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SEMINAR FOR LAW SOUTH

COLLATERAL WARRANTIES

SESSION 1: CREATING LIABILITY FOR THIRD PARTY LOSSES

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PART A: THE THIRD PARTY LIABILITY PROBLEM

1. Practical issues

In many construction projects those who suffer loss, purchasers, tenants, funders, if there are defects in design or construction do not have direct contractual links with those responsible for the design and construction. Furthermore, because of the doctrine of *caveat emptor* and the widespread use of full repairing leases, purchasers and tenants will have no recourse against the original developer, who does have direct contractual links with those responsible for the defects.

Even where there is a contractual chain of liability between the person suffering the loss and those responsible for that loss, it may be broken, for instance by intermediate insolvency.

In such cases, the common law of contract and tort provides little assistance.

2. Contract issues (privity)

Under the doctrine of privity of contract only a person who is a party to a contract, one who has given consideration for the other party's promises, can sue and be sued on that contract. Thus, subject to a limited number of exceptions, a contract cannot create enforceable rights for persons (third parties) who have not given consideration to the promisee. Neither can a contract impose burdens on third parties.

3. Tort issues – the duty of care problem in negligence

Apart from where the third party has suffered physical injury or damage to other property (property other than that for which the designer/contractor was responsible), the availability of a remedy in negligence is problematic.

Losses due to defects in the property itself are generally regarded as economic. Thus, unlike in a physical injury or damage to other property case, the mere putting into circulation of a defective chattel without the possibility of intermediate inspection, is not sufficient to establish proximity (the second limb of the three stage duty test: foreseeability, proximity and justice and reasonableness).

Proximity in an economic loss claim must be established by showing reliance and reasonableness of reliance on statements (seldom applicable where third parties acquire a

leasehold or freehold interest in a completed development), Caparo Industries v. Dickman [1990] 2 AC 605, or voluntary assumption of responsibility, Henderson v. Merrett Syndicates [1994] 3 WLR 761 (problematic for policy reasons on construction projects).¹

This is hard to do: Bellefield Carpenter v. E Turner & Sons Ltd [2000] BLR 97 (CA)² (physical damage); Machin v. Adams [1997] 84 Build LR 79 (pure economic loss);³ Baxhall Securities Ltd v. Sheard Walshaw [2001] BLR 36 (physical damage);⁴ see [2002] BLR 100 (CA) (CA differed from the judge on causation). Note also Payne v. John Setchell [2002] BLR 489, 513ff⁵ (pure economic loss).

4. Solutions to the third party loss problem

There are various methods which may be used, more or less successfully, to deal with the third party loss problem.

Assignment

Assignment is the unilateral transfer to a third party of a party's benefits under a contract. For a legal assignment, the assignment must be absolute, must be in writing signed by the assignor, and notice must be given in writing to the other contract party (s. 136 LPA 1925). If one or more of these conditions are not satisfied, the assignment may, nevertheless, be effective in equity.⁶

¹ **Henderson:** Two relationships Direct Names employ managing agent (but limitation problems). Indirect Names are members of a syndicate (employ Members' Agent). The Members' Agent employs a Managing Agent. No contract between managing agent (negligent) and names. Existence of contractual right not inconsistent with co-existence of right in tort, but agreement of parties can modify shape of duties in tort which, in absence of contact would be available. Managing agents owed duty of care to names, had voluntarily assumed responsibility for provision of underwriting services (under this head the just and reasonableness requirement less important) and there was concomitant reliance. But have to ask whether assumption of responsibility is consistent with the contractual matrix. Not usually in the case of building contract works.

² **Bellefield:** Builder constructed industrial building. Fire Separating wall between two parts of building negligently constructed and did not extend full height. Purchaser of building suffered damage when fire spread from one side of building to the other, both to building and contents. Held: Fact that one side of building used for different purpose from other, did not make other property from other side of building, but could recover loss caused by fire damage to contents, not building itself as no duty owed in respect of pure economic loss. Other property rule a policy issue.

³ **Machin** Machin agreed to purchase property being extended, contract provided for the issue of a final certificate by the architect. The architect knew that property to be sold, and that his client needed a letter indicating the extent of the works, he knew or must have known would be shown to someone else. Letter said works satisfactory standard to date, two weeks left to complete. Did he owe duty of care in negligence to purchaser shown letter. Held, no reliance by Ms Machin, and did not owe duty of care because ignorant of purpose for which advice in letter required by Ms Machin, thus no assumption of responsibility and, because anticipated would return to site to certify completion, could not anticipate that Ms Machin would rely on letter to take irrevocable step. Need for a connecting thread between purpose for which advice given and the action which an advisee who relies on it takes, and therefore with the damages the advisee suffers. Here no such thread, could not say from what harm the architect was to be regarded as having undertaken to guard the purchaser.

