

Back to basics: collateral warranties



What is a collateral warranty?

In relation to construction projects, a collateral warranty is a contract between a party involved in the works and a third party beneficiary who has an interest in the works but is not party to the building contract/appointments. The collateral warranty provides that the party who has carried out works and/or services has complied with its obligations under the underlying contract.

Who should require a collateral warranty?

Generally, it will be funders, purchasers and/or tenants who should require collateral warranties.

Why are collateral warranties needed?

Defective design or workmanship may cause third parties who have an interest in a project to suffer a loss. Without a collateral warranty the third party would not have a contract with the party responsible for the defect.

What are the essential requirements of a collateral warranty from a beneficiary's perspective?

A beneficiary should ensure that there are obligations for the warrantor:



- to comply with its underlying appointment
- to carry out and complete the works properly in respect of any workmanship
- to exercise reasonable skill care and diligence in relation to any design
- not use or specify deleterious (harmful) materials in the project (this is usually subject to the exercise of reasonable skill care and diligence).
- to provide a copyright licence for the beneficiary to copy and use the design prepared by the warrantor for purposes relating to the project. The licence should be irrevocable, transferrable and there should be the right to grant sub-licences. The licence should be given without condition (so not subject to the payment of fees).
- to carry and maintain professional indemnity insurance at the level required in the underlying contract for the liability period (for commercial projects 12 years is the standard.)

The collateral warranty should have the following provisions:

- that the warrantor's duties or liabilities under the collateral warranty will not be negated or limited because of any approval, inspection or testing or omission to do the same.
- step-in rights (purchaser and funders only). As an example, step in rights would enable a funder to step into the construction documents in order to complete the project in the event that its borrower becomes insolvent.
- An assignment clause that allows for at least two assignments with assignments to group companies or to funders by way of security excluded as counting towards the number of assignments.

Clauses standardly required by the warrantor

- A limit on the number of assignments (see preceding bullet point)
- A no greater obligations provision that the warrantor will not owe the beneficiary any obligations that are greater under the collateral warranty than owed under the underlying contract.
- Provision that the warrantor may raise equivalent rights of defence as it would have had if the beneficiary had been named as a joint employer under the underlying appointment (but not taking into account any set-off or counterclaim against the actual employer under the underlying appointment).
- Provision that the warrantor may rely on any defence, limitation on liability or other term in the underlying contract.
- A cap on liability. The beneficiary should ensure that any cap is in line with the agreed level of the warrantor's professional insurance.

Conclusion

It is important to note that the above provisions of a collateral warranty are of a commercial standard and are typically included in most templates. Nevertheless, the terms will be dependent upon who the beneficiary is and more bespoke clauses may be required depending on the works to be undertaken and the needs of the beneficiary.

Notwithstanding this, it is imperative that there is uniformity in a collateral warranty's clauses across the whole key design team so there are no discrepancies between the obligations owed by each consultant.



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