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CONTRACT MODIFICATION - SOME GOOD STUFF BUT OPPORTUNITIES MISSED?

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Importance and current position

Contract modification is a hugely important topic in practice, and is one of the areas in which procurement law advice is most frequently sought. As those experienced in advising on procurement law will know, if a contract is substantially modified post-award then that is treated as if a new contract had been awarded[1].

The position reached via case law such as *Pressetext* was codified (and arguably expanded) in the 2014 Directives, becoming what is now Regulation 72 of the Public Contracts Regulations 2015[2].

The Procurement Bill will make some significant change in this important area. What are the changes proposed in the Bill and what impact are they likely to have? And what more could have been done to better achieve the objectives of procurement[3] and reduce the burden of procurement law compliance?

Starting point: would a more liberal contract modification regime comply with the TCA and the GPA?

A quick look in both the TCA and the GPA didn't reveal anything which bears specifically on the question of contract amendments so to that extent, Cabinet Office has a free hand in deciding what is appropriate[4].

Clearly, as the jurisprudence reflects and common sense requires, a point must be reached at which supposed modifications to an existing contract must be considered as tantamount to a new contract, so no-one would sensibly argue for complete free rein for contracting authorities to amend contracts in flight.

But I don't see anything obvious impacting the possible liberalisation suggested in this paper.

So if I can propose the question before proffering an answer, what degree of latitude is desirable to promote efficiency and value for money whilst not impinging adversely and to an unacceptable extent on the objectives of procurement law as now stated in the Bill?

What are the key changes proposed by the Bill?

A modification to a contract usually will not have been advertised or the subject of any transparent award process. As a result, any substantial modification will generally be considered unlawful.

In mitigation of this potentially-harsh position, the 2014 EU directives, which were largely copied out to constitute the Public Contracts Regulations 2015 (**PCR**), contained a number of softenings of that otherwise draconian rule.

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[1] See for example, *Pressetext* Case C-454/06

[2] And there are similar provisions in the Concessions Regulations (Reg 43) and the Utilities Regulations Reg 88). This paper focuses on the mainstream regulations

[3] Set out in clause 11 of the Bill, to which amendments have been proposed at Committee Stage

[4] Though Article X 11 of the GPA deals with modifications during the award process

Those softenings have been of some use but are narrow. There are also gaps which negatively impact efficiency and certainty.

Has the Bill delivered a more liberal approach? The relevant provisions are in clauses 69-71 and schedule 8 of the Bill. The answer is not clear cut, so:

- there are new softenings, but

- the opportunity to deal with a number of commonly-occurring situations has not been grasped;

- there are some important elements of clause 69 and schedule 8 which are not clear or where the drafters' commendable attempt to simplify and move away from 'Euro-speak' has potentially created some pitfalls; and

- arguably, one of the most important softenings (on business transfers) has been narrowed when it could have been widened or at least clarified.

Taking each of these in turn:

What are the new softenings?

There are three principal new exceptions which, if applicable, obviate the need for a new award process. They are as follows:

- non "Substantial" modifications are permitted (see below);

- modification is allowed in cases of urgency and protection of life: the origin of this provision is obvious and is a natural complement to the provisions elsewhere in the Bill which allow direct awards in similar circumstances;

- modification is allowed on materialisation of a known risk: this softening is odd, complex and likely not to be useable in all but a narrow range of situations, particularly because the known risk has to have been identified in the tender or transparency notice, along with the possibility of modification to deal with it: I'm imagining unresolved ground stability issues, market volatility or ongoing legislative amendments.[5]

Its availability is based on the subjective judgment of the contracting authority as to the existence of the required circumstances. It's interesting that there is a test as to whether awarding a further contract (as opposed to modification of the existing contract) would or would not be in the public interest. This contrasts with the approach to some of the other exceptions (on which see below). But there is still a 50% test: if it would not be in the public interest to award a new contract, then why have the 50% test at all?