⁴ **Baxhall v. Sheard:** Defective design/supervision of roof drainage by defendant, Architect – two faults, should have noticed overflows omitted, system undersized. Claimant takes lease after having property surveyed. Subsequent flood due to lack of overflows and blockage. Second flood due to undersized system and no overflows. Liable for damage to goods stored in premises due to second flood because of undersized system (latent defect) a material cause. Not liable for first flood because a reasonable possibility of discovery of defect on inspection. No liability for works necessary to correct defects in the roof system itself. Court of Appeal did not disagree with the legal principles adopted, but concluded, as a matter of causation, that the reason for both floods was the same, the lack of overflows – thus no liability for either occurrence.

⁵ **Payne:** Consultant was engaged to provide designs for terraced properties including foundations. At end of work provided letter to client, Mr Wright, dated October 1998, certifying that work was carried out to its satisfaction. Held, the purpose of providing the letter was to provide the then owner with a document that could be used to satisfy a prospective purchaser that the foundations could be treated as having been soundly built to a satisfactory design (Defendant accepted this in evidence). The document was intended to be seen and relied on by a prospective purchaser who might come on the scene at any time after 1998. Thus defendant had duty in law not only to Mr Wright but to subsequent purchasers and those likely to lend money secured on the house to take care that the statements were reliable. The judge remarked obiter that the duty was not indefinite in time, could be regarded as owed 10 years, since the certificate was to be treated as tantamount to NHBC cover (well there you go!!!).

⁶ **Allied Carpet v. Grant** [2002] BLR 433. Not necessary for an equitable assignment to follow any particular form, but there should be an intention to assign and some act by the assignee showing that he is passing the chose in action to the supposed assignee. No evidence of that here. The lease was assigned, but nothing to suggest that the warranty was.

- Only benefits can be assigned in contract law, not burdens; although the latter can be vicariously performed (sub-contracted). Re-assignment by the assignee is possible.
- Contractual prohibitions on assignment or re-assignment will be effective to invalidate an assignment; Linden Garden Trust v. Lenesta Sludge Disposals [1994] 1 AC 85 (HL).⁷
- Assignment is most often used where the development is sold to a single purchaser and there are no bars to assignment (as there often are) in the relevant contracts.

If the assignment is effective, the assignee stands in the original assignor's place as regards the benefits of the contract. Its position cannot be better than the original assignor's and is subject to prior equities. The assignee's claims cannot exceed those that could have been recoverable by the (original) assignor, had there been no assignment; Linden Garden Trust v. Lenesta Sludge Disposals [1994] 1 AC 85 (HL).⁸

Novation

If contractual burdens are to be transferred, this must be by agreement between the original contracting parties and the third person that is to assume the relevant obligations. A true novation extinguishes (rescinds) the original contract and replaces it with a new contract.

Novation is sometimes used in the design and build procurement route to ensure that the client's designers are responsible to the contractor for completing the design⁹ but with some obligations to the original client retained. There is great scope for conflicts of interest in such an arrangement and it may, as in Blyth & Blyth v. Carillion (2002) 79 Con LR 142¹⁰ (Scotland), not amount to a true novation.

If novation is envisaged, the relevant contracts should provide for this and identify the terms on which the novation is to be concluded, which should be by deed if the principal contract is by deed. If this is not done, novation cannot be compelled, other than by commercial pressure.

Recovering losses for third party owners

Where the party engaging designers and/or contractors does not have, or sells its interest in the land on which the project is constructed, it may, nevertheless, be able to recover substantial (cost of rectification?) damages on behalf of the land owner under the narrow, Albazero, and broad, loss of performance expectation, principles discussed in Linden Garden Trust v. Lenesta Sludge Disposals [1994] 1 AC 85 (HL);¹¹ Darlington BC v. Wiltshire Northern.

⁷ Linden Gardens Contractual bar on assignment without consent, valid, assignment void as between original contract parties.

⁸ Linden Gardens: This gets round the argument that if the property is sold at full market value, there is no loss.

⁹ For further discussion of this type of arrangement see Try Build Ltd v. Invecta [1999] 71 Con LR 140.

¹⁰ Blyth: The "Novation" Agreement did not amount to a full rescission of the original contract, some residual rights remained; but it provided that the liability of the designer both before and after assignment would be owed to the contractor. Held, on construction, that this agreement did not give contractor a right to recover damages suffered by it for breach of the consultant's agreement prior to novation, since original client had not suffered damage. Note; it was accepted by Carillion that the novation agreement operated more like an assignment than a true novation.

