



## PFI Schools Academy Conversion

Note of advice for Tameside Metropolitan Borough Council

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### Background

Tameside Metropolitan Borough Council (**TMBC**) is in discussions with the Department for Education (**DfE**) regarding the possible conversion of Pinfold Primary School and Arundale Community Primary School (**Schools**) into academy schools (the **Proposed Conversion**).

The Schools were built under the terms of a PFI project agreement dated 19 June 2002 between TMBC and Pyramid Schools (Tameside) Limited (the **Project Agreement** and the **Project Co**). The Project Agreement will remain in force if the Proposed Conversion takes place.

TMBC is concerned that the model documents issued by the DfE relating to the conversion of PFI schools to academies (**Model Documents**) may leave TMBC exposed to certain risks that TMBC did not previously bear.

### Specific questions

Therefore TMBC seeks answers to the following specific questions:

- what are the key risks associated with conversion of the schools to academy status?
- do the Model Documents fully protect TMBC from the risks associated with the Academy occupying the schools?
- if not, what risks remain with TMBC?

### Summary of Advice

#### What are the key risks associated with conversion to academy status?

- (1) **The Unitary Charge Contribution Risk:** Following the conversion of the Schools to Academy status, TMBC will retain primary liability to pay the Unitary Charge to Project Co under the Project Agreement. Currently, a proportion of the Unitary Charge is contributed by the Schools. Following conversion of the Schools to academies, a proportion will continue to be contributed by the Schools, but the Schools as academies will be separate legal entities and no longer under the control of TMBC. In the absence of specific protection, the key risk to be

considered here is that if the Academy does not pay this contribution for any reason (for example as a result of breach of contract or insolvency), TMBC may not be able to recover this contribution, and yet TMBC will remain liable to pay the full Unitary Charge to Project Co (including the proportion that should have been contributed by the Academy). TMBC may also have to incur costs to recover monies due.

- (2) **The Academy Breach Risk:** Following Academy conversion, the Schools as separate legal entities will occupy the School buildings that were built and are maintained by Project Co under the Project Agreement. In occupation, the Academy may act in a manner that is not consistent with the terms of the Project Agreement (for example, its staff may "wilfully impede" Project Co and its sub-contractors in the performance of its duties, or it may cause damage to the buildings or M&E infrastructure). In the absence of specific protection, the key risk to be considered here is that in so doing they may crystallise a liability for TMBC to Project Co under the Project Agreement in circumstances where TMBC is unable to recover all the loss from the Academy (for example because the Academy becomes insolvent). TMBC may also have to incur costs to recover monies due.

**Do the Model Documents fully protect TMBC from the risks outlined above, and, if not what risks remain?**

- (3) Some protection is afforded by the Model Documents to TMBC. But TMBC is not fully protected from each risk. Consequently TMBC would have some limited additional exposure if the Schools converted to Academies.
- (4) In the Model Documents, the DfE gives an indemnity in favour of TMBC in respect of "Direct Losses" arising from "Normal Payment Matters" (the "**DfE Indemnity**"). The precise and specific meanings of these terms are outlined at paragraphs 2.5 and 2.6 below. As explained at paragraph 2.8 below, there are some heads of potential loss that are not covered by these specific meanings. Where this is the case, the DfE will not be liable under the DfE indemnity
- (5) In relation to the Academy Breach Risk:
- (a) TMBC's primary relevant protection is the benefit of a contractual obligation from the Academy not to cause TMBC to be in breach of the Project Agreement. If the Academy breaches this obligation, so that TMBC is liable to Project Co, then TMBC would have a contractual right to claim against the Academy to recover any loss suffered. Recovery of this loss would be subject to the usual "general law" requirements to substantiate a contractual claim. The Academy is therefore appropriately obligated to TMBC. But this obligation alone does not give TMBC comfort in relation to the risk that the Academy may default on its payment obligation (and this of course is the purpose of the DfE Indemnity);
- (b) as explained in more detail at paragraph 2.8 below, the DfE *may* in some circumstances under the DfE indemnity be liable for losses that TMBC suffer by reason of the Academy's breach. But not all heads of potential loss are covered, and the DfE is only liable to the extent it "reasonably determines" it should have such liability. Therefore TMBC does not have certainty that the DfE indemnity could be enforced in all circumstances;

