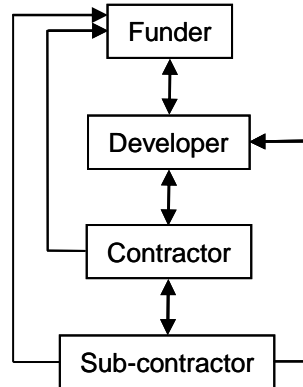




What is a Collateral Warranty?

It is a contract under which a consultant such as an architect or a contractor / sub-contractor warrants to a third party (e.g. a funder, landlord or purchaser) that it has complied with its professional appointment or duties under a building contract.



Why have Collateral Warranties?

The appointment of a consultant or the award of a building contract will be between two parties i.e. the developer and the consultant or between the employer and the contractor. Often a third party will need the benefit of the contract even though it is not a party to the contract.



The collateral warranty will contain statements to the effect that the consultant or contractor:

- takes proper skill, care and diligence in design;
- uses materials of appropriate quality;
- carries out the work in a proper workmanlike manner;
- maintains an adequate level of insurance.

The collateral warranty may also provide the third party with a contractual right of redress enabling it to sue for losses which would not otherwise be recoverable.

Are Collateral Warranties really enforceable?

No-one ever sues on a collateral warranty right? Wrong, as the case below demonstrates.

In *Scottish Widows Services Limited v Harmon & others [2010]*, Scottish Widows claimed several million pounds against a contractor who had installed defective cladding under a collateral warranty that had been assigned to it. The case is important because the contractor had been careful to include a 'net contribution' clause, which it believed would limit its liability. This was held to be effective in overriding the principle of 'joint and several' liability i.e. that a single party can be held singularly

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responsible for the liability caused by a collection of wrongdoers. As a result of the 'net contribution' clause, the contractor was only responsible for the proportion of those losses which it had caused and not the total losses incurred by Scottish Widows.

Pitfalls

Parties will often attempt to include its rights of 'set-off' or counterclaim in the collateral warranty. A third party beneficiary should ensure that such rights are excluded. If a consultant or contractor has not been paid for its works under the building or engineering contract, then this could be used to 'set-off' any claim against it and could reduce the liability of the contractor under the collateral warranty to nil. In effect, the collateral warranty would become worthless.



Many insurance policies exclude liabilities that are assumed by way of a guarantee. This can cause problems in collateral warranties where the consultant or contractor 'warrants', 'covenants' or 'ensures' that no prohibited materials have been used. The reason is that such terms are akin to giving an express guarantee. Therefore the consultant or contractor should only 'see' that prohibited materials are not used. Precise drafting is very important.



It is also crucial to include a 'no greater' liability clause. Professional indemnity insurance policies commonly exclude cover for claims where the collateral warranty has imposed obligations which are more onerous or longer lasting than the equivalent liability under the building or engineering contract.

The Future?

Collateral warranties may create certainty and is favoured by the construction and engineering industries as well as funders. The resulting paper-chase can however be time-consuming. As a result, some major projects and consultancy appointments make use of a schedule of third party rights. This makes use of the Contracts (Rights of Third Parties) Act 1999 and is intended to provide the same benefit as a collateral warranty without the need for a separate document.

The downside is that the drafting and negotiation of the master document becomes more complex. For instance, a schedule of third party rights requires the contracting parties to consider carefully the relevant contract terms so that they benefit not only the contracting parties, but also consider the third party requirements and whether that third party can enforce those terms. The master contract will also need to deal with the risk of double recovery by those third parties.

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The JCT 2005 suite provides the option of a third party rights schedule on all standard form contracts. Many funders however still insist upon being granted a collateral warranty as a separate document. They regard the 'step-in' rights (allowing the funder to take over the development if the developer or contractor becomes insolvent) as being better worded and therefore more certain as security. This remains a culture hard to shift.

A Word of Caution

Even if a collateral warranty has been provided, a consultant or contractor may become insolvent. Professional indemnity insurance must be renewed annually so it is often a warning sign of foreseeable cashflow problems if parties delay or refuse to forward policies or other evidence of insurance cover.



A solution can be found in 'latent defects insurance', which is a non-cancellable policy to cover the cost of repairing hidden defects and insulate against consequential losses. Policies vary however and this is merely an extra level of protection. This kind of insurance is not a substitute for a robust collateral warranty providing a wider contractual right of redress whilst the parties remain trading.



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