"Known risk" is defined relatively narrowly because it needs to be something which "*could jeopardise the satisfactory performance of the contract*": I doubt that this would cover mere price increases, for example. Why not link it the procurement objectives set out in clause 11?

In other cases, the exceptions are based on those set out in the PCR, with some changes.

What are the missed opportunities?

- removal of the requirement, in the so-called 'safe harbour' provisions (now referred to as "below threshold" modification), that the value of the contract modification be less than the applicable threshold value would have made the safe harbour provisions very much more useful in practice. This threshold-related requirement renders the safe harbour useless in many cases for larger contracts, even where any independent observer would conclude that a new award process would be illogical and inefficient.

Consider, for example, a 5-year IT supply and outsourcing agreement with a value of £100M which contains a schedule of advantageous fixed prices. Several years in, an amendment is desirable to include the provision of £250k of additional kit the requirement for which was not (and could not have

[5] Of course, if we can be "unambiguous" about the change then another exception might apply (on which see below).

been) known at the time the contract was entered in to; the kit is branded kit so the 'incompatibility' and 'disproportionate technical difficulties' barriers[6] aren't passed. Does anyone consider that a new procurement is a sensible commercial approach or is likely to result in an efficient outcome? Should an authority therefore be obliged to pay more via a new process for this small incremental requirement and be barred from utilising the advantageous unit rates in the existing contract?

The other point with my suggested changes is a legal compliance point: in the circumstances I've described, we all know that the reality is that contracting authorities will be tempted (despite legal advice as to the risk of challenge) to press on and take a view because the practical consequences of doing as the law suggests is too painful and awkward and because experience suggests that the challenge risk is low. This is not a good outcome from the point of view of respect for the law: we shouldn't be facing contracting authorities with the prospect of either breaking the law or adopting an uncommercial and inefficient solution. Far better for procurement law, at least in most circumstances, to avoid such scenarios.

Where could the Bill could be clearer?

The changes on business transfers (Schedule 8, paragraph 9):

- The PCR permit contract modification without a fresh process in cases of "*universal or partial succession into the position of the initial contractor, following corporate restructuring, including takeover, merger, acquisition or insolvency*" – this is commendably broad (as caselaw has confirmed)[7]. And while the Bill expressly refers to "*novation or assignment*" of a contract (which helpfully clears up a potential wrinkle in the PCR wording) the wording is arguably narrower than the PCR in two critical respects:

> - the relevant provision refers to the change being "*required*": when can it ever be said (even in the case of the insolvency of the original contractor) that a change of contractor is <u>required</u>, as opposed to conduct of a new award process, however desirable/efficient/appropriate it might be? This will give lawyers for purchasers in M&A deals sleepless nights.
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> - the Bill's language ("*following a corporate restructuring or similar circumstance*") is significantly narrower than that in the PCR, and it does not seem credible to assume that this is a mere attempt at simplification. Can these words stretch to encompass M&A deals or insolvency? Those types of operation seem well beyond the boundaries of "*similar circumstance[s]*". And the Bill actually references insolvency in other contexts[8]. It would be an odd and commercially -harmful outcome if the Bill were found to require new award processes in place of a transfer of a contract in cases where a business is being transferred in normal commercial circumstances.

The Bill does not echo the PCR's requirement that the replacement contractor pass the selection criteria for the original competition. While superficially welcome, this may have unintended negative consequences for contracting authorities, especially if the contract allows transfer by way of unilateral act on the part of the contractor.

It is to be hoped that some of these issues, at least those which require mere clarification, will be addressed in the Committee Stage. Other changes which would have been welcome will, one fears, have to await the next Procurement Bill.