¹¹ Linden Gardens Contractual bar on assignment without consent, valid, assignment void as between original contract parties. In the McAlpine case, breach and damage occurred after the employer, St Martin, had sold the property and purported to give assignment. Held: St Martin could recover real damages, even though no property interest at date of breach since both parties knew at time of contract formation was going to be occupied, possibly purchased by third parties, not by St Martin, and no automatic acquisition of rights against purchaser on acquisition, the Albazero [1977] AC 744, principle applied.

(1994) 69 Build LR 1 (CA);¹² Alfred McAlpine v. Panatown [2000] BLR 331 (HL).¹³ But this will not be the case, if the landowner has its own, even if inferior, rights against the parties responsible for the defects.

Statutory transfer or causes of action in negligence

Section 3 of the Latent Damage Act 1986 provides that where a cause of action in negligence has accrued to a person in respect of damage to property (does this include to pure economic loss claims?), and another person acquires an interest in that property before the material facts about the damage have become known to a person with any interest in that property, a fresh cause of action accrues to that other person on the date he acquires his interest, but subject to the original 15 year long stop.

This provision was considered in Payne v. John Setchell [2002] BLR 489;¹⁴ surely wrong in holding that the concurrent duty owed by consultants did not encompass pure economic loss consider Barclays Bank v. Fairclough Building (1995) 68 BLR 1 (CA);¹⁵ compare Storey v. Charles Church (1997) 12 Const LJ 206.¹⁶

The Defective Premises Act 1972

There is under this Act a statutory duty, actionable in damages, to see that work taken in connection with the provision of (including conversion to) a dwelling is done in a workmanlike manner or a professional manner, as appropriate, with proper materials and so that as regards that work the building will be fit for habitation when completed. The duty is owed by a person who takes on such work for example, developers, suppliers of goods, local authorities and possibly DIY enthusiasts. If engaged in the business of undertaking that work the duty encompasses the work of sub-contractors engaged by that person. The duty is owed to the person commissioning the works and to any person who acquires an interest (legal or equitable) in the dwelling.

The scope of the Act is narrow. "Provision of a dwelling" does not encompass rectification works to an existing dwelling, Andrews v Schooling [1993] 1 All ER 723 (CA). Also, the gist of the action is unfitness for habitation at date of completion, Thompson v. Clive Alexander and Partners (1992) CILL 755. There is a limited defence for those who follow instructions.

¹² **Darlington:** Darlington agreed with Morgan Grenfell, who did not own property, that latter would be employer under building contract for construction of the Dolphin Centre. Wiltshire was the contractor. At end of construction, rights under the contracts were to be assigned to Darlington. After completion defects emerged, the rights were assigned to Darlington. Did Darlington have a claim for real damages. Yes applying the St Martins (Albazero) principle (which doesn't really work since Morgan Grenfell never had property). The court also discussed the possibility of Morgan Grenfell having a performance interest, which could be compensated.

¹³ **Panatown** Employer did not own land on which building to be constructed and no interest in that land (different companies in the same group). Building alleged to be defective: could employer recover substantial damages? Discussion of the narrow ground of liability (Albazero principle – under which the consignee's loss is attributed to the consignor where it is in the contemplation of the contracting parties that property would pass from the consignor after contract formation. The consignor is treated as having contracted on behalf of those who will acquire an interest. The consignor must account to such persons for the damages recovered). Also a broad ground of liability was identified (the performance interest). This was that a person who engaged someone to provide work and materials and did not receive the contracted for performance suffered a loss, at least where intended to pay for the remedial works. Consideration of whether the duty of care agreement by contractor to the land owner affected these principles. Yes, because neither principle applied where the parties contemplated a direct claim between landowner and contractor.

¹⁴ **Payne:** The judge doubted that a cause of action for pure economic loss could transfer under this provision, since it was not a claim for damage to property.

¹⁵ **Barclays:** Bedlam LJ, obiter. Contractor doing work invites reliance no less than a financial or other professional advisor. I would hold that the sub-contractor in performing its work owned a concurrent duty in tort to avoid causing economic loss by failing to exercise the skill and care of a competent contractor.

¹⁶ In Storey the judge considered that the concurrent duty included pure economic loss. In Payne, the judge considered that such a view was inconsistent with the reasoning in Murphy v. Brentwood, and that the concurrent duty only extended to damage to persons and other property(!).

The limitation period is six years from the date the dwelling was completed or, in the case of further work carried out by a person to rectify his earlier work, six years from the time that work is finished (s. 1(5)); see Avril Alderson v. Beetham Organisation [2003] BLR 217 (CA).¹⁷

The Contracts (Rights of Third Parties) Act 1999

Section 1 of this Act provides that a third party, identified in the contract by name, as a member of a class, or as answering to a particular description, may enforce a term of a contract if the contract expressly states that the third party may, s. 1(1)(a), or if the contract purports to confer a benefit on that third party unless, in the latter case, the contract shows that the parties did not intend the term to be enforceable by the third party, ss. 1(1)(b), 1(2).

