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Environment, Transport and Works Bureau
Technical Circular (Works) No. 18/2003

Substitution of Listing Status and
Transfer of Benefits and Obligations of Contracts

Scope

This Circular amends Section 6 of the Contractor Management Handbook – Revision A (CMH) promulgated under Works Bureau Technical Circular No. 25/2002. The amendments involve stipulation of: -

- (a) the date after which applications for substitution of listing status will no longer be considered; and
- (b) the only circumstances where requests to transfer the contractors' benefits and obligations under contracts with the Government to third parties having separate legal status will be permitted.

Effective Date

2. This Circular takes immediate effect.

Effect on Existing Circulars

3. This Circular amends paragraphs 5(i) and 5(j) of WBTC No. 25/2002 entitled “Contractor Management Handbook – Revision A”.

Background

4. As stated in note (5) in Appendix 6A to the CMH, once the old company on the List and/or the Specialist List has been substituted by the new company, the past performance records of the outgoing company will be regarded as the performance of the new company in the consideration of its future bids for Government works. However, it is considered that such arrangement is not entirely satisfactory as the outgoing and new companies are in fact separate legal entities with each standing for itself and not the other. Accordingly, it is decided that, after the date set out in paragraph 6 below, any application for substitution will no longer be allowed.

5. Separately, as promulgated under WBTCs Nos. 22/2002 and 23/2002 concerning the use of marking scheme and formula approach in tender evaluation for works contracts respectively, the award of a contract to a contractor is now based on the combined assessment of his tender price and technical score or performance rating. In order to uphold the principle of open and fair competition, a proposal to transfer the benefits and obligations of a contractor under a contract with the Government to a third party, including a sister company, holding company or a subsidiary company having a separate legal status, will not be permitted except under some special circumstances. This is because if the third party were to submit a tender in place for the contractor, the third party might not have been awarded the contract.

Policy

6. **No application for substitution will be considered/allowed after 18 September 2003.** Where applications for substitution are made on or after the date of this Circular but received before this deadline, the following shall apply: -

- (a) All contractors on the List and/or the Specialist List who meet the conditions and pre-requisites set out in Sub-section 6.5 and Appendix 6A

to the CMH, including those who are currently under suspension, are eligible for applying for substitution.

- (b) In an application for substitution, the complete set of the following documents must be furnished: -
 - (i) a certified copy of the Application by Firm or by other Body Unincorporate for Registration of Business(es) Carried On by such Body in Hong Kong [i.e. Form 1(c) issued by the Inland Revenue Department] of the outgoing company, if the application is based on change of structure of the outgoing contractor from a partnership (comprising individuals only) or sole proprietorship to a limited company;
 - (ii) a full list of the new company's directors and shareholders filed in the Companies Registry;
 - (iii) a certified copy of Business Registration Certificate, the Certificate of Incorporation and the Memorandum & Articles of Association of the new company;
 - (iv) the original or a certified true copy of the latest 3 years' unconsolidated audited accounts, if any, of the new company;
 - (v) a certified statement of outstanding contracts of the new company (including contracts with private sector if applying to be listed under Group C), and
 - (vi) a certified statement of all contracts to be novated in respect of the outgoing company.
- (c) Approval on substitution will only be given if the outgoing company is cleared of all suspension, and both the outgoing and new companies meet all the requirements set out in Sub-section 6.5 of and Appendix 6A to the CMH.

(d) **The application for substitution will be rejected and not further considered in the event that the applicant cannot satisfy all the requirements within 12 months from the date of application.**

(e) For the avoidance of doubt, references to “application for substitution” or “substitution” in the sub-paragraphs above of this paragraph 6 shall mean substitution the applications for which are made on or after the date of this Circular. In the event of any inconsistency between the forgoing sub-paragraphs of this paragraph 6 and the other provisions in the CMH in respect of those applications, the provisions of the foregoing paragraphs shall prevail. For the further avoidance of doubt, the foregoing sub-paragraphs of this paragraph 6 shall not apply to applications for substitution already made before the date of this Circular which shall continue to be considered/processed in accordance with the existing provisions of the CMH notwithstanding paragraph 6 (a) to (d) above, save that if the applicant cannot satisfy all the requirements within 12 months from the date of this Circular, his application for substitution will be rejected and not further considered.