Let's look in a little more detail at the most important circumstances in which modifications will be permitted:

"Substantial" and "Below-threshold" modifications - general

A first point to note is that while it appears that Regulation 72(5) refers to an <u>increase</u> in value[9], the value test for a "Below-threshold" modification and the change in contract duration for the purposes of defining

[6] Now reflected in Schedule 8 of the Bill
[7] See *<u>Advania Sverige</u>*
[8] See paragraph 12 of Schedule 5.
[9] It's actually written in terms of the value of the increase being "below" the relevant percentage; this could potentially be read as cutting both ways, but it feels awkward

"Substantial" modification are both written expressly in terms of increase or decrease. I guess that the logic, at least as regards "Below-threshold" modifications, is that if a very large contract were awarded and then significantly reduced in scope, that could mean that smaller businesses who might have tendered had the smaller contract been advertised were deterred from bidding and so such a reduction could have negative consequences, but:

- the 10%/15% threshold seems quite small as regards reduction if this is what it is aimed at; and

- it isn't immediately clear why reduction of contract duration (especially with a threshold of just 10%) should be considered potentially to have pernicious consequences.

My suggestion is that asymmetry would be desirable as between increases and decreases, reflecting greater latitude for decreases.

Looking at the detail of each exception in turn:

"Substantial"

Modifications which are not "substantial" are permitted, and this is new: the 4 tests mentioned[10], which would render a modification "substantial" are:

- that the term is increased or decreased by more than 10% of the original maximum term (Limb 1);

- that the overall nature of the contract is not changed (Limb 2);

- that the scope of the contract is not materially changed (Limb 3)[11];

- that the economic balance of the contract is not materially altered in favour of the contractor Limb 4).

The first question is whether these tests all need to be satisfied?[12] Because there is an "or" in the text between the penultimate and final bullets, the assumption must be that "failing" any one of these tests will render a modification "substantial". But this gives rise to several problems:

- first, it is hard to understand how, in most circumstances, failing Limb 1 as regards an extension to a contract (for example) would not also lead to failure of Limb 4. Take the example of a contract to manufacture a widget which involves set-up costs and is to run for 10 years. The price specified in the contract will presumably reflect recoupment of set-up costs over those 10 years. There is therefore a degree of windfall to the contractor if the contract is extended for a year on the basis of the same prices, because all of the set-up costs have been recouped, even though that does not fall foul of Limb 1, because the windfall (if material) offends Limb 4;

- if amends to a contract would not alter the economic balance but would involve an extension to duration of greater than 10%, then does this fall foul of the tests? For example, imagine a service which involves the contractor reacting to major emergencies and the contract provides for 10 episodes of assistance over 5 years; in the event, the service is only utilised once in the first four years, so the parties agree to extend to 10 years but the contractor holds its price (ie probably an economic detriment to the contractor) and the number of episodes to be serviced is unchanged over the extended contract life. This would seem to be fine under limbs 2-4 but fails Limb 1. Is that the outcome we'd expect?

[10] In Clause 69(3) of the Bill

[11] I have artificially separated Limbs 2 and 3 above for clarity although they are actually part of a single bullet in the Bill.

[12] "*Or*" is seemingly not always disjunctive, at least in a contract context, according to Coulson LJ in *Royal Devon v ATOS*

- it's not clear to me why Limb 3 has the word "material" attached but Limb 2 does not. Would a court, then, read Limb 2 as catching any overall change in the nature of the contract even if not material? Why should this be the case? Isn't materiality a sensible overlay to each such test?[13]

- it would have been very helpful in practice if the Bill were to permit short extensions to longer-term contracts where the time remaining does not permit an orderly re-award procedure. While conceding that this could be seen as rewarding poor contracting authority practise in some cases, in others (for example where market developments or legislative change or a challenge to an award process import delays, or it is commercially sensible to delay slightly), this latitude would have been useful. The "substantial" exception goes some way to addressing this issue, but not as far as one would have wished for two reasons:

> - the extension permitted by Limb 1 is not expressed in absolute terms, but in terms of the duration of the base contract. In the circumstances I have outlined, this is unhelpful. On the assumption that one needs (at least) 6 months to run a compliant process on a complex contract, the "substantial" exception is not a complete answer for contracts whose original term was less than 5 years; why is a 6-year contract worthy of a suitably-long extension when a 4-year contract is not?
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> - more fundamentally, assuming that all four Limbs must be passed, the "substantial" exception is not useable where (for example) the economic balance has shifted in favour of the contractor. But for the reasons given in the example above, it will often, perhaps usually, be the case that an extension will shift the economic balance in favour of the contractor.

- although the "Below-threshold" provision seems to mirror[14] Regulation 72 in providing for aggregation of "Below-threshold" modifications, there is no such provision as regards "Substantial" modifications. So can I make serial "Substantial" modifications without aggregation or restriction?

"Below-threshold"

As with "substantial" modifications, there is a four-limb test, though in contrast in this case the final one is ended with an "and". One suspects that this difference will be noted by those litigating these provisions!

When the 10%/15% thresholds appeared in the 2014 Directives, I was puzzled: why are works contracts deserving of greater latitude than service or supply contracts? Arguably (if anything) the converse should be the case: is it not likely to be an innovative or high-tech contract that is more deserving of greater latitude? I was told (unofficially) that these percentages were no more than the result of a political compromise during the drafting of the Directives, and had no grounding in the realities of the different types of public contract. I'm not sure why Cabinet Office needs to perpetuate this compromise; why not (at least) 15% in all cases?

The concept of 'no scope change' is common to the definition of both "substantial" modifications and "below-threshold" modifications, but is it intentional that in the former case, this is qualified by the word "materially" but that that word doesn't appear in the latter? Again, I can see litigators making much of this distinction where contract modification is in issue.

Schedule 8 and other permitted modifications

I have already dealt with the business transfer, materialisation of known risk and urgency exceptions, and I don't intend going through the other four exceptions in Schedule 8 in great detail, but here are some thoughts:

Modifications provided for in the contract: the first exception partially mirrors Regulation 72(1)(a), but in line with the use of new language in place of 'Euro-speak', "*clear, precise and unequivocal*" has gone and is replaced by a reference to "*the possibility of modification [being]… unambiguously provided for*". This seems quite a bit broader and looser than Regulation 72. For example, if the contract says:

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[13] See also below where the materiality overlay does not apply to scope change for "Below-threshold" purposes or to two of the Schedule 8 the exceptions.

[14] Though it's not as clear as it might be

"*The parties agree that this contract will need to be amended during its term and they will co-operate in order to do so*"

is that not unambiguous? Or is the intention that the basis on which modification will be made, as well as the fact that modification will occur, need to be set out clearly, precisely and unequivocally?! Is an unambiguous 'agreement to agree' sufficient or not?

The Bill requires that the possibility of modification is referenced both in the contract and in the tender or transparency notice – Regulation 72 refers only to the procurement documents, but I don't view this as a difference of substance.

The Bill also replicates the reference to there being no change to the overall nature of the contract, and the word "material" is not used.

Unforeseeable circumstances: this largely mirrors Regulation 72(1)(c) but:

- the test of foreseeability is one based on reasonableness rather than foreseeability by a diligent contracting authority (as in the Directives); so the test in the Bill seems marginally softer, and is arguably partially subjective - it seems to refer to what was reasonably foreseeable by this authority rather than a hypothetical diligent authority

- our old friend "no change to overall nature of the contract" is there, without the word "material".

Additional goods, services or works: commendably, compared to Regulation 72, the problematic word "necessary" has been dropped.

In addition, the tests of disproportionate technical difficulties and duplication of costs have been altered so as to be matters for the subjective judgment of the contracting authority.

The final exception in schedule 8 refers to **defence authority contracts** and I do not consider it in detail in this paper.

Contract Change Notices (CCNs) and voluntary standstill on contract modification

This is a new requirement and is set out in clause 70.

There is, of course, no longer the possibility of using a VTN.

Where the contract as modified has an estimated value of more than £2 Million, there is also an obligation to publish a copy of the contract as modified within 90 days of the modification.

The CCN needs to be published before the modification is made and must both state that the contracting authority intends to modify the contract and contain any other information required pursuant to regulations yet to be published.

Given that one sees contracts which undergo dozens of modifications, the CCN and contract publication processes could become cottage industries!

An interesting question which has arisen under the PCR in a different context is whether conditionality works: it will in many cases be desirable to effect the change conditional on submission of the CCN and no challenge emerging. Is that possible or is this jumping the gun: has the contract been amended even if the coming in to effect of the modification is conditional on the publication of the CCN and no challenge?[15]

There are exceptions to the requirement to publish a CCN for light touch contracts, and in the following other circumstances (presumably disjunctive)[16]:

[15] And does it matter whether any condition is a (true) condition precedent or a condition subsequent?
[16] There are also carve-outs from clause 70 for certain Welsh and Northern Irish agreements, defence and security contracts and (as with a large number of other provisions in the Bill) private utilities.

-contract value increase or decrease 10%/15% or less;

- contract term increase or decrease 10% or less.

This is an odd (partial) mix of the "No Substantial Modification" and "Below Threshold" exceptions. There is neither an "and" nor an "or" in this list, but given the reference to Light Touch this list must be intended to be disjunctively applied.

There is no reference to aggregation of successive modifications, so repeated modifications could be made below the above thresholds without a CCN being required.

Clause 71 states that a contracting authority may not modify a public contract before the end of any standstill period provided for in the CCN: so it is a voluntary matter whether to include a standstill period, but if a contracting authority does so, it must not then proceed with the modification before the end of that standstill period. The conditionality issue considered above rears its head again here.

There is no stated minimum duration that I can find for the standstill period.

This requirement mirrors the concept of voluntary standstill on contract award for light touch and certain other contracts[17].

Note that voluntary standstill has consequences as regards remedies:

- Clause 90(1) prohibits a contracting authority from proceeding with a contract modification where proceedings have been commenced and notified to it where a voluntary standstill is in force; but

- Clause 90(3) provides that this does not apply if the proceedings are notified after the end of any voluntary standstill period. So a voluntary standstill gives certainty if there is a gap between the end of a voluntary standstill period and the making of the modification.

And if I am right that there is no minimum duration for the standstill period, the cynic in me wonders why not publish a CCN with a very short standstill period, too short for a complainant to be able to react by issuing proceedings?

Clause 92 provides for set-aside if the court is satisfied that the claimant was denied a proper opportunity to seek a remedy, but only where the modification has taken place;

- before the end of any applicable standstill period; or

- during an automatic suspension period pursuant to Clause 90; or

- where the breach only became apparent:

    - on publication of a CCN; or

    - after the contract was modified.[18]

So it seems that there is value in a voluntary standstill.

And my cynicism seems to be validated by Clause 94(3) which states that there will be no set-aside where there has been a voluntary standstill, without stating a minimum duration for that standstill.

Some other noteworthy provisions

[17] See clause 49(4)

[18] And the Bill very usefully clears up a potential issue under the PCR by stating that the set-aside will relate only to the modification: it is unclear under the PCR whether ineffectiveness relates solely to the modification or to the whole of the contract as modified

The Bill deals expressly with the situation where a contract not previously within the scope of procurement law becomes so subject as a result of the modification: These are termed "*convertible contracts*". This seems sensible.

Light Touch contracts may seemingly be freely modified. I'm not sure whether to conclude that this is welcome or goes too far: if one can make unlimited changes to Light Touch contracts, why regulate Light Touch contracts at all?

What does this mean for contracting authorities and suppliers?

Unfortunately, an opportunity to make some significant efficiency-enhancing changes has (so far) been missed. Stakeholders will want to lobby for change in the Committee Stage.

I have pointed out a number of areas in which the language in the Bill needs to be tightened or clarified, as well as a number of areas in which some greater liberalisation would be of practical value without a concomitant weakening of the aims of the Bill. Hopefully at least some of this can be accommodated in the interest of certainty and avoidance of litigation.

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