

# Collateral Warranties

## What is a collateral warranty?

A collateral warranty gives its beneficiary a direct contractual link to the specialist contractor so that should the specialist contractor be at fault and the beneficiary suffers loss as a direct result of that fault, the beneficiary can sue the specialist contractor directly for breach of the terms of the warranty to recover its loss.

A collateral warranty is therefore a form of security against the risk that any of the party(ies) between the beneficiary and the specialist contractor becomes insolvent.

## When is a collateral warranty required?

The requirement to enter into the collateral warranty will be contained in a clause in the contract employing the specialist contractor. The nature of that clause will dictate whether the form of collateral warranty is prescribed or whether the parties are able to negotiate the terms of the collateral warranty.

A collateral warranty is required where the specialist contractor has either; design responsibility (in whole or in part), is responsible for the selection of materials or is carrying out a large portion of the works.

## Who will require a collateral warranty?

There are three types of beneficiary which may require a collateral warranty due to their having an interest in the works being carried out:

- Employers further upstream;
- Funders; or,
- Purchasers/Tenants.

## Judge for yourself the risks contained in typical clauses

The following highlights the form of clauses you should expect to see in a collateral warranty:

## Duty of care

The specialist contractor should owe no greater duty of care in respect of design, performance and selection of materials, under the collateral warranty than it would under general law, ie reasonable skill and care, or than it does under its contract of employment.

You should not be obliged to ensure your works are ‘fit for their intended purpose’ unless the purpose(s) are as stated in the specialist contractor’s contract of works.

## Limitation of liability

It is now standard industry practice to include clauses to ensure;

- The specialist contractor owes nothing further under the collateral warranty, than it does to its employer under its contract of employment, and
- That in the event of defects and damage arising in the project which cannot with certainty be exclusively attributed to any specific party’s breach, the specialist contractor’s liability is restricted to that portion of the loss which it caused. Without such a clause the beneficiary could recover its entire loss from the specialist contractor, regardless of whether the specialist contractor was only partly responsible. This is known as a net contribution clause and is vital to the protection of the specialist contractor under the warranty.
- Prohibition on specifying certain deleterious materials – the most acceptable method of drafting such a clause is for the beneficiary to require the specialist contractor not to use or specify for use (where it is responsible for specification), materials known to be deleterious to the construction industry in the UK at the time or under any British or equivalent.
- European Codes of Practice. If reference is to be made to a list, it should be to a list held by an

institution who takes responsibility for ensuring such a list is up-to-date, such as Ove Arup.

- Any specifically hazardous or deleterious materials intended to be used should explicitly be carved out of this clause.

### **Licence to use copyright material**

The specialist contractor should ensure that it retains the copyright in design documents and instead, grants, subject to payment of all outstanding monies owed under the contract, a licence to use the drawings, etc for the purpose for which they were produced (no other purposes). If the licence includes the right to grant sub-licences this should be without liability to the specialist contractor.

### **Professional indemnity cover**

You will need to ensure you do not oblige yourself under the warranty to insure beyond the extent of your actual current insurance cover. You should therefore obtain the advice of your insurers before promising to execute a warranty. The requirement for insurance should:

- be so long as such insurance is available at commercially reasonable rates; and,
- run from practical completion of the specialist contractor's works and not the main contract works, otherwise the clause does not provide the specialist contractor with the ability to ascertain a firm date, when its liability will end and it should be recognised that the specialist contractor has no control over the issue of such certificate and no redress if the certificate is delayed or not issued.

If the specialist contractor is required to supply evidence of such insurance, it should be upon reasonable request, which puts the onus on the beneficiary to request the evidence not on the specialist contractor to supply it year after year to each beneficiary— otherwise if the specialist contractor forgot to supply such evidence each year at the requisite time it would find itself in breach of the warranty.

### **Step-in rights (usually by a funder)**

It is extremely important to ensure you:

- Do not agree to notify the beneficiary and allow it a period of contemplation, during which you cannot exercise your right to terminate your contract of employment and must continue working without payment at your own risk, for an overly lengthy period.
- Are paid any sums you are owed before you can be obliged to continue working for the beneficiary or its nominee direct.

- Are employed by the beneficiary or its nominee, under the same terms and conditions as you were previously employed under.

### **Further warranties**

There is an increasing trend to insert clauses requiring the specialist contractor to provide further warranties or a power of attorney to allow the beneficiary into enter the warranties on the specialist contractor's behalf. If you are agreeing to such a clause it should be limited in the following ways:

- A time period within which you can be required to execute further warranties, such as one year from practical completion of your works.
- A cap on the number of warranties.
- A specified category of persons who are eligible to be beneficiaries of such warranties.
- Pre-agree the terms of such warranties.

### **Assignment**

The law allows a party to transfer his rights of benefits (not his obligations) under a contract to a third party. To ensure the duty of care owed by the specialist contractor is not passed unrestrictedly to others, the beneficiary's right to assign should be limited to two times only and only to specified groups of persons, ie funders and those taking an interest in the land (note the limitation on assignment will effect the financial marketability of the building).

### **Period of liability**

The limitation period is the period within which the beneficiary may bring an action against the specialist contractor for breach of contract. The duration of this period should be judged carefully, so that you can assess the period of risk. The period is usually six or 12 years. The limitation period should only ever run from practical completion of the specialist contractor's works not the main contract works.

### **Judge for yourself**

- It is important to price for the giving of and agree the terms of any collateral warranty at the time of entering into your contract of employment, because it is your contract of employment which will dictate the requirement, and therefore your scope for negotiation of the warranties to be entered into by you.
- Where possible, it is prudent to make the terms of the collateral warranty 'subject to payment to the specialist contractor of all outstanding monies owed under the specialist contractor's contract of employment'. This maximises your commercial leverage to be paid, by ensuring the warranty does

not become operative unless you have been paid everything you are owed.

- Always ensure you are not extending your liability under the warranty beyond that which you have given under your contract of employment and that you are only ever liable for the loss which you cause.
- The specialist contractor should never warrant the works of others, eg the design supplied to him by another or the materials specified for use by another.
- Warranties must be agreed by professional indemnity insurers before they are executed to ensure the specialist contractor does not extend its liability beyond that which it is insured for.
- Step-in rights may mean you are required to continue working for a period without pay awaiting confirmation of their use, and subsequently employed by another whose identity and financial standing is as yet unknown to you.

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