

The Benefits of
Collateral
Warranties in
Commercial
Developments

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

THE BENEFITS OF COLLATERAL WARRANTIES IN COMMERCIAL DEVELOPMENTS

Introduction

A collateral warranty, in the context of a commercial development, stands alongside a principal agreement, usually a contract and/or a letter of appointment. The need for collateral warranties arose because, in general, the party that commissions a building and has it erected is not the party that carries the burden if there is a defect in the building. Prior to 1989, as illustrated by *D & F Estates Limited v Church Commissioners for England* (1989 1 AC 177), third parties presumed that they had the protection of the general law of tort if there was a defect in a building. *D & F Estates Limited* established that third parties could not claim pure economic loss. This case also established that the cost of remedying a defective building fell into the category of pure economic loss and therefore such costs could not be recovered.

Benefits and Burdens of Collateral Warranties

A collateral warranty, where a third party is named specifically as a beneficiary, is designed to create a contractual route for the pursuit of claims by third parties. It is seen as a commercial necessity where a client intends to sell or let the complete building and where the construction is being financed by a lending institution. They are usually provided by a contractor, architect, civil and structural engineer, and mechanical and electrical engineer.

The aspect of collateral warranties that most concern the professionals providing them is the issue of joint and several liability. Potentially, a warrantor could be responsible for the entire cost of remedying the defect when it is only partially at fault. In addition, consequential and business losses that may result from losses are incalculable and difficult, if not impossible, to insure. A funder who has negotiated step-in rights to complete a development will also be interested in collateral warranties.

Effectiveness and Collateral Warranties

There is no absolute guarantee that a beneficiary under collateral warranty will be able to recover the costs it incurs in relation to an inherent defect from a warrantor. The beneficiary must prove negligence and hope that the warrantor remains solvent and has adequate levels of professional liability insurance in place. For the tenant, in particular, it is preferable for the

landlord to accept liability for inherent defects throughout the term of the lease. Although the landlord would be unlikely to agree to this, a compromise should be reached.

A collateral warranty should contain provisions which cover the following:

- ▣ Reasonable skill and care – the warrantor must exercise reasonable skill and care under the appointment. There should be no separate acknowledgement of the duty of care to a tenant, developer or funder, and there should be no obligation as to fitness for purpose. The warrantor must also warrant that it will not break any express or implied term of the letter of appointment.
- ▣ Insurance – the insurance policy should be based on a claims-made basis. Claims are to be dealt with under the policy in force at the time the claim is made, not the policy in force when the works were completed or collateral warranty entered into. This may create an unsatisfactory situation for the beneficiary, as while they may have validated the adequacy of the warrantor's professional indemnity insurance at the time of construction, if there is no insurance in place 10 years later, or if the limits are insufficient or the cause of the particular loss is not specifically included, the collateral warranty may be useless. If the requisite cover is still in place, the limited are adequate and the particular cause of the loss is not excluded, the next difficulty is the net contribution clause that professional indemnity insurers like to insert to protect themselves against the consequences of joint and several liability. This means that the insurance policy will pay out only to the extent of the warrantor's portioned liability and no more. No guarantee of the insurance is generally given; the warrantor merely gives a general assurance regarding the professional's intention to use its best endeavours to maintain adequate professional indemnity insurance for as long as it is reasonably available in commercial terms.
- ▣ Fair shares clause – this endeavour to limit the liability of the warrantor to the contribution which it would have made had others provided similar collateral warranties and paid their fair share under similar warranties using a standard form.
- ▣ Assignments – a collateral warranty is usually assignable only once notice has been given to the warrantor.
- ▣ Deleterious material – the collateral warranty should contain a deleterious materials clause. This clause should be limited to an agreement on the part of an architect, undertaking not to specify these materials for use. The use of any deleterious materials would be contrary to applicable current Irish standards and codes of practice. Potentially, this obligation could be impossible to fulfil. The warrantor should

not agree to ensure that deleterious materials are not used, as it has no way of checking whether certain materials are included in the components of the building.

- ▣ Dispute resolution – it is recommended that the collateral warranty refer to conciliation in accordance with the conciliation procedure published by the appropriate professional body (eg, Royal Institute of Architects of Ireland) in agreement with the Society of Chartered Surveyors and the Construction Industry Federation. If no agreed dispute resolution procedure exists, the matter should be referred to arbitration.
- ▣ Termination of appointment – the collateral warranty must stipulate that the warrantor will give at least 21 days' notice before taking any step to end its employment under the appointment.
- ▣ Concurrent liabilities – the collateral warranty should refer to concurrent liabilities and stipulate that nothing in the collateral warranty will prejudice the beneficiary's common law rights and remedies.
- ▣ Time period – a collateral warranty usually lasts for a period of six year.

Impact of Structural Defects Insurance

Structural defects insurance was implemented in some larger projects in Ireland (eg, the Dundrum Shopping Centre and the international Financial Services Centre). This cover protects the developer, future owners, their funders and tenants against the consequences of structural defects if loss occurs any time over the 12-year period of cover on a no-fault basis, eliminating the need for litigation, uncertainty, delay and cost. Cover lasts for up to 10 years and commences on the issue of the certificate of practical completion. Structural defects insurance may be the preferred option, given that some argue that collateral warranties are of relatively limited value.

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Author: Linda Lynch

CONTACT US

Our Offices

Dublin

33 Sir John Rogerson's Quay,
Dublin 2,
Ireland.
Tel: +353 1 667 0022
Fax.: +353 1 667 0042

Cork

8 Webworks Cork,
Eglinton Street,
Cork, Ireland.
Tel: +353 21 425 0630
Fax: +353 21 425 0632

Boston

26th Floor,
225 Franklin Street,
Boston, MA 02110,
United States of America.
Tel: +1 617 217 2866
Fax: +1 617 217 2566

New York

245 Park Avenue
39th Floor
New York, NY 10167
United States
Tel: +1 212 792 4166
Fax: +1 212 792 4167

Tokyo

12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
Tel: +813 6860 4885
Fax: +813 6860 4501

e-mail: enquiries@dilloneustace.ie
website: www.dilloneustace.ie

Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.

Paul Eustace

e-mail: paul.eustace@dilloneustace.ie
Tel : +353 1 667 0022
Fax: + 353 1 667 0042

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DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

33 Sir John Rogerson's Quay, Dublin 2, Ireland.
www.dilloneustace.ie

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