Collateral Warranties – Keep Covered and Mind the Gaps!

When negotiating a collateral warranty one of the key considerations for the party providing the warranty is whether it exposes them to greater liability than the underlying contract. This is particularly important for consultants (and contractors with design responsibility), because professional indemnity insurance policies often exclude cover for collateral warranties which provide a greater or longer lasting benefit to the beneficiary than is provided under the underlying contract.

Those providing collateral warranties therefore commonly require the inclusion of provisions which state that:

- the warranty grants the beneficiary no greater rights than it would have had; and
- in any claim by the beneficiary the party providing the warranty can raise equivalent rights of defence and rely upon any limitation of liability as it would have had;

if the beneficiary was named as “joint employer” with the original client/employer under the appointment (“A Joint Employer Clause”).

Until recently there had been little case law on Joint Employer Clauses and accordingly there was some uncertainty as to how they would be construed. The recent case of *Oakapple Homes (Glossop) Ltd v DTR (2009) Ltd (In Liquidation)* considered the effect of a Joint Employer Clause and confirmed that such clauses will reduce the risk of liability under a collateral warranty being excluded from one’s professional indemnity insurance. However, it also demonstrates that the effect of a Joint Employer Clause will depend upon the precise wording being used and the defence which is being relied upon: in this particular case the Joint Employer Clause did not entitle the defendant to rely upon the defence of contributory negligence to reduce the damages payable to the beneficiary.

**Facts**

In 2004 Oakapple Home (“the Employer”) appointed DTR Ltd (“the Architect”) in connection with the conversion of a former cotton mill into 72 residential apartments, with commercial units at ground floor level. The Architect’s contract with the Employer (“the Appointment”) required the Architect to enter into collateral warranties for the benefit of purchasers and tenants of the property.

The Employer subsequently entered into a building contract (“the Contract”) with Oakapple Construction (“the Contractor”) a company closely connected to the Employer, as the name suggests, following which the Architect’s Appointment was novated to the Contractor. Under the Appointment the Architect was obliged to provide a collateral warranty to the Employer following novation.

After completion of the project the property was largely destroyed by fire, by which point nearly all of the 72 residential apartments had been let and occupied. Although the Architect had executed
collateral warranties in favour of the occupiers of the retail units, no collateral warranties had been executed in relation to the purchasers of the leasehold interests in the residential apartments.

In June 2011 the Employer issued a letter of claim to the Architect (who was now managed by liquidators, having entered into creditor’s voluntary liquidation) alleging that the fire and its rapid spread had been caused by the Architect’s breach of their design and inspection duties. The letter of claim also called on the Architect to issue collateral warranties in favour of the residential lessees.

The Architect’s liquidators were concerned whether, if the collateral warranties were executed, there would be professional indemnity insurance cover to meet any claims made under them. The Architect alleged that the Contractor had breached its design obligations under the Contract and that it could raise the defence of contributory negligence given the close connection between the Employer and the Contractor.

The court was therefore required to consider two issues:

1. Would the Architect be entitled to defend claims by beneficiaries of the residential tenant collateral warranties on the basis of the Contractor’s “contributory negligence”?

2. If not, would exclusions in the Architect’s professional insurance policy entitle its insurers to decline to indemnify the Architect for any liability which it might have to the beneficiaries of the residential tenant collateral warranties?

Contributory Negligence

Clause 1.2 of the collateral warranty (“Clause 1.2”) was a “Joint Employer Clause”, which provided as follows:

“The Consultant has no liability hereunder which is greater or of longer duration than it would have had if the Beneficiary had been a party to the Appointment as joint employer PROVIDED that the Consultant shall not be entitled to raise under this Deed any set-off or counterclaim in respect of sums due under the Appointment.”

The Architect argued that the effect of Clause 1.2 was to limit the liability of the Architect to that which it would have had under the Appointment if the relevant beneficiary had been the “joint employer”. On the basis that the Employer and the Contractor were connected companies the Architect also argued that the Employer was responsible for the Contractor’s breaches of its design obligations and that it could therefore raise a defence of contributory negligence against the Employer in respect of these breaches. To this end the Architect sought to rely upon Clause 1.2 to reduce any damages that might be payable to a beneficiary to take account of the Contractor’s “contributory negligence”.