7. Novation of a contract is only allowed under one of the following special circumstances:

- (a) Where application for substitution of listing status has been approved.
- (b) A contractor is winding up, will no longer be in existence, or is unable to complete the contract. The Government on balance, in the interest of the Government and public fund, agrees to a novation instead of terminating the contract.

Additional provisions to be put in the Novation Agreement

8. In cases of novation where there is doubt on the financial position of the outgoing contractor but winding up has yet to commence, since the Government normally do not have much details or knowledge of the deal between the outgoing contractor and the new contractor behind the novation transaction, and there is a possibility of avoidance of transaction under section 266 of the Companies Ordinance Cap. 32 if the novation is made within 6 months before the commencement of the outgoing contractor’s winding up or under section(s) 49 and/or 50 of the Bankruptcy Ordinance, there should be added an indemnity clause in the Novation Agreement to

the effect that the outgoing contractor and the new contractor shall, jointly and severally, indemnify and keep indemnified the Government against any loss, damages, costs, expenses etc. arising out of or in connection with any challenge or meeting any challenge to the novation transaction, in particular under section 266 of the Companies Ordinance (for outgoing contractor which is a company) or under section(s) 49 and/or 50 of the Bankruptcy Ordinance (for outgoing contractor which is an individual or are individuals). A sample indemnity clause to be put in the Novation Agreement is shown in **Appendix A** to this Circular.

Amendments

9. The following amendments are incorporated into the Contractor Management Handbook – Revision A: -

- (a) Add paragraph 6 above as new paragraph 6.5.2.
- (b) Re-number the original paragraphs 6.5.2 and 6.5.3 to read as paragraphs 6.5.3 and 6.5.4 respectively.
- (c) Paragraph 6.6.1 to be rewritten as: “Apart from the substitution process as mentioned in Sub-section 6.5 above, a contractor may apply to transfer his benefits and obligations under a contract with the Government to a third party only if he is winding up, will no longer be in existence, or is unable to complete the contract. The Government on balance, in the interest of the Government and public fund, may agree to a novation instead of terminating the contract but under such circumstances, the contractor will normally be removed from the List and/or the Specialist List in accordance with Section 5 above. In all the aforementioned cases, a novation agreement is required. Other than these cases, the transfer of a contractor’s benefits and obligations under a contract with the Government to a third party, including a sister company, holding company or a subsidiary company having a separate legal status, will not be permitted. This is to uphold the principle of open and fair competition as the award of a contract to a contractor is based on the combined assessment of his tender price and technical score or performance rating. If the third party were to submit a tender in place for the contractor, the third party might not have been awarded the contract.”

- (d) The first sentence of paragraph 6.7.3 to be replaced by: “The departments concerned must check to ensure that the third party taking over has the technical, management and financial capability and is a fit substitute for the outgoing contractor.”
- (e) Add the following sentence after the first sentence of paragraph 6.7.5: “In the case where the contract to be novated is made between the Government and the contractor together with other person or persons trading as an unincorporated joint venture, such other person or persons shall also join in the execution of the agreement.”
- (f) Add the indemnity clause as shown in Appendix A to the two standard forms of novation agreement at Appendices 6C & 6D of the CMH and add an asterisk “*” footnote to the indemnity clause which reads: *The department concerned should consider paragraph 8 of ETWB TC(W) No. 18/2003 as to the need for this indemnity clause.

10. The amended Sub-sections 6.5, 6.6 and 6.7 of the CMH are shown in **Appendix B** to this Circular.

(W S Chan)
**Deputy Secretary for the Environment,
Transport and Works (Works) 2**

Indemnity Clause to be Inserted in Novation Agreement

The Contractor and the New Contractor shall, jointly and severally, indemnify and keep indemnified the Government against all losses, damages, costs, expenses, claims or liabilities etc. and any legal or other professional costs (on a full indemnity basis) incurred or suffered (whether direct or indirect) arising out of or in connection with any challenge or meeting any challenge to this novation transaction, in particular under [section 266 of the Companies Ordinance Cap. 32] [section(s) 49 and/or 50 of the Bankruptcy Ordinance Cap. 6] [section 266 of the Companies Ordinance Cap. 32 and section(s) 49 and/or 50 of the Bankruptcy Ordinance Cap. 6 as appropriate]*.