- Section 2 provides that, unless the contract expressly states otherwise, the parties cannot vary or rescind the contract without the third party's consent so as to affect the third party's benefit¹⁸ where the third party has communicated its assent to the term to the promisor, where the promisor is aware that the third party has relied on the term or where the promisor can reasonably be expected to have foreseen that the third party would rely, and it has in fact done so.
- Section 3 provides that the third party's rights are subject to the defences (which would include limitations and exemptions) and set-offs available to the promisor.
- Section 5 provides some protection from double recovery in that, if the promisee has already recovered a sum in respect of the third party's losses under the relevant term, the third party's damages are to be reduced by an appropriate amount.
- Section 8 provides that the third party's rights are subject to the arbitration clause, if any, in the Contract; see Nisshin Shipping v. Cleaves [2004] 1 Lloyd's Rep 38.¹⁹
- It is unclear if the provisions in Part II of the Housing Grants, Construction and Regeneration Act 1996 apply (other than by contract). The third party is not "a party to a construction contract".
- Although not expressly dealt with, since a third party's rights under the Act are a chose in action, they would appear to be assignable, unless the contract says otherwise.

At present, most standard form contracts used in the construction industry seek to exclude the operation of this Act. This may be beginning to change, see the JCT Major Projects Form, but the lack of authority on the Act, is hampering this trend.

One possibility would be to exclude all s. 1(1)(b) rights, while expressly identifying those rights that are to be enforceable by specific named third parties or by classes or descriptions of third parties. If so, consider the following.

- It may be necessary to identify when those rights accrue, and to identify the provisions of the contract that are to be enforceable; for example. specific clauses concerned with design and/or construction obligations.

¹⁷ **Avril**: Beetham the developer converted premises to dwellings. Work done defectively. Damp due to inadequate damp-proofing so uninhabitable on completion, but that was more than 6 years before claim brought. Beetham also carried out remedial work in a good and workmanlike manner but because of mis-diagnosis of the problem did not cure the damp. This work was completed less than 6 years before the action. Held that the intention of Parliament was to give a fresh cause of action to provide a dwelling fit for habitation if the further work did not rectify the original work as intended. No doubt the further action is only in respect of the further work, but that work is for the purpose of rectifying the original work. Thus damages were based for the failure to rectify the original work.

¹⁸ This, probably, does not restrict parties exercising rights under the contract, such as to instruct variations.

¹⁹ **Nisshin**: A broker was able to enforce rights under a charter party pursuant to s. 1 of the Act. But although not a party to the arbitration agreement, was entitled and obliged to arbitrate those rights by reason of s. 8.

- It may be necessary to limit the third party's rights, such as by reference to limits on heads of losses or net contribution, number of permitted assignments (see collateral warranties, below).
- If there is an arbitration clause in the contract, it may be necessary to allow for joinder; for example, through use of CIMAR. If third party claims are to be subject to the adjudication regime in the Contract, this should be stated expressly.
- It may be necessary to provide for absolute or qualified rights of variation or recession of the contract, other than with the consent of the third party, or for the third party's consent to be not unreasonably withheld.
- It has been said that the provisions of the Act cannot be used to create step in rights for funders (since it cannot impose obligations on the third party). If so, rights under the Act do not provide a complete substitute for a funder's warranty.

Collateral warranties

This is the principal method (at present) for extending protection to third parties that may suffer loss or damage if the project is defective. A warranty is a contractually binding promise given to a third party (the warrantee) by a party to a contract (the warrantor) with another party (the principal), concerning the warrantor's performance of its contractual obligations, or certain of those obligations, to the principal. The warranty is collateral because it is secondary and parasitic on the principal contract to which it relates. It may, nevertheless, include obligations that go beyond those found in the principal contract.²⁰

²⁰ Such as, in the JCT Warranty, NSC/W, entered into between the employer and a nominated sub-contractor, under which the sub-contractor undertakes design obligations to the employer that it does not have under the sub-contract. See also the step in provisions found in funder's warranties.

COURSE FOR BPP PROFESSIONAL EDUCATION
CONSTRUCTION LAW – BASIC PRINCIPLES

SESSION 2: COLLATERAL WARRANTIES AND THEIR TERMS

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1. The use of collateral warranties

Collateral warranties are commonly used either to extend the contractual matrix to persons not directly involved in the procurement process, or to augment an existing contractual matrix by providing links between persons directly involved in the procurement process, although not, otherwise, in contract with each other.

Extending the contractual matrix

The principal persons to whom the contractual matrix is, ordinarily, extended, are funders, purchasers, (major) tenants and, if other than the employer/client, the owner of the land on which the project is to be constructed.

