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This memorandum is a general summary of developments and is not a complete statement of the law. Specific legal advice should be obtained before taking action.

## Collateral Warranties - Requirements and Pitfalls

A collateral warranty is ancillary to another principal contract. There are usually two parties to a collateral warranty, the party giving the warranty ("**the Warrantor**") and the party receiving the benefit of the warranty ("**the Beneficiary**") (where there are step in rights, there may be a third party). Typically in construction, collateral warranties are provided by designers, contractors and specialist sub-contractors to, say, a tenant or purchaser acquiring an interest in the property, or a funder financing the development. The collateral warranty provides the Beneficiary with a direct contractual remedy against the Warrantor where none would otherwise be available.

This Note summarises the key elements of a Collateral Warranty:

### The Primary Covenant

This is a promise by the Warrantor to fulfil the obligations under the principal contract. As a Beneficiary, you need to have sight of the principal contract, as many of the benefits under the warranty will depend on the terms of the principal contract. In its simplest form, a warranty need simply state that the Warrantor has not broken and shall not break its obligations arising under the principal contract.

### No Greater Liability Clause

Warrantors may require the primary covenant to be qualified by a provision which states that the Warrantor is at no greater risk under the warranty than he is or would be under the principal contract (known as the "no greater liability" clause). The significance of including this clause was demonstrated in the UK decision of *Safeway Stores Ltd v Interserve Project Services Limited* [2006]. In that case, the supermarket chain, Safeway Stores plc ("**Safeway**") entered into a design and construct contract with Chelverton Properties Limited ("**Chelverton**") for a new supermarket and two storey car park. Chelverton engaged Interserve Projects Limited ("**Interserve**") to build the supermarket and Interserve entered into a collateral warranty with Safeway that contained the following provision:

*"The Contractor shall owe no duty or have any liability under this deed which are greater or of longer duration than that which it owes to the Developer under this Building Contract"*

A dispute subsequently arose over defects to the car park. In the meantime, Chelverton became insolvent whilst still owing Interserve £1.3 million under the main contract. Safeway decided to carry out remedial works to the car park itself and in July 2004 commenced proceedings against Interserve under the Collateral Warranty claiming £413,000 in damages for the costs of the remedial works.

The Court found that Safeway was barred from pursuing Interserve under the collateral warranty because of the greater sum owing to Interserve by Chelverton under the main contract. It stated:

*“The purpose of Clause 3.3 is clear: it is to restrict Interserve’s liability to Safeway to its equivalent liability to Chelverton under the building contract. It still provides a direct route for Safeway to bring proceedings against Interserve, but it ensures that the extent of that liability is no greater than the liability of Interserve to Chelverton.”*

The reasoning was that had Chelverton gone into liquidation during the performance of the building contract, Safeway could have taken over the main contract subject to first paying to Interserve any amounts owing under the main contract. The effect of Clause 3.3 of the Collateral Warranty was to preserve this situation, such that Safeway could not recover £400,000 from Interserve in respect of the defect unless and until Interserve had been fully paid the £1.3 million due to it from Chelverton.

## Net contribution clause

The purpose of net contribution clauses is to transfer to the Beneficiary the risk that other persons responsible for the same damage may be unable to pay or may have ceased to exist. The Beneficiary will assume the burden of pursuing such contribution from third parties as may be available. The most aggressive forms of net contribution clause are those which define the defendant’s liability in terms of a fair and reasonable share of the total loss. The mildest forms of net contribution clause consist of an undertaking by the Beneficiary to obtain (or an obligation on the developer to put in place) collateral warranties from other specified parties, usually the other members of the design team and the contractor. There may also be a provision that no action will arise against the Warrantor unless such other warranties are obtained.

## Step-In Rights

Where a bank is funding a development (“the Funder”) or a purchaser is entering into a

commitment with the developer prior to completion, they will probably require “step-in rights” entitling them to step-in and take over the development in the event of developer or contractor default. Step-in provisions are usually included in collateral warranties to enