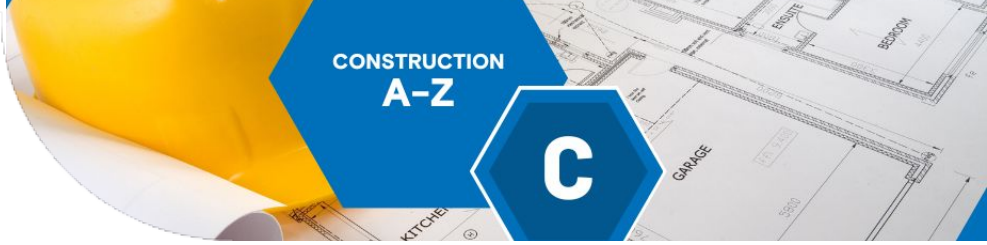

Construction A-Z: Collateral Warranties

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Why are collateral warranties needed?

A key principle of English common law is that you cannot either enforce the benefit of or be liable for any obligation under a contract to which you are not a party. This is known as privity of contract. One way to enforce the provisions of a construction contract to which you are not a party is to enter into a collateral warranty.

What is a collateral warranty?

A collateral warranty is a contract that is associated with another underlying, primary contract (e.g. a building contract, a sub-contract or a consultant's appointment).

It is entered into between:

(a) the party employed under the primary contract (e.g. the contractor, sub-contractor or consultant) and

(b) a third party who has an interest in the project, to enable them to rely on the provisions of the primary contract.

If the warranty grants step-in rights to the beneficiary, the original employer will also be a party to consent to the proposed arrangements (more on this below).

In simple terms, a collateral warranty bridges the contractual gap between those responsible for designing and/or building a construction project – commonly referred to as 'the warrantor' – and a relevant third party, such as a purchaser, tenant, funder or management company – commonly referred to as 'the beneficiary'. The beneficiary can then rely upon the undertakings or covenants contained in the warranty, enabling them to bring a claim against the warrantor in the event of a breach.

Most collateral warranties expressly refer to the duties and obligations set out in the underlying contract, and the warrantor warrants to the third party that it has performed (and, where relevant, will continue to perform)

those duties and obligations in accordance with the contract.

Is a collateral warranty a construction contract?

A topic of much discussion in recent years has been whether a collateral warranty constitutes a 'construction contract' under the Housing Grants, Construction and Regeneration Act 1996 ("Construction Act") and, therefore, whether the statutory right to adjudicate applies to disputes under the warranty.

Much-needed guidance was provided by Abbey Healthcare (Mill Hill) Limited v Simply Construct (UK) LLP [2022] EWCA Civ 823. The Court of Appeal confirmed that a collateral warranty could be deemed a construction contract under section 104(1) of the Construction Act in certain circumstances – namely, if the collateral warranty:

(a) warrants both past/ongoing and future performance of obligations, rather than warranting a past state of affairs; and

(b) includes a nominal payment arrangement as required under the Construction Act.

As a result, any party (including the beneficiary) would have an automatic right to refer a dispute under the collateral warranty to adjudication, even if the warranty does not include express clauses allowing adjudication.

Some parties (or their insurers) wish to avoid this statutory right to adjudicate.

Lord Justice Jackson identified differences in warranty wording, which, although subtle, may have very significant consequences in determining whether or not a collateral warranty is a construction contract. However, there is no 'one size fits all' formula for excluding the statutory regime, and those who are already parties (or potential parties) to collateral warranties should, therefore, seek advice on achieving this in practice.

Who can request a collateral warranty?

The underlying contract usually dictates who is entitled to receive a collateral warranty, usually identifying beneficiaries by reference to their interest in the project (e.g., a funder, purchaser, landlord, tenant or management company). However, interested third parties may also request (usually at a cost) collateral warranties even where there is no express contractual requirement for the contractor or consultant to provide them.

Step-in rights – what are they?

As well as the ability to claim against the warrantor if a problem arises, certain beneficiaries such as funders and employers (in the case of sub-contractor warranties) may require the ability to 'step-in' to the underlying

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contract in certain circumstances during the construction phase, such as:

(a) where the employer or contractor becomes insolvent; or

(b) when the contractor/sub-contractor intends to terminate their employment under the relevant contract.

The beneficiary essentially becomes the employer under the underlying contract, with the aim of ensuring the continuance of the project.

As some beneficiaries may lack the necessary expertise to take on the original party's role, step-in rights may permit the beneficiary to nominate another party to perform that role. For example, a funder may want the option to dispose of the development or to appoint a new developer to complete the project to (hopefully) recoup its investment. These arrangements must be permitted in all relevant agreements in the contractual chain so that the project team cannot refuse to continue if the original employer is replaced and to ensure continuity of payment.

As such, well-drafted step-in rights can sometimes offer a lifeline to contractors, sub-contractors and consultants working for an insolvent employer, especially in light of amendments made to the Insolvency Act 1986 by the Corporate Insolvency and Governance Act 2020, which prevent an employee from terminating its contract due to the employer (or employing contractor, as the case may be) becoming insolvent. The ability for a beneficiary to step in and take the place of the employer (including their payment obligations) can, therefore, be a welcome solution to ensure that the contractor, consultant or sub-contractor is still paid for its services. Otherwise, it must continue with its duties to the (insolvent) employer without any guarantee that it will be paid.

Final comment

It is worth noting that the absence of a collateral warranty does not mean that a third party is unable to take legal action against a contractor or professional. Indeed, a third party who has an interest in a completed residential project may be able to bring a claim under the Defective Premises Act 1972 if serious defects arise, making the building unfit for human habitation. (Keep an eye out for our next article, which covers Defects.)

Tip – Is my collateral warranty 'good enough'?

A collateral warranty is only as good as its underlying contract. It is, therefore, crucial that collateral warranties are drafted consistently (i.e., 'back-to-back') with the consultant's appointment or building contract/sub-contract to which it relates. Indeed, if the parties do not include the same provisions or use similar words that do not have the exact same meaning, the collateral warranty may be harder (or even impossible) to enforce.

If the underlying contract is missing or contains unacceptable terms, this can sometimes be resolved by careful bespoke drafting.

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Please get in touch with our construction team if you need assistance with drafting or reviewing a collateral warranty or for strategic advice on how to enforce warranties or step-in rights.

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