- (c) as explained in more detail at paragraphs 2.9 to 2.12, TMBC has the benefit of some additional contractual protection where the Academy acts in "material" breach of the School Agreement, and this results in TMBC being in breach of the Project Agreement. In these circumstances TMBC may request that DfE intervenes under DfE's intervention rights (which are set out in the Academy articles of association and/or funding agreement), and may request compensation for direct losses incurred as a result of the breach. But DfE has discretion as to whether or not it takes TMBC's requested action, and TMBC cannot force it to do so. Therefore TMBC cannot be certain as to the value of this obligation. There is also some uncertainty as to exactly what breaches would fall within the scope of this contractual mechanic by reason of being "material", and this protection would not apply to "immaterial" breaches (including immaterial breaches of a persistent nature); and
  - (d) The Academy may cause TMBC to be liable to Project Co under the indemnities which TMBC provides to Project Co under the Project Agreement in respect of personal injury and property damage claims. Whilst the Model Document provides that the Academy will be "responsible" in such circumstances, the protection given falls short of being "back to back". TMBC may therefore be liable on an indemnity basis to Project Co under the Project Agreement, but to recover from the Academy TMBC would have to prove its contractual rights against the Academy (and potentially the DfE) on a different basis. This means that there could be a mismatch in the value of the recoverable amounts and the timing of recovery.
- (5) In relation to the Unitary Charge Contribution Risk:
- (a) the principal liability is expressly covered by the DfE Indemnity (see paragraph 2.6(a) below). Therefore, so long as the Model Document is appropriately drafted with accurate details of what the Academy should be liable for, TMBC can be comfortable in this respect; but
  - (b) as with the Academy Breach Risk, and as more fully explained at paragraph 2.8 below, not all potential heads of loss are covered.

## IN DETAIL

### 1 Background

- 1.1 The conversion of a PFI school into an academy is subject to a suite of Model Documents available from the DfE's website which regulate the relationships between the DfE, the Academy and TMBC.
- 1.2 The Project Agreement will remain in force between TMBC and Project Co, and the Academy will not become a party to it. TMBC will continue to pay for the services at the school through the Unitary Charge under the Project Agreement, but will no longer occupy the school site.
- 1.3 Grant Thornton has previously made a recommendation to TMBC to keep its PFI school contracts under review and, if a proposal were made to convert to academy status, to ensure that any agreement with an academy and DfE mitigated risk to TMBC associated with TMBC's obligations under the Project Agreement.
- 1.4 On the basis of the Grant Thornton advice, TMBC has adopted a policy that as a pre-condition of its consenting to any PFI school academy conversion it must be held harmless and/or indemnified for:
  - (a) the legal costs to the conversion process by the converting school; and
  - (b) all liabilities under the contract caused by any default of the academy.

### 2 The Model Documents

- 2.1 The main documents that concern TMBC are:
  - (a) the School Agreement to be entered into between (1) TMBC and (2) the Academy; and
  - (b) a Principal Agreement to be entered into between (1) TMBC (2) the Secretary of State for Education and (3) the Academy,
 together the **Model Documents**.

#### School Agreement

- 2.2 The School Agreement governs the relationship between the Academy and TMBC in relation to the ongoing Project Agreement. Under the School Agreement (amongst other things):
  - (a) the Academy agrees not to take any action, or fail to take any action, which would cause TMBC to be in breach of the Project Agreement (clause 3.2); and

- (b) the Academy agrees to pay the Relevant Proportion prior to the due date for payment by TMBC of the Unitary Charge under the Project Agreement (clause 12.1). The Relevant Proportion is expressed as a percentage of the 'Adjusted Schools Budget', namely a sum of money which TMBC would otherwise have allocated to the school if it were not converted. The calculation methodology is blank in the Model Document.

### Principal Agreement

- 2.3 Under the Principal Agreement, the DfE agrees (amongst other things) to cover certain potential costs and losses which may be incurred by TMBC. Clause 4 (Normal Payment Matters) details the mechanism by which the DfE agrees to pay certain costs which may fall due from the Academy to TMBC but are not in fact paid.
- 2.4 Under clause 4.1 of the Principal Agreement, the Academy indemnifies and holds harmless TMBC for "**Direct Losses**" that arise out of "**Normal Payment Matters**".
- 2.5 Direct Losses are *"all damages, losses, liabilities, claims, actions, costs, expenses (including the cost of legal or professional services, legal costs being on an indemnity basis) to the extent that TMBC is obliged to pay them to Project Co under the Project Agreement"*.
- 2.6 Normal Payment Matters comprise the following defined elements:
  - (a) *"failure by the Academy to pay to TMBC its contribution to the Project Agreement Unitary Charge when it is due and payable under the School Agreement;*
  - (b) *failure by the Academy to pay to TMBC vandalism costs contributions under the School Agreement to the extent that these are required to be paid to Project Co by TMBC under the Project Agreement;*
  - (c) *failure by the Academy to pay to TMBC amounts due under the School Agreement or Principal Agreement to the extent that they relate to amounts due to Project Co under the Project Agreement and DfE has expressly provided funding to the Academy to pay such amounts;*
  - (d) *failure by the Academy to pay to TMBC amounts due under the School Agreement in respect of insurance cost contributions, excess costs or deductibles to the extent they relate to payments due from TMBC to Project Co under the Project Agreement; and*
  - (e) *any other liability of the Academy under the Principal Agreement and the School Agreement to the extent that these relate to payments due to Project Co under the Project Agreement which the DfE reasonably determines should be payable to TMBC by the Academy."*
- 2.7 If a Direct Loss in relation to a Normal Payment Matter occurs, and the Academy does not pay the required amount to TMBC, TMBC can notify the DfE of the same and the DfE shall pay that amount to TMBC under clause 4.4 of the Principal Agreement. To this extent therefore, significant comfort is provided to TMBC. Put another way, the DfE indemnity would apply to

payments owed by TMBC to Project Co caused by the Academy where the loss suffered is a "Direct Loss" and it arose out of a "Normal Payment Matter".