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The definition of Appointment in the collateral warranty referred to the agreement between the Architect and the Employer and not the Appointment “as novated” and therefore Ramsey J considered Clause 1.2 on this basis. He held that the Employer was not liable under the Appointment for the negligence of the Contractor as they were two separate legal entities and an employer under a construction contract is not liable, vicariously or otherwise, for the negligence of the contractor. As the damages due to the Employer could not be reduced to take account of the alleged “contributory negligence”, Clause 1.2 would not reduce the damages payable to a beneficiary.

Ramsey J also held that the position would not have changed even if the collateral warranty had referred to the Appointment “as novated” largely because of a distinction between “liability” and “damages”. The novation agreement stated that the Architect would be liable to the Contractor as if it had been named “as a party thereto ab initio in lieu of the Employer”. In a claim by the Contractor against the Architect for negligent design, the Architect’s liability would not be reduced to take into account any fault of the Contractor; instead the damages recoverable by the Contractor would be reduced under the Law Reform (Contributory Negligence) Act 1947 to “such extent as the court thinks just and equitable having regard to the claimant’s share in the responsibility for the damage”.

Whilst these comments are obiter, it follows from the above that even if the defence of contributory negligence had been established against either the Contractor or the Employer, Clause 1.2 would not have reduced the damages payable to a beneficiary, as it only refers to the “liability” of the Architect.

**The Insurance Policy**

Clause 5.9 of the Architect’s professional insurance policy (“Clause 5.9”) provided that the policy would only indemnify the Architect in respect of a collateral warranty if “the benefit of such Warranty .... is no greater or longer lasting than that in the original contract to which it relates”.

The Architect’s insurers argued that because the Architect was not entitled to defend claims by beneficiaries on the basis of the Contractor’s contributory negligence, the beneficiaries would enjoy a greater benefit under the warranty than the Contractor enjoyed under the Appointment following novation and that, accordingly, Clause 5.9 entitled the insurer to decline to indemnify the Architect.

Ramsey J held that Clause 5.9 would not entitle the insurers to decline to indemnify the Architect in respect of the collateral warranty. It was considered that reference to “the benefit of the warranty” in Clause 5.9 was to the contractual liability of the Architect to the beneficiaries. As the defence of contributory negligence determines the damages payable by a defendant and not the defendant’s liability (see above), in the event of any claim the Architect’s liability under the collateral warranties would be no greater or longer than under the original Appointment. The requirement in clause 5.9 was therefore satisfied by the Joint Employer Clause in clause 1.2.
Comment

This case underlines the importance of ensuring that a collateral warranty includes a Joint Employer Clause. Whilst the position will always depend upon the wording of both the collateral warranty and the insurance policy, a Joint Employer Clause will reduce the risk of a collateral warranty falling outside the scope of a professional indemnity insurance policy.

However, this case also demonstrates that the effect of a Joint Employer Clause will depend upon the precise wording used and the strength of any defence which is being relied upon. As with any limitation of liability, the wording of a Joint Employer Clause should be considered very carefully and there will always be a limit to the extent to which any particular clause can be relied upon.

Interestingly, it appears that Clause 1.2 would not enable the Architect to argue that any damages payable to a beneficiary should be reduced as a result of the contributory negligence of either the Employer or the Contractor, as if successful such a defence reduces the damages payable by the defendant and not its liability (although Ramsey J’s comments in this respect were obiter).

Had Clause 1.2 also enabled the Architect to raise equivalent rights of defence against the beneficiary (provided such rights were not limited to rights in defence of liability as per the CIC warranties) the Architect may have been able to rely upon a defence of contributory negligence against the Employer, but this would not have included such a defence against the Contractor, as the Architect attempted to rely upon in this case. For a Joint Employer Clause to cover such a defence it appears it would need to make clear that it applies to Appointment “as novated”, although careful consideration would need to be given to avoid the risk of the clause no longer applying to defences against the Employer.

In any event, the Architect would most likely have been in a stronger position had the collateral warranty and/or the Appointment contained a net contribution clause. Net contribution clauses are relatively common in standard form documents (such as the RIBA Standard Conditions, the ACE Agreement and the CIC Collateral Warranties) and limit one’s liability to the proportion of the loss which it is just and equitable for them to pay, having regard to the extent of their responsibility for the relevant loss or damage. However, any net contribution clause must also be carefully drafted to ensure it provides the intended protection (see our recent note on West and another v Ian Finlay & Associates).

They are often a contentious issue in negotiations, but this case highlights the importance of ensuring robust protection in any collateral warranty by way of both Joint Employer Clauses and net contribution clauses wherever possible and of carefully considering such protection in the context of the contractual documents.

September 2013

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