently demonstrated that insourcing a service is not driven by any ideological objectives but rather a need to improve the service for end users; allowing local councillors to reconfigure services towards local priorities, rather than being fettered by contract specifications, which, in many cases, are no longer fit for purpose. Moreover contract payments can limit the ability of local councils to respond to changing finances, gearing cuts towards the remaining controllable areas of the budget, thus exacerbating the impact and limiting the flexibility of the local authority to manage its own finances.

Whilst local authorities will undoubtedly continue to spend large sums with the private sector on the supply of goods and services, and APSE has always advocated a positive relationship with business and social partners, the collapse of Carillion is a timely reminder to reconsider outsourced services. Opportunities will arise through the natural expiry of a contract, through contract reviews and in some cases through contract failure (through non-performance or as in the case of Carillion contractor insolvency) allowing local authorities the opportunity to fully review **its' delivery models**. **Such opportunities should not be considered a burden but a necessary part of democratic accountability, ensuring that money spent on local public services provides value for money, high quality, responsive and sustainable local delivery, which enhances local economic prosperity.** [APSE Solutions](#) service is able to assist with such reviews. Please contact Andy Mudd on amudd@apse.org.uk

As APSE continues its ongoing work on insourcing please free to get in touch to share your experiences on this issue. Please contact Mo Baines on mbaines@apse.org.uk.

APSE is also considering a roundtable event with Walker Morris to consider the impact of Carillion and what this means to contracting in the public sector. If you are interested in attending this informal event please contact Mo on mbaines@apse.org.uk. For legal advice on this topic please feel free to contact David Kilduff, Ben Sheppard or Kate Webster at Walker Morris LLP email: david.kilduff@walkermorris.co.uk email: kate.webster@walkermorris.co.uk email: ben.sheppard@walkermorris.co.uk

Mo Baines

APSE, Head of Communication and Coordination

@apseevents @apsenews