2.8 However, it should be noted that:

- (a) limbs (a) to (d) of the definition of "Normal Payment Matters" are very specific in nature. The indemnity would apply to the principal liabilities associated with these matters (not including costs) so long as the *"TMBC is obliged to pay them to Project Co under the Project Agreement"*. TMBC can therefore take significant comfort in relation to the principal liabilities referred to at paragraph 2.6(a) to (d) (including therefore the Authority Contribution Risk). But these limbs would not cover the Authority Breach Risk. And see paragraph 2.8(c) below in relation to costs.
- (b) limb (e) of the Normal Payment Matters" is wider and *may* mean that the indemnity covers principal liabilities (not including costs) in relation to the Academy Breach Risk. But under this Limb (e) TMBC can take comfort only where the DfE "reasonably determines" the indemnity should be paid. There is no definition, interpretation or guidance as to what would constitute a reasonable determination by DfE and therefore this is uncertain. DfE retains the benefit of being able to determine its own liability, in a manner that is not clear. This is not optimal for TMBC.
- (c) in respect of costs incurred in relation to the principal liabilities referred to at paragraph 2.8 (a) and (b), it is not clear that the DfE indemnity would apply. Specifically:
  - (i) where Project Co claims for costs against TMBC in respect of a breach of the Project Agreement caused by the Academy, TMBC would wish (and *may* be able) to argue that these costs should be recoverable under the DfE indemnity. But we think that the DfE could potentially argue that such costs do not fall within the definition of "Direct Losses" because TMBC would not be *"obliged to pay them to Project Co under the Project Agreement"* (i.e. because TMBC would be obliged to pay them under general contractual principles arising from breach rather than under the express terms of the Project Agreement); and
  - (ii) we do not think that any of (1) TMBC's own internal costs (2) TMBC's third party costs incurred dealing with the claim (such as legal fees) or (3) any additional third party costs of TMBC incurred in dealing with the circumstances that gave rise to the breach incurred in dealing with the claim would be covered for similar reasons. It is certainly the case that they are not clearly covered under the relevant wording, and our recommendation would be to make this clear should TMBC wish to be protected in these respects.

#### **DfE Comfort**

2.9 DfE provides a degree of additional comfort under clause 14 of the Principal Agreement (**DfE Comfort**). Under this clause, if the Academy is in "material" breach of the School Agreement

which has placed TMBC in breach of the Project Agreement, then TMBC may request that DfE:

- (a) exercise its Intervention Rights under the Academy's articles of association and or funding agreement with the DfE;
  - (b) take any reasonable action to the extent DfE is permitted to do so, such action to be agreed between DfE and TMBC, both acting reasonably; and/or
  - (c) compensate TMBC for Direct Losses incurred as a result of the breach.
- 2.10 DfE will consult with TMBC and act reasonably in deciding how to respond to a request made by TMBC, but retains absolute discretion over the action it might take, providing that it acts reasonably.
- 2.11 It is worth noting that this comfort:
- (a) applies only to "material" breach of the School Agreement, and not to "any" breach of the School Agreement. The comfort is silent as to whether multiple, minor breaches may be subject of this comfort;
  - (b) allows for compensation only of Direct Losses as referred to in paragraph 2.5 of this note, which may not be the full extent of TMBC's losses.
- 2.12 It is also worth noting that the extent that DfE has Intervention Rights are set out in the Academy's articles of association and or funding agreements, and would therefore require due diligence on a case by case basis to understand the nature and full extent of them.

### 3 Operation of Project Agreement indemnities

- 3.1 TMBC provides various indemnities to Project Co under the Project Agreement in relation to claims in respect of:
- (a) personal injury of any TMBC or a TMBC Party employee;
  - (b) any third party injured by TMBC or a TMBC Party; and
  - (c) in respect of any damage caused by the act or omission of TMBC or TMBC Party.
- 3.2 These Project Agreement indemnities are not varied by the entry by TMBC into the Model Documents. TMBC would therefore remain liable under these indemnities to Project Co. The definition of TMBC Party in the Project Agreement includes the Academy, teachers, pupils and visitors to the school.
- 3.3 To the extent that any such claim occurs, TMBC is still required to indemnify Project Co, even if the Academy or its employees or pupils were the actual cause. Under clause 21.4 of the School Agreement, if the Academy has caused such claims by its negligence it will be "responsible" for such claims, but does not explicitly include a "back to back" indemnity from the Academy to TMBC to the same extent that TMBC indemnifies Project Co.

- 3.4 If TMBC is liable to Project Co under a Project Agreement indemnity, TMBC's ability to recover from the Academy would therefore rely on establishing a contractual claim against the Academy on the basis that the Academy is responsible for the claim and should compensate TMBC's loss. The extent to which DfE would indemnify any amount that TMBC claimed was due from the Academy would also be subject to the same considerations discussed in paragraphs 2.8 and 2.9.

**Addleshaw Goddard LLP**

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