Augmenting the contractual matrix

The contractual matrix may need to be augmented where those engaged to design and/or construct the works intend to sub-contract the bulk or, as in the case of construction management, all of the work or, for instance, have been specially created for the project or have limited assets. The concern, in both cases, is to ensure direct contractual links between the client/employer and those actually providing the work.

2. Extending the contractual matrix

There are, in addition to a myriad number of bespoke forms, a number of standard form warranties for use by funder or by purchasers and tenants. The principal ones are the BPF²¹ warranties, CoWa/F and CoWa/P&T (1992 and 1993 editions) and the JCT standard form warranties, MCWa/F and MCWa/P&T (2001 editions). The BPF warranties are drafted for use by consultants and funders (F) or purchasers and tenants (P&T). The JCT warranties are drafted for use by contractors and funders (F) or purchasers and tenants (P&T).

The principal difference between a funder's warranty and a purchaser and tenant's warranty is that the former will, generally, include step in rights.

A consultant's warranty should never be used for construction works (the obligations are insufficiently onerous, consider McAlpine v. Panatown [2000] BLR 331 (HL)), nor a contractor's warranty for consultant's works (the obligations may be too onerous).

Typical warranty provisions (such as in the BPF/JCT warranties) include the following.

²¹ Drafted in conjunction with the ACE, RIAS, RIBA and RICS.

Recitals

It is commonplace to recite the contracts, and their parties, entered into, or to be entered into, to which the warranty is collateral. For example, in the case of a funder's warranty, the finance agreement, the principal contract (consultant's agreement or construction contract to be warranted) and, in the case of a consultant's warranty, the construction contract as well.

It is important that the recitals and, indeed the terms of the warranty, are compatible with those in the principal contract. For example, terms such as Practical Completion, are not found in all construction contracts.

The operative clause

This will either be general, "the Contractor warrants that it has complied and will continue to comply with the Building Contract", or specific, "the firm warrants that it has exercised and will continue to exercise reasonable skill and care in the performance of its services to the Client under the Appointment".

- The operative clause must be drafted in a manner appropriate to the obligations under the principal contract. In the case of a consultant's warranty, what is the nature of the design obligation in the principal contract? Skill and care; skill, care and diligence; or just skill? In the case of a contractor's warranty, is the contractor designing as well as constructing? Does the consultant have inspection duties during the course of the works (it may not on a design and build project)?
- If expressed in general terms, all obligations will be picked up; for example, time, liquidated damages, payment notices, maintenance of records. This may be too wide and undesirable.
- Where the operative clause is in general terms, limits are sometime identified, for example, excluding liability for delay.
- Obligations of fitness for purpose of design are undesirable. They are, generally, uninsurable.
- Indemnities should be avoided, they extend the limitation period indefinitely.

The excluded materials clause

Provisions stating that certain materials will not be specified or used in the construction, are common place. These either incorporate lists of such materials or refer to texts concerned with such matters.²² The latter approach may be nonsensically vague, the former approach a potential restraint of trade.

- Such clauses, since they go beyond what will be found the principal contract, are undesirable in principle. It is, in any case, doubtful whether they add much, since the operative clause is probably sufficient to encompass an obligation not to use clearly inappropriate materials.
- A consultant should not be asked to warrant that the listed materials will not be used, only that it will not specify them. It has little control over what is used or specified by others. A contractor may have similar problems since it may have no control over the specification or instructions to which it works. In such cases a contractor's obligations may be limited to notifying the warrantee if it is required use excluded materials.
- If a list is included, it should be prepared by a technical specialist, not a lawyer.

²² For example, Ove Arup; Good Practice in Selection of Construction Materials (1997).

Copyright

If the warranty is given by a designer (or a design and build contractor), it is usual to include provisions giving the warrantee a licence to use the designer's models, drawings, calculations and specifications, and the like, for the construction, alteration, rebuilding and/or extension of the development.

- The licence should be similarly worded to that in the principal contract. Provisions making the licence conditional on payment, or which impose indemnities, and restrictions on indemnities (such as where following the employer's instructions), for infringement of patent rights, are difficult to transfer into the warranty and, thus, often overlooked.²³
- Copyright should not, ordinarily, be assigned to the warrantee.
- If the material covered by the licence is extensive, it may be appropriate to provide that the warrantor is to be reimbursed reasonable retrieving and copying charges.

Insurance

If the warranty is given by a designer (or contractor undertaking design) it is usual to include a clause requiring the warrantor to have and (use best endeavours to) maintain professional indemnity insurance of designated amount for a designated period, and to pay the applicable premiums.

- The insurance requirement should be consistent with that in the principal contract.
- The stated level of cover is ordinarily stated on an each and every occurrence, or series of occurrences arising out of one event, basis. But levels of pollution cover are often stated on an aggregate basis.
- The usual periods of cover are 6 and 12 years. Significantly longer periods may be specified, if there is a concern with tort and contribution. The need for such periods to be stated is due to the "claims made" nature of such insurance and it being renewable on an annual basis.
- The effectiveness of such clauses depends on the vagaries of the insurance market. Thus, an obligation to warn of problems with cover is sometimes included. But this is of doubtful use.
- Clauses that require details of the policy to be provided or which require confirmation in writing that the warranty is covered by insurance, may conflict with insurer's procedures on such matters.

Assignment

Provisions restricting the number of assignments are common; provisions barring any assignments less so.

- Restrictions on the number of re-assignments may be required by the warrantor's insurers.
- If restrictions are required, care must be taken to see that that they don't apply afresh on each assignment. Some warranties deal with this by making the assignment conditional on obtaining the permission of the warrantor, and obliging it to consent to only so many assignments.

²³ One possible consequence, is that the warrantee can exercise the licence and use the material to compete the project without paying any outstanding sums due to the warrantor.

- It is preferable to permit only legal assignments, to avoid the uncertainties and potential fragmentation of benefits inherent in equitable assignments.
- Original tenant assignors may find themselves exposed if they remain contractually liable to the landlord after assigning their lease.

Restrictions on liability

Warranties generally contain provisions seeking to limit the nature and extent of the warrantor's liability. The acceptance of such provisions depends, principally, on the relative bargaining strength of the parties and the implications, if any, of the Unfair Contract Terms Act 1977.

- Net contribution clause. These are designed to ensure that the warrantor does not have to bear the full amount of the warrantee's loss because warranties were not obtained from others who were responsible for the same damage and, thus, contribution cannot be recovered from them under the Civil liability (Contribution) Act 1978.

Net contribution clauses are of two types. The first states that the warranty does not come into effect unless certain other named/designated parties have concluded collateral warranties with the warrantee to the same effect (warrantors like this, warrantees don't). The second states that liability is limited to such proportion of the warrantee's losses as it would be just and reasonable for the warrantor to pay having regard to the extent of the warrantor's liability and on the assumption that other named/designated parties have given warranties in similar form, and have paid to the warrantee such portions of the warrantee's losses as it is just and reasonable for them to pay having regard to the extent of their liability. Such provisions have yet to be tested in court but, in either case, it is important that the list of other named/designated persons is sufficiently precise to avoid risks of the clause falling in whole or part for uncertainty.

- Exclusion of consequential losses. There is some doubt about what such provisions are intended to cover. If the intention is to exclude liability for all but the cost of remedial works, they are likely to be ineffective. The courts have, generally, construed consequential loss to mean losses falling under the second limb of the rule in Hadley v. Baxendale; for a recent case, see Hotel Services v. Hilton [2000] BLR 235 (CA). Thus losses directly arising in the usual course of things from the breach (which could include loss of profit and relocation costs, as well as re-building costs) are unlikely to be excluded by such wording.

A better way to deal with such concerns is to state positively the type of losses for which the warrantor can be liable, such as, for the cost of repair and reinstatement to the extent that the warrantee becomes liable for such costs. Alternatively, a monetary cap can be placed on liability or certain heads of damage, such as loss of profit/relocation costs.

- Limitation periods. A limitation period may be expressly stated, usually a period of years from Practical Completion (this may be a hostage to fortune, if such a state is never reached). Alternatively it is provided that, in respect of any breach, the limitation period under the warranty is co-extensive with the limitation period which would apply to the related breach of the principal contract.
- Defences under the principal contract. The warranty may provide that the warrantor can rely on any term of the principal contract and raise the equivalent right in defence of liability as it would have against the principal under the principal contract.
- Contract (Rights of Third Parties) Act 1999. It is usual to exclude all potential rights under this Act.

- Deeming provisions. Provisions under which the warrantor acknowledges that it had been paid all sums due and owing to it by the principal at the date of the warranty agreement are often included where there is a step in clause. The intention is to limit the warrantee's exposure to historic claims after it steps in. It is often expressly stated that the warrantee cannot issue instructions to the warrantor and has no obligations to the warrantor unless and until it steps in.

Step in rights and novation

Funders (occasionally purchasers) may be concerned to complete the works and, thereby, preserve their investment in the event of major breaches of the finance/ sale agreement or where the warrantor has grounds for determining the principal contract or its employment under that contract. This is often done by including provisions whereby the warrantor, and principal, agree that, in the event of certain specified occurrences, and on notice from the warrantee in the stipulated form, the warrantor will enter into a direct agreement with the warrantee, or its appointee, for the completion of the work/services to be provided under the principal contract. Alternatively, the "step in" is achieved by stipulating that, in such circumstances, the warrantor will accept instructions from the warrantee or its nominee, to the exclusion of the principal.

