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IT'S THE LAW: Collateral Warranties

This edition of IT'S THE LAW looks at the position where an Employer enters into a Building Contract with a Contractor and the Contractor enters into a Sub-Contract with a Sub-Contractor.

In the beginning…

On a 'normal' construction project, if there is such a thing, the Employer will enter into a building contract with the Contractor. The Contractor will agree to build the building and the Employer will agree to pay. Usually, the Contractor will then subcontract all or some of the actual work to Sub-Contractors. In that scenario, the Employer has a contract with the Contractor but not with the Sub-Contractor. So, collateral warranties were invented. A collateral warranty will provide the Employer with a direct contractual link to the Sub-Contractor.

So, what happens if the building falls over?

Without that contractual link, if something goes wrong, the Employer can only pursue the Sub-Contractor in negligence. They wouldn't be able to bring a claim for breach of contract against the Sub-Contractor – because they have no contract with them. Negligence is a pain. The Employer would need to prove that the Sub-Contractor owed them a duty of care, that they breached that duty and that, as a result of that particular breach, the Employer had suffered loss. In cases of building defects, where losses are often considered to be 'purely economic', the legal hurdles are even more difficult to jump.

But if the Employer has a collateral warranty from the Sub-Contractor – it will allow the Employer to pursue them directly for breach of contract. That's way more straightforward and allows recovery of pure economic losses.

Effectively, a collateral warranty is a 'mini' contract between the Employer and the Sub-Contractor in which the Sub-Contractor agrees to perform all of the obligations in its main contract with the Contractor. So the Employer ends up with the same rights and remedies as the Contractor has against the Sub-Contractor for breach of contract.

There is no alternative? Well actually there is

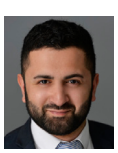
An alternative method to confer such rights is provided by the Contracts (Rights of Third Parties) Act 1999 which allows third parties to obtain the benefits from contracts, which are entered into by others. The use of such rights must be considered with an air of caution. A Court has held that whilst a party with the benefit of third party rights can rely on remedies arising out of the contract (say, claiming damages for breach of contract) they don't take the benefit of procedural rights (such as the right to refer a matter to adjudication). Given this judicial uncertainty, collateral warranties are still widely used.

Main Terms to Consider

No greater liability/ equivalent rights in defence

A warranty must set out that the Sub-Contractor (usually referred to as the Warrantor) has complied with (and will continue to comply with) its obligations under its main contract with the Contractor. The precise form of wording needs to be tailored to reflect the obligation in that underlying contract.

Standard forms of warranty usually provide a 'no greater liability' clause and an 'equivalent rights in defence' provision. These provide that the Sub-Contractor has no greater liability to the Employer than it has under the underlying contract with the Contractor. And that if the Employer makes a claim,



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then the Sub-Contractor is entitled to use the protections of any limitation of liability in the underlying contract with the Contractor (say, a financial cap on total liability). Therefore, to understand what rights it's getting, an Employer needs to review both the warranty and the underlying sub-contract.

In terms of an 'equivalent rights in defence' clause, the Employer must ensure that set-offs and counterclaims are specifically excluded. This exclusion will prevent the Sub-Contractor from setting-off any amount due to it from the Contractor under the underlying sub-contract (for example, outstanding fees due from the Contractor) against any claim by the Employer.

Step-in Provisions

A step-in clause allows the Employer (usually referred to as the Beneficiary) to step-in to the underlying contract and assume the obligations of the Contractor. If the Contractor has breached the terms of the underlying sub-contract, the Sub-Contractor may have the right to walk away. Step-in provisions give the Beneficiary the ability to 'step-in' and take over the obligations of the Contractor. The Employer may prefer this (rather than see the underlying sub-contract come to an end) so as to maintain service continuity.

Copyright

It is important to ensure that the Employer gets an irrevocable licence to use proprietary material for any purpose connected with the Development.

They will want to retain the right to grant sub-licences and to include an obligation on the Sub-Contractor to provide them with a complete set of all the proprietary materials.

Insurance

A warranty should specify the level of professional indemnity/ product liability insurance that the Sub-Contractor is to maintain – and the length of time they need to maintain it. It's all very well for the Employer to have a claim against the Sub-Contractor for breach of contract – but it will still end in tears if the Sub-Contractor has no money (or insurance) to cover that claim.

Cover is usually provided on an 'each and every claim' basis, although claims arising from pollution or contamination may be subject to aggregated limits. Cover is usually to be maintained for 12 years after Practical Completion.

Assignment

It is important to retain the right of assignment in a warranty. If the Employer sells their building then the new owner will have the same problem that the Employer had – i.e. no contractual link with the Sub-Contractor. So the Employer will want the warranty to allow them to assign its benefit to a new owner. Assignment is often limited to a maximum of two occasions.

Request for Additional Warranties

But what happens if the Employer wants to grant a lease or to mortgage, rather than sell, the whole building? The new tenant or lender may want the benefit of a collateral warranty but the Employer won't want to lose theirs. The trick is to include an obligation on the Sub-Contractor to provide additional warranties on request. There will usually be a fair amount of 'constructive debate' as to how often and in what circumstances such requests can be made.

Limitations on Liability

These clauses are not uncommon – but Employers should watch out. Their purpose is to prevent the Employer from bringing a claim against the Sub-Contractor after a specified number of years or to cap the maximum amount of that claim – even if the loss suffered is higher.

Net Contribution Clauses

These types of clauses are commonly requested by a Sub-Contractor giving a warranty. Under common law, a Sub-Contractor can be held liable for 100% of a loss suffered, even though a number of parties are jointly responsible for that loss. A net contribution clause has the effect of reversing that common law rule, so that the Sub-Contractor will only be liable for a fair proportion of the loss.

That might sound fair – but it puts the Employer at risk. The other contributory parties might have become insolvent or no longer exist. The Employer will then not be in a position to recover the fair proportion due from them and so will be left out of pocket.

Execution

An Employer will always want their collateral warranties to be executed as Deeds rather than signed as ordinary contracts. The former means 12 years of liability for the Sub-Contractor. And the latter, 6 years.

The 'I'll do it mañana' Syndrome

The construction industry has a habit of only realising they never got round to signing and dating the contacts and warranties when they want to make a claim – by which time it's too late.

Any sensible Employer will keep a list of all the collateral warranties they are expecting and tick them off as they are executed and dated.

Find out more

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