Legal Briefing

Hackney Empire Ltd v Aviva Insurance UK Ltd

[2011] EWHC 2378 (TCC), Mr Justice Edwards-Stuart

The Facts

Hackney Empire Ltd ("HEL") owns the Hackney Empire Theatre in East London. It engaged Sunley Turriff Construction Limited ("STC") to carry out extensive refurbishment work to the theatre. The key events are summarised as follows:

- May 2001 – STC took possession of the site and started work under a letter of intent authorising it to carry out up to £500,000 of work.
- 6 August 2001 – Aviva Insurance UK Limited ("Aviva") issued a bond in favour of HEL for £1,106,852 to secure the performance of STC under the building contract.
- 5 March 2002 – The building contract between HEL and STC was finally entered into. The building contract required a completion date of 2 September 2002 with liquidated damages at £5,000 per week.
- December 2002 – The parties entered into a verbal agreement by which HEL paid £500,000 on account of STC's claims for loss and expense with two further payments of £250,000 to follow. In return STC agreed to provide a programme demonstrating how it could complete the works by 31 May 2003 and agreed to complete them by that date.
- February 2003 – the parties entered into a side agreement which limited the amount of liquidated damages payable by STC if the target completion date was met, and prevented the parties from referring disputes to adjudication for a period of time. The side agreement also referred to the £500,000 paid in December 2002 and the two further payments of £250,000. The first of these 2 further payments was made. The agreement provided that if STC did not meet the target date for completion of the works (which was 31 May 2003 but which by correspondence between the parties had been extended to 31 July 2003), it agreed to repay all of the sums paid under the side agreement.
- 2 July 2003 – STC went into administration.
- 7 July 2003 – HEL demanded repayment of the £750,000 paid under the side agreement.
- 5 February 2004 – HEL wrote to STC's administrator confirming it had suffered losses of £3,154,142 as a result of STC's failure to complete the work.
- 8 March 2004 – HEL made a claim under the bond for the full amount.

The Issues

Aviva argued that the rule *Holme v Brunskill* meant that the payments to STC under the side agreement had discharged its liability under the bond. This rule provides that if there is any agreement between the principals (in this case HEL and STC) to alter the principal contract (ie the building contract) then the surety should be consulted and if the surety has not consented to the alteration, or if it is not self-evident that the alteration is unsubstantial or which cannot be prejudicial to the surety, then the court will not go into the merits of the alteration or the question of whether it is prejudicial but will instead allow the surety to be discharged from its obligations. In effect, Aviva argued that they did not consent to the agreement (either the verbal one in December 2002 or the written side agreement in

February 2003) and it was not self-evident that the alteration was unsubstantial or could not be prejudicial to Aviva. On this basis, the court should not go into the merits of the alteration in question or whether or not it is prejudicial but should allow Aviva to treat itself as discharged.

HEL's case was that rule only applied if the variation of the principal contract is such that it is increases the risk of default by the principal and therefore that there will be a call on the bond. HEL argued this was quite different to the position where the variation merely affects the amount of the surety's ultimate liability but leaves the risk of default unchanged. Put another way, the payment of sums on account only create or increase the indebtedness but do not increase the risk of STC not performing under the building contract.

The Decision

The court rejected Aviva's argument and held that whilst the side agreement did vary the building contract it did so only in 2 ways both of which fell within the exceptions to the rule in *Holme v Brunskill*. This was because the side agreement effectively limited the amount of liquidated damages HEL could claim to £100,000.00 if STC met the target completion date (which was beneficial, rather than prejudicial, to Aviva) and it provided that neither HEL or STC would refer disputes to adjudication for an agreed period (which the court held was of no consequence to Aviva).

However, the court held that whilst Aviva were not discharged from their obligations under the bond, that bond did not extend to the obligations under the side agreement as these obligations had not been contemplated by Aviva when assuming liability under the bond.

Comment

The Court has in its decision clarified the common law position between varying the terms of an existing contract, and entering into a separate side agreement (or a course of conduct), which whilst not varying an existing contract might be prejudicial to the surety.

Where parties vary an existing contract, the surety will be entitled to discharge a bond unless it is self evident, and without enquiry, that the variation is insignificant or non-prejudicial (*Holme v Brunskill*). However a side agreement (or course of conduct) which does not vary the terms of an existing contract must prima facie be prejudicial to the surety, in order for it to discharge its obligations under the bond (*General Steam Navigation v Rolt*).

The case is also a lesson for employers to proceed with caution when entering into side agreements with contractors; they should not automatically assume that any agreement will come under the ambit of the bond. If in any doubt, the consent of the surety should be sought.

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