- To be effective, the principal must be a party to the warranty, and, unless by deed, give consideration so that it is bound by the step in provisions.
- It is necessary to state that the warrantor is not to be in breach of the principal contract by allowing the step in rights to be exercised.
- It is common for the warrantor to be obliged to give notice to the warrantee before exercising rights of determination (under the contract or at common law) in respect of the principal contract and, if the warrantee steps in, not exercise those rights.
- Most such agreements require the warrantee to accept liability for all payments that are or become due to the warrantor under the principal agreement. It is difficult to see how the relationship could continue if it did not do so.
- The mechanisms by which the warrantor "steps in" may not be clear. It may be preferable for this to be clarified by, for instance, including with the warranty, a novation agreement, which is to be executed by all concerned, by deed if the principal contract is by deed, if the step in right is exercised. The difficulty is that, in the absence of provisions to the contrary, this may render the warrantee liable for prior defaults of the principal.
- The lack of clarity over how the "step in" works leads some to suggest that such warranties are construction contracts within the meaning of Part II of the Housing Grants, Construction and Regeneration Act 1996.

Duration of the warranty

There may be a long stop for liability under the warranty by reference to a stipulated number of years after the project is completed. If words such as Practical Completion are used, it should be ensured that these are found in the principal contract. Such provisions are difficult to operate where Practical Completion does not occur.

Notice provisions

Where the warranty includes step in rights, it is usual to include a provision dealing with the giving of notices, and their formalities. These should cover the giving of notices both between the warrantor and warrantee, and also to the principal.

Dispute resolution

Ordinarily, nothing is said about this, or the court is given non exclusive jurisdiction. If the principal contract provides for arbitration, the inclusion of such an agreement in the warranty, and the incorporation of CIMAR, which provides for joinder, in all the agreements, may be advisable. It is doubtful whether a warranty, since it is not an agreement to carry out, or arrange, or provide labour or the labour of others, for the carrying out of construction operations, is a construction contract within the meaning of Part II of the Housing Grants, Construction and Regeneration Act 1996.²⁴

3. **Augmenting the contractual matrix**

The same issues arise in respect of collateral warranties intended to augment the contractual matrix between existing participants in the procurement process, as arise when considering warranties that extend the contractual matrix to non-participants. But, such warranties may also be used to create rights and obligations which are additional to those in the principal contract; for example, concerning design by client designated specialists, for which the main contractor is not prepared to accept responsibly.²⁵

²⁴ Warranties, unlike bonds and guarantees, are not expressly excluded from the ambit of the Act, see the Construction Contracts (England and Wales) Exclusion Order 1998.

²⁵ See the JCT standard form of Employer/Nominated Sub-contractor Agreement, NSC/W. This imposes design obligations on the sub-contractor, which have no parallel in the sub-contract, coupled with limited obligations on the employer to pay for design where done before the main contract is concluded. It also provides for the sub-contractor to be liable to the employer if it delays the main contract works.

COURSE FOR BPP PROFESSIONAL EDUCATION
CONSTRUCTION LAW – BASIC PRINCIPLES

SESSION 3: NEGOTIATING AND CONCLUDING COLLATERAL WARRANTIES

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1. Procurement route

In devising a matrix of warranties, consideration has to be given to the route by which the project is to be procured: For instance, general contracting, design and build (in whole or part), management contracting/construction management, turnkey, design, build and operated (PFI). Procurement routes place primary responsibility for design and for construction with different participants; those who actually do the work. It is these from whom warranties are usually sought.

2. Number of warranties

Where warranties are intended to extend the contractual matrix, those looking for warranties will include funders, if any, the purchaser, if the development is to be sold, or major tenants, if the development is to be leased. If the property owner is not the employer/client, it will also wish to have warranties in its favour.

If it is envisaged that the development may be sold during construction, agreed terms of novation may be preferable to warranties.

Persons from whom warranties are usually sought include those, such as the principal designers and the main contractor, engaged by the employer/client, and principal specialists and sub-contractors, engaged by the main contractor, and those who are concerned with the major elements of work, foundations, structural frame, envelope, mechanical and electrical services, and the like.

Where warranties are intended to augment the contractual matrix it will, generally, be the employer/client that is looking for warranties from the principal specialists and sub-contractors engaged by the main contractor as well as, in the case of a design and build contract, the principal designers engaged by the main contractor.

3. Negotiation issues

The question of collateral warranties (who should provide them to what categories of persons, on what terms) should, ideally, be considered at the outset of the project.

