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The Building Safety Act 2022: Managing risks for private equity investors and acquirers

18 October 2024

The Building Safety Act 2022 (BSA) and associated regulations have introduced an extensive and wide-ranging regulatory regime affecting all businesses involved directly or indirectly in the construction and real estate sectors.

This regime has increased the risk profile for businesses impacted by the BSA significantly, and acquirers and private equity houses investing into those businesses need to understand those risks and how those risks can be mitigated and managed.

What are the risks?

The BSA has introduced the 'building liability order' (BLO) by which certain liabilities of a body corporate (within the meaning of a BSA) can be imposed on 'associated' body corporates under common control. This is to issue and prevent developers from escaping liability for safety defects by hiding behind complicated legal structures or winding up the entity with the liability.

'Associated' is broadly defined, and the imposition of a BLO could extend to the private equity sponsor depending on how the private equity fund is structured and the nature and extent of the investment. Therefore, it cannot be assumed that the risks associated with the BSA are confined to the body corporate exposed to day-to-day regulation (the TradeCo).

The entities forming part of a group or private equity structure are 'associated' if (i) both are 'body corporates' (which includes limited companies, LLPs and nominee arrangements but not LPs) and (ii) those body corporates are under 'common control'.

In the case of private equity entities, this appears likely to mean:

- the 'common control' requirement will be satisfied where the private equity sponsor may be 'entitled to acquire' control by having enhanced voting rights on a swamping event (and, by exposing the PE sponsor to the risk of a BLO, extend the scope of the PE sponsor’s liability beyond the direct investment terms);
- the test for association can include minority interests without swamping rights if the private equity sponsor may receive majority of assets on a winding up which often arises with loan notes and preference share structures; and
- other private equity portfolio companies held by other newcos (and those newcos themselves) fall within the definition of being 'associated' given that each newco (and the subsidiaries of each newco “controlled” by that newco) are under common control.

A BLO can only be made by the court in respect of certain liabilities, and only where it is just and equitable to do so. The BSA does not define what this means and (unfortunately from a private equity sponsor and acquirer perspective) the limited cases that have been reported to date demonstrate that the just and equitable requirement may be one that is relatively easy to satisfy; especially if the TradeCo is unable to satisfy the liability.

There would appear to be a greater risk that a BLO be made against topco or a company beneath topco if one of those entities becomes insolvent given the proximity between them (common management etc. engaged in carrying on significantly the same business albeit in different corporate entities /shared financing/ intercompany dividends/ loans/ common directors). There have been two cases recently where the court has used its powers to make an order against a parent company or an associated company where the relevant trading subsidiary has not met its obligations. At the other end of the spectrum, portfolio companies completely unconnected (other than being deemed to be connected because of section 131 of the BSA) would appear very unlikely to be subject to a BLO. However, the BSA allows third parties to apply to the High Court to seek information about the associated entities connected to a body corporate to help claimants identify who they may be able to take action against in the case of opaque corporate structures.

Period at risk

An 'associated' body corporate is exposed to the risk of a BLO in relation to:

- certain legacy liabilities arising from work carried out by the TradeCo prior to the body corporates becoming 'associated' (even if the work is complete) – so the target group (and/or associated private equity entities) will be considered associated for any historic works carried out before completion of the acquisition of the target which have finalised at completion if at the time a BLO is made, the target group (and/or associated PE entities) is still associated with the relevant target; and
- certain liabilities arising from the work carried out by the TradeCo during the period that the body corporates were 'associated' – this would include works being carried on at completion of the acquisition of a target which have not completed at completion, so target group/ private equity entities will be associated from that point onwards and will remain associated.

This risk associated with these liabilities continues even if the body corporate ceases to be 'associated' with the TradeCo (e.g. on exit), and, in some instances, continues essentially indefinitely.

On an exit, an associated body corporate will not be exposed to the risk of a BLO in relation to certain liabilities arising from any work which is commenced by the TradeCo after the body corporate ceases to be associated (e.g. in respect of works carried out after an exit and where those works did not commence prior to the exit).

Management of risk

We are working with acquirers and private equity sponsors to manage the risk associated with the BSA through enhanced due diligence, the inclusion of bespoke indemnities and warranties in acquisition documents, seeking to maximise insurance cover to the extent possible through a combination of W&I, product liability and professional indemnity insurance, and supporting the TradeCo with a tailored 100-day BSA plan.

Due diligence

BSA-focused due diligence is key for acquisitions of TradeCos and should be tailored to ensure a comprehensive understanding of the application of the BSA to the TradeCo and the baseline knowledge and understanding of the regulation and risk profile within the organisation, as well as to enable an analysis of factors which will influence the risk profile for the acquirer/ private equity house (such as the existing internal processes the TradeCo has in place to drive compliance with the changes introduced by the BSA).

Indemnities and warranties

On an acquisition of a TradeCo, the ideal position would be to obtain a blanket indemnity from the vendors in respect of all risks arising in relation to the BSA that are uninsured. In reality this may be hard to agree; especially if there are no known actual or potential liabilities at the time of completion. However, this doesn’t solve the problem for BSA liabilities arising after the date of completion.

Acquirers and private equity houses may, therefore, have to rely on coverage provided by warranties in the SPA which are tailored to cover the BSA-specific risks to which the acquirer / PE house may be exposed.

Private equity sponsors should also consider:

- seeking an indemnity from newco and all of the trading subsidiaries within the target group to cover (so far as possible) against the risk of a BLO being made against the private equity sponsor;
- a breach of the BSA or a claim that there is a breach of the BSA, a BLO being issued or likely to be issued being swamping events.

Insurance

The insurance market is at an early stage in responding to the risks presented by the BSA and so there needs to be heightened dialogue with brokers to understand what insurance may be available depending upon the specific facts of the transaction, the risk profile of the TradeCo, and the entities within the group / private equity sponsor which may be named on any policies.

We are working with insurance brokers who are beginning to respond to the new regulatory landscape, to include insuring BSA risks in W&I insurance and securing policies which extend the cover of the newco to be equivalent to that under the PI insurance of the TradeCo.

100-day BSA plan

Following an acquisition, the TradeCo should be supported to implement processes for the on-going management of the risk profile presented by the BSA for the benefit of the newco and the group structure of the acquirer / private equity sponsor.

The group should also consider creating a specific risk committee for building safety and including this (and the reporting requirements) as a standard item on board packs, properly documenting 'the golden thread of information' and other processes the group has in place to monitor compliance etc. This helps demonstrate the group is doing what it can to mitigate the risk, show that there are systems are in place and that the group understands its new responsibilities and is taking steps to comply with them.

We are working with TradeCos across a range of sectors to implement 100-day BSA plans which include delivering in-house, tailored training to develop a baseline of knowledge and understanding of the regulatory risk and risk management within the organisation, refreshing disclaimers, standard terms and warranties to respond to the BSA, centralising BSA-specific document suites for use by operational teams, and establishing due diligence and record-keeping policies and procedures to drive compliance by the TradeCo with the regulations.

Summary

The regulatory regime introduced by the BSA regime is complex, organisation specific, and exposes organisations and personnel to extensive commercial and regulatory risk (including fines and imprisonment). This risk is not limited to the TradeCo and extends into the group structure, potentially affecting acquirers and private equity sponsors.

Any organisation which has not begun to take the steps necessary to manage the risk associated with the BSA needs to do so now. If you have any queries, or would like a discussion as to the potential risk profile for your organisation and how we may be able to support you, please get in touch.

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