

COURT CONFIRMS TWO-TIER SYSTEM FOR COLLATERAL WARRANTIES

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A recent Court decision confirms a two-tier system applies for collateral warranties with far-reaching implications for construction projects and real estate transactions. In *Toppan Holdings Limited and another v Simply Construct (UK) LLP*, the Technology and Construction Court (“TCC”) has provided rare guidance on whether collateral warranties given on construction projects are “construction contracts” within the meaning of Section 104 of the Housing Grants, Regeneration and Construction Act 1996 (the “Act”) and whether an adjudication can be brought under collateral warranties.

Ever since the 2013 judgment in *Parkwood Leisure*¹, collateral warranties may be construction contracts dependent on the interpretation of their *terms*. However judicial guidance on the application of the Act to collateral warranties has since been sparse, with no further reported High Court authority on the topic.

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Now, following a summary judgment application to enforce two adjudicator's decisions, the Court has emphasised the *timing* of the execution of a collateral warranty as paramount in construing whether it is a construction contract capable of being adjudicated upon.

In this case, the Court found that a collateral warranty executed after completion of the works was not a construction contract, and accordingly the adjudicator did not have jurisdiction in the dispute referred to him. This meant the Court declined to enforce one of the two adjudicator's decisions on which summary judgment was sought.

COLLATERAL WARRANTIES AND BACKGROUND

Since the 1990s, the law has restricted the right to recover losses from physical damage to buildings in the absence of contractual relationships. This restriction arose for policy reasons and from a concern about opening the floodgates to

litigation.

To overcome this restriction, collateral warranties have developed to connect two parties who might not otherwise have a contractual relationship to enable a right to sue in the event of future problems with the works or services. For example, a building contractor or a consultant providing works or services under a “primary” contract (such as a building contract or consultant’s appointment) might be connected through a collateral warranty with a third party beneficiary with an interest in the project. The collateral warranty provides a means through which a claim may be brought if losses arise from the completed works or services performed, such as if latent defects are found after completion. That right to sue might not otherwise exist in the absence of the contractual relationship and so collateral warranties are an important part of the security package on a construction project and real estate transaction.

If a contract is a “construction contract” under Section 104 of the Act, there is an implied right to refer any disputes arising under such a contract to adjudication at any time, even if the relevant contract contains no provisions relating to adjudication. That entitlement is attractive as adjudication as a form of dispute resolution is much quicker and more cost effective than court proceedings where it may take years, rather than months, to obtain a decision.

THE FACTS

Toppan Holdings Limited (“Toppan”) is the freehold owner of a luxury care home in London (“Care Home”) built by Simply Construct (UK) LLP (“Simply”). Following completion of the works, Simply’s building contract was novated to Toppan, which established a contractual link between those parties. The Care Home was let to the tenant operator, Abbey Healthcare (Mill Hill) Limited (“Abbey”). A collateral warranty to the benefit of the tenant was not procured from Simply at the time when Abbey commenced its lease.

After completion of the works and the opening of the Care Home, construction defects were identified which required remedial works. Certain losses from remedying the defects were incurred by Toppan as landlord and other losses were incurred by Abbey as tenant. This meant that both Toppan and Abbey required contractual links to sue.

As the building contract had been novated to Toppan, it had a direct recourse to adjudicate the disputes. However, there was no contractual link between Simply and Abbey. Toppan subsequently exercised its right to ask Simply to execute a collateral warranty to Abbey’s benefit. The Abbey collateral warranty from Simply (the “Collateral Warranty”) was only provided after High Court proceedings for specific performance had been issued against the latter.

Toppan and Abbey then brought parallel adjudications against Simply for recovery of their respective losses which were awarded in two separate awards. When Simply did not pay, the Claimants issued joint enforcement proceedings against them in the TCC. Simply defended the Abbey claim on grounds of jurisdiction, namely that the Collateral Warranty was not a construction contract within the meaning of the Act and so the right to adjudicate did not apply.

THE DECISION

The Court noted that while the Collateral Warranty was for past and future construction operations, it had not been executed prior to practical completion, but following the discovery of the latent defects which had been remedied. While in *Parkwood*, Akenhead J had noted that:

1. a construction contract may be retrospective in effect and still fall within the Act – it does not need to be “wholly or partly prospective”;
2. the Act was intended by Parliament to confer a wide definition on “construction contracts” subject to the Act; and
3. where the contract is for the “carrying out and completion” of construction operations, it will invariably fall under the Act.