It is in neither party's interest to conclude a collateral warranty whose operative clause does not properly relate to the relevant obligations under the principal contract.

It is in neither party's interest to conclude a collateral warranty with a consultant that creates uninsurable liabilities.

Excluded materials clauses should, if required, be based on appropriate technical advice and reflect what the warrantor can control.

Step in rights are, generally, acceptable, but there can be only one warrantee with such rights. Where there are several funders, this will have to be sorted out between them.

Licences to use copyright material are generally acceptable. But the costs of providing such material and whether this need be done if the warrantor has not been paid may have to be negotiated.

Insurance obligations in a design warranty are commonplace, but they should not conflict with the insurer's restrictions on providing copies of the policy and the like.

The warrantor will be concerned to ensure, by appropriate limitation clauses, that its liability under the warranty, as regards extent and duration, is no more onerous and, preferably, less onerous than under the principal contract. The warrantee will be concerned to ensure a liability that is no less onerous than the warrantor's liability under the principal contract. The resolution of such differences of view is, primarily, a matter of bargaining strength.

If non-standard warranties are proposed, the legal costs of drafting and agreeing these may be high. The proposed warrantor may be reluctant to bear any of these costs, and certainly no more than its own costs.

4. Insurance issues

Professional indemnity insurers have, in the last 15 years or so, become somewhat more relaxed about collateral warranties.

Some insurers have expressly approved the use of certain standard form warranties, specifically the BPF warranties. But the statement of approval is somewhat dated, and its currency should be checked. Furthermore, the approval is to the use of the forms, un-amended.

Policy endorsements concerned with collateral warranties are more common than formerly. Such endorsements extend cover to liability assumed under collateral warranties, duty of care agreements and the like, given by the assured in the conduct of its insured professional duties. Likely exclusions include liability arising from express terms warranting fitness for purpose, liability arising from periods of liability exceeding those under the principal contract and (although some insurers don't insist on this) liability to assignees where the warranty has been re-assigned more than a stipulated number of times (often once or twice).

In practice most collateral warranties proposed to consultants and (design) contractors are in non standard or amended form. If there is any doubt about whether these are within the scope of the relevant policy endorsement, a final draft should be referred to insurers, for approval, before agreed.

If there is no policy endorsement for collateral warranties, all warranties should be passed to insurers for approval.

Concluded warranties must, in any case, be declared by the insured at annual renewal dates.

5. Concluding collateral warranties

An agreement to enter into a collateral warranty should be made prior to or at the time and, generally, as part of the principal contract. If it is sought later, there may be no incentive on the other party to agree. The agreement should stipulate the terms of that warranty, including, in the case of a standard form warranty, any entries that have to be made in that form and when, for instance on notice from the principal, it is to be executed. The agreement must also stipulate the person, or categories of persons to whom the warranty must be given. If the warranty is in non-standard form, a copy of the terms should be annexed to the principal contract.

If this is not done, the intended warrantor will be under no obligation, other than commercial, to conclude a warranty when asked to do so. Once it is awarded the principal contract, the commercial pressure to do so may be weak.

If there is an enforceable obligation to enter into a warranty, then it should be executed at the appropriate time, in the appropriate form. If the proposed warrantor refuses, a claim for damages or, more usually, specific performance may lie against it.

The JCT has published standard enabling clauses, 19A (MCWa/P&T) and 19B (MCWa/F) for use with its warranties. These, to be valid, require a significant amount of information to have been provided to the warrantor before the principal contract is concluded and, in the case of the purchaser and tenant's warranty, restrict the right to require such warranties to be entered into before Practical Completion. Such detailed and restrictive provisions may not be acceptable to employer developers. On the other hand, if the information referred to is not available before the principal contract is concluded, there is a risk that the obligation to enter into the warranty will fail as an agreement to agree.

The warranty itself must be supported by consideration or executed as a deed, if it is to bind the warrantor. Consideration of £10.00 or so is sufficient in law but may be problematic in equity, as may be execution of the warranty as a deed in lieu of valuable consideration. This will matter if specific performance is sought to enforce terms of the warranty (not usually required, but consider the step in provisions).

If the principal contract is a deed, the related warranties should, ordinarily, also be by deed.

6. Assignment issues

If involved in property transactions relating to projects on which warranties have been obtained, it is important to ensure that these are correctly assigned to purchasers, checking that any restrictions or formalities relating to assignment are satisfied. This is a particular problem where property portfolios change hands; consider Allied Carpet v. Grant [2002] BLR 433.²⁶

²⁶ Allied Carpet: The original warrantee went into liquidation and its property was sold. The warranty given by the designer was not expressly assigned in the sale transaction. The purchaser became concerned that the property was defectively deigned. The court held that there was no legal or equitable assignment, thus it had no rights under the warranty.