* Choose the appropriate one, depending on whether the Contractor and the New Contractor are individuals or companies

Amended Sub-sections 6.5, 6.6 and 6.7 of the CMH

6.5 Substitution of Listing Status

6.5.1 The structure of a contractor may change, for example, from a partnership or sole-proprietorship to a limited company or a company may wish to transfer its listing status to its holding or subsidiary company. All these cases are regarded as applications for substitution. The “Notes for Application for Substitution” at **Appendix 6A** describes the pre-requisites and essential information for the completion of the substitution process. A sample of undertaking, which should be signed by both the company being substituted (outgoing company) and the new company is shown at **Appendix 6B**. The date of approval for substitution will be the day executing novation agreements of all outstanding contracts, if any, among the outgoing company, the new company and the Government.

6.5.2 **No application for substitution will be considered/allowed after 18 September 2003.** Where applications for substitution are made on or after the date of ETWB TC(W) No. 18/2003 but received before this deadline, the following shall apply: -

- (a) All contractors on the List and/or the Specialist List who meet the conditions and pre-requisites set out in Sub-section 6.5 and Appendix 6A to the CMH, including those who are currently under suspension, are eligible for applying for substitution.
- (b) In an application for substitution, the complete set of the following documents must be furnished:
 - (i) a certified copy of the Application by Firm or by other Body Unincorporate for Registration of Business(es) Carried On by such Body in Hong Kong [i.e. Form 1(c) issued by the Inland Revenue Department] of the outgoing company, if the application is based on change of structure of the outgoing contractor from a partnership (comprising individuals only) or sole proprietorship to a limited company;

- (ii) a full list of the new company's directors and shareholders filed in the Companies Registry;
 - (iii) a certified copy of Business Registration Certificate, the Certificate of Incorporation and the Memorandum & Articles of Association of the new company;
 - (iv) the original or a certified true copy of the latest 3 years' unconsolidated audited accounts, if any, of the new company;
 - (v) a certified statement of outstanding contracts of the new company (including contracts with private sector if applying to be listed under Group C), and
 - (vi) a certified statement of all contracts to be novated in respect of the outgoing company.
- (c) Approval on substitution will only be given if the outgoing company is cleared of all suspension, and both the outgoing and new companies meet all the requirements set out in Sub-section 6.5 of and Appendix 6A to the CMH.
- (d) The application for substitution will be rejected and not further considered in the event that the applicant cannot satisfy all the requirements within 12 months from the date of application.**
- (e) For the avoidance of doubt, references to "application for substitution" or "substitution" in sub-paragraphs above of this paragraph 6.5.2 shall mean substitution the applications for which are made on or after the date of ETWB TC(W) No. 18/2003. In the event of any inconsistency between the forgoing sub-paragraphs of this paragraph 6.5.2 and the other provisions in the CMH in respect of those applications, the provisions of the foregoing paragraphs shall prevail. For the further avoidance of doubt, the foregoing sub-paragraphs of this paragraph 6.5.2 shall not apply to applications for substitution already made before the date of ETWB TC(W) No. 18/2003 which shall continue to be considered/processed in accordance with the existing provisions of the CMH notwithstanding sub-paragraphs (a) to (d) above, save that if the applicant cannot satisfy all the requirements within 12 months from the date of ETWB TC(W) No. 18/2003, his application for substitution will be rejected and not further considered.

6.5.3 Upon receipt of an application for substitution, SEO(PS) of Environment, Transport and Works Bureau will refer the application to the Managing Departments concerned for the vetting of the technical and management capability of the new company. These cases will be handled in the same manner as application for admission. In addition, all Works Departments will be required to check whether the outgoing company has any outstanding contracts with them and confirm to SEO(PS) of Environment, Transport and Works Bureau within 3 working days the full list of contracts requiring novation. The basic principle is to **novate all contracts where final payment certificates have not yet been issued and those contracts where final payment certificates have been unilaterally issued by the Engineers/Architects but disputed by the contractor**. Departments should however be reminded to check cautiously all contracts still undertaken by the outgoing company (such as those in Maintenance Periods) and bring to the attention of Environment, Transport and Works Bureau if exceptional contracts have to be included in or excluded from the novation list. Upon confirmation by the departments concerned the full list of contracts to be novated, SEO(PS) will forward the lists together with the application to the Finance Section of Environment, Transport and Works Bureau for financial vetting. The new company will be assessed financially on whether it is eligible for admission and for taking up the outstanding contracts surrendered by the outgoing company.

6.5.4 If the Managing Departments recommend the substitution, they should submit an updated list of outstanding contracts requiring novation and a list of outstanding issues that have to be cleared by the outgoing company before novation and substitution can be proceeded. SEO(PS), Environment, Transport and Works Bureau will also check with other Works Departments to consolidate a full list of outstanding contracts. If discrepancies are found between this list and the one collected before processing the application, SEO(PS) will draw the attention of the Finance Section, Environment, Transport and Works Bureau, who may conduct a re-assessment on the new company's financial capability if required. Separately, SEO(PS) will coordinate the returns from all departments on outstanding issues and request the outgoing company to furnish the required documents. Having collected the required documents from the outgoing company, SEO(PS) will send the documents to the departments concerned for vetting. If only one department is involved in the novation process, that department should follow up all issues related to the novation and advise SEO(PS) of the date fixed for the execution of novation agreement(s). The Secretary for Environment, Transport and Works will issue a letter to the new company approving its inclusion in substitution of the outgoing

company **on the date of executing novation agreement(s)**. If the novation agreement(s) is subsequently not executed on the specified day, the approval for substitution will become void and invalid. In the event that more than one Works Departments are involved in the novation process, SEO(PS) will facilitate as a central coordinator between the Works Departments concerned and the outgoing and new companies. The Works Department which holds the greatest contract value for those outstanding contracts requiring novation will be responsible for the logistical arrangement for the novation procedures such as checking of documents on authorized signatories, preparation of standardized novation agreement forms and arranging venue for signing novation agreements.

6.6 Transfer of Benefits and Obligations of Contracts

6.6.1 Apart from the substitution process as mentioned in Sub-section 6.5 above, a contractor may apply to transfer his benefits and obligations under a contract with the Government to a third party only if he is winding up, will no longer be in existence, or is unable to complete the contract. The Government on balance, in the interest of the Government and public fund, may agree to a novation instead of terminating the contract but under such circumstances, the contractor will normally be removed from the List and/or the Specialist List in accordance with Section 5 above. In all the aforementioned cases, a novation agreement is required. Other than these cases, the transfer of a contractor's benefits and obligations under a contract with the Government to a third party, including a sister company, holding company or a subsidiary company having a separate legal status, will not be permitted. This is to uphold the principle of open and fair competition as the award of a contract to a contractor is based on the combined assessment of his tender price and technical score or performance rating. If the third party were to submit a tender in place for the contractor, the third party might not have been awarded the contract.

6.7 A Novation Agreement

6.7.1 For public works contracts, a novation agreement is a tripartite agreement entered into by the Employer (Government), the contractor and a third party, whereby the contractor is released from and the third party assumes all the Contractor's obligations and rights under the stated contract(s). The two standard forms of novation agreement are shown at **Appendices 6C&D**. More than one contract may be included in a novation agreement.

6.7.2 For all novation, advice from the Legal Advisory Division (Works) of Environment, Transport and Works Bureau must be sought on any proposed change to the standard forms of novation agreement.

6.7.3 The departments concerned must check to ensure that the third party taking over has the technical, management and financial capability and is a fit substitute for the outgoing contractor. One of the basic requirements is that the party must be an approved contractor under the relevant category/categories of works in the List and/or the Specialist List. In the event that the contractor has assigned the financial benefit of his contract with the Government to a financial institution, the contractor is required to resolve matters relating to the financial assignment to the satisfaction of the Government before the Government considers agreeing to the proposed novation.

6.7.4 Before a novation agreement is executed, departments concerned should first confirm the financial capability of the third party with the Finance Section of Environment, Transport and Works Bureau. They should then apply to the Secretary for the Environment, Transport and Works (Attn: PAS(W)4), with a copy of confirmation memo from the Finance Section of Environment, Transport and Works Bureau, for approval in principle before the execution of the novation agreement. In the application, the details of the contract, the parties involved in the novation agreement and the expected time required for the completion of the novation agreement should be indicated. Environment, Transport and Works Bureau will monitor the progress of the arrangement.

6.7.5 All three parties shall execute the agreement on the same date. In the case where the contract to be novated is made between the Government and the contractor together with other person or persons trading as an unincorporated joint venture, such other person or persons shall also join in the execution of the agreement. Copies of the executed novation agreement shall be sent to the Secretary for the Environment, Transport and Works (Attn: PAS(W)4) and the Secretary for Financial Services and the Treasury within 3 working days from the date of execution.