These comments had been tempered by his statement that a pointer against a collateral warranty being a construction contract is that *“all the works are completed and that the contractor is simply warranting a past state of affairs as reaching a certain level, quality or standard”*.

This latter consideration was key to the finding in this case that the Collateral Warranty was not a construction contract subject to the Act. While express language had been included in respect of future construction operations, the Collateral Warranty could not relate to future construction operations as it was executed *after* practical completion.

Although the Collateral Warranty confirmed that Abbey acquired no greater rights under the Collateral Warranty than would be available under the building contract, this did not mean that equivalent rights extended to an entitlement to adjudicate. The Court said that documents such as parent company guarantees may also be considered “parasitic” to their underlying contract but are not construction contracts.

As a result, the Court declined to enforce the adjudication decision in Abbey’s favour. However, three further defences raised by Simply to resist enforcement of the adjudicator’s decisions were rejected. In respect of both Toppan and Abbey, the Court refused to order a stay of execution, being satisfied Toppan and Abbey are sufficiently financially strong so as to repay any award finally determined in Simply’s favour.

COMMENTARY

This decision, the first where two adjudicator’s decisions have been considered in the same enforcement proceedings, raises important issues for the construction industry and on real estate transactions:

1. This case makes clear that the Courts will adopt as crucial the *timing* of the execution of the warranty as much as the *terms* of the collateral warranty. If the warranty is executed where uncompleted works remain, that will be a “very strong pointer” that the agreement is one which falls under the Act. If the warranty is executed after completion of the works, even in the case of latent defects which have been remedied, then the warranty is “unlikely” to be a construction contract, but more akin to a manufacturer’s product warranty. This judgment therefore represents a reduced emphasis on the express terms of a warranty relating to construction operations in favour of emphasis on commercial context;

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2. The case creates uncertainty as to which cases may or may not be adjudicated under a collateral warranty. This decision represents a narrowing of the circumstances in which a collateral warranty may be a construction contract capable of being subject to adjudication. It is unclear whether *Parkwood* would be decided in the same way in light of this decision, as *Parkwood* concerned latent defects covered by a collateral warranty executed *prior* to completion of construction operations. Where a collateral warranty is entered into during construction, but a dispute arises out of latent defects which have or are being remedied, it is not certain that a beneficiary of such a warranty could now adjudicate a dispute;
3. The judgment is now likely to make it more difficult to procure warranties on live projects, where warrantors may seek to avoid or delay providing warranties governed by the Act. That is contrary to the wide ambit of the Act, and the desire to adjudicate quickly and cost-effectively. While it is often said that a job is not complete until all the paperwork is done, it takes time and effort to ensure that a complete construction pack is in place. Sometimes, parties are reluctant to extend their liability by providing collateral warranties to third party beneficiaries and delay in doing so. The decision will not make it any easier to procure collateral warranties;
4. By disincentivising parties to provide collateral warranties on live construction projects, it will make it more difficult to restructure jobs in the event of insolvency. For example, where a building contractor becomes insolvent on a live project, the employer may complete the remaining works by engaging subcontractors directly. The employer benefits, under a collateral warranty, from a warranty for works already carried out by a subcontractor for the building contractor. The remaining works are then warranted under a new contract between the subcontractor and the employer. If a collateral warranty has not been procured during a live project, there will be no warranty for works carried out up to the date of insolvency. The employer might only be able to obtain protection for historic, but incomplete, works by taking over the old contract between the building contractor and the subcontractor. This risks landing the employer with the financial liabilities of the insolvent building contractor. As this is likely to be commercially unacceptable, it will be more difficult to restructure incomplete projects; and
5. Some transactions, such as forward commitment agreements and/or forward funding agreements, are structured so that collateral warranties are only provided after practical completion is achieved. The case creates uncertainty as to whether beneficiaries of warranties on such transactions will benefit from Act compliant collateral warranties or collateral warranties that are merely akin to a product guarantee.

In summary, the judgment brings into sharp focus the need for parties to pay close attention not just to the terms of collateral warranties agreed, but also to the timing of the entry into warranties and whether there are construction operations still to complete. Commercial negotiations may reflect the varying rights conferred by collateral warranties executed at different times. A collateral warranty conferring the right to adjudicate will likely be considered more valuable than one entered after practical completion which would now limit a beneficiary's rights to adjudicate as a result of this decision. As a result, the Claimant intends to appeal the decision to the Court of Appeal.

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[1] *Parkwood Leisure Ltd v Laing O'Rourke Wales and West Ltd* [2013] EWHC 2665 (TCC)

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