COURT OF APPEAL TO REVISIT TWO-TIER SYSTEM FOR COLLATERAL WARRANTIES

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INTRODUCTION

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The first instance decision by the Technology and Construction Court in *Toppan Holdings Limited and another v Simply Construct (UK)*[1] *LLP* emphasised the *timing*, rather than the *terms*, of execution of a collateral warranty as paramount in construing whether statutory adjudication rights apply to collateral warranties. Now following a successful application for permission to appeal in which Watson Farley & Williams LLP act for the appellant, the Court of Appeal has confirmed it wants to review the first instance decision given the issues are of public importance.

Collateral warranties are currently in the spotlight in view of the ongoing building safety scandal. Leaseholders are common beneficiaries of collateral warranties and may rely on these contractual links to sue those responsible for the construction, design or certification of buildings determined to be unsafe.

Whether a collateral warranty attracts statutory adjudication rights is important because adjudication is much quicker and more cost effective than court proceedings, in which it may take years, rather than months, to obtain a decision. The first instance decision raised concerns about a two-tier system for collateral warranties, with collateral warranties drafted in the same terms attracting differing rights to sue, simply based on the date when the collateral warranty was signed.

COLLATERAL WARRANTIES AND BACKGROUND

Collateral warranties provide contractual links between those with an interest in a construction project and those who built, designed or certified the works. The collateral warranty provides a right to sue, if for example latent defects are found after completion. That right might not otherwise exist because the law restricts claims from physical damage to buildings in the absence of a contractual relationship. Collateral warranties are therefore an important part of the security package on most UK construction projects and real estate transactions. If a contract is a "construction contract" under Section 104 of the Housing Grants, Construction and Regeneration Act 1996 (the "Act"), there is an implied right to refer any disputes to adjudication at any time, even if the relevant contract contains no provisions relating to adjudication. That entitlement is attractive as adjudication is a quicker and cost-effective means of dispute resolution.

THE FACTS

The first claimant 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 the landlord, establishing a contractual link between those parties. Subsequently, the Care Home was let to the tenant operator.

Simply did not provide a collateral warranty to the tenant and following completion defects were identified which required remedial works. Certain losses were incurred by the landlord and other losses by the tenant. This meant that both the landlord and the tenant required contractual links to sue. The landlord could adjudicate its disputes as the building contract had been novated to the landlord but there was no contractual link between the contractor and the tenant.

The contractor subsequently provided a collateral warranty to the benefit of the tenant after High Court specific performance proceedings had been issued against the contractor. The landlord and the tenant then brought parallel adjudications against the contractor for recovery of their respective losses which were awarded in two separate awards.

When the contractor did not pay, the Claimants issued joint enforcement proceedings against the contractor. The contractor defended the tenant's 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 FIRST INSTANCE DECISION

The Court noted that while the collateral warranty in this case 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. In *Parkwood*[2], Akenhead J noted that a construction contract may be retrospective in effect and still fall within the Act. The Act was also intended by Parliament to confer a wide definition on "construction contracts". A contract for the "carrying out and completion" of construction operations will invariably fall under the Act. However, these comments were tempered by his statement elsewhere in the judgment that a point against a collateral warranty being a construction contract is that "*all the works are completed and that the contractor is simply warrantying a past state of affairs as reaching a certain level, quality or standard*".

This latter consideration was key to the finding at first instance 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, it was said that the collateral warranty could not relate to future construction operations as it was executed *after* practical completion. Although the collateral warranty confirmed that the tenant 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. As a result, the Court declined to enforce the adjudication decision in the tenant's favour.

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THE PERMISSION TO APPEAL

Granting permission to appeal the first instance decision, the Court of Appeal held there were a number of matters which might be said to support the submission that the collateral warranty was a construction contract for purposes of the Act. They included a purposive approach to the Act, the proper construction of the collateral warranty, the lack of any direct authority dealing with the point and possible wider considerations of business efficacy and common sense.

As long as the Act continues to pick and choose between those contracts it covers and those it does not, and as long as adjudication continues to be a popular and cost effective dispute resolution process, there will continue to be arguments about what kind of contracts fall within and outside the scope of the Act. Whether or not collateral warranties generally fall within the scope of the Act is therefore a point of public importance such that permission to appeal the first instance decision was granted.

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COMMENTARY

The first instance decision in this case creates a two-tier system for collateral warranties, with collateral warranties executed before practical completion attracting statutory adjudication rights but those executed afterwards being akin to a manufacturer's product warranty. The decision has raised logistical challenges in procuring collateral warranties, with beneficiaries keen to ensure collateral warranties are signed as early as possible to attract statutory adjudication rights but with those providing such warranties delaying their execution until after practical completion to avoid potential statutory adjudication claims.

Disincentivising parties to provide collateral warranties on live construction projects makes it more difficult to restructure jobs in the event of insolvency. 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 and potentially no step-in rights. Without a collateral warranty the party seeking to restructure a project might have no alternative but to take over the old contract, which could include the financial liabilities of the insolvent party. As this is likely to be commercially unacceptable, it will be more difficult to restructure incomplete projects in the absence of collateral warranties.

The first instance decision has also created uncertainty as to the appropriate practical completion date for determining whether statutory adjudication rights apply. Would statutory adjudication rights apply if a subcontract collateral warranty was signed after a subcontract package achieves practical completion but before practical completion of the entire project?

Furthermore, under the current arrangements, beneficiaries of collateral warranties with consistent drafting would attract differing rights simply based on the timing of execution. Beneficiaries may not be able to update the drafting in collateral warranties to include a contractual right of adjudication because the templates on which collateral warranties are currently being procured may have been agreed years, if not months, previously when the contracts were first entered into.

A collateral warranty conferring the right to adjudicate will likely be considered more valuable than one entered into after practical completion, which would not attract adjudication rights as a result of this decision.

The first instance decision raises many questions with practitioners still seeking to fully understand its implications. Welcome clarification should be provided by the Court of Appeal on these issues with the full appeal expected to be heard in the first quarter of 2022.

[1] [2021] EWHC 2110 (TCC)
[2] *Parkwood Leisure Limited v Laing O'Rourke Wales & West Limited* [2013] B.L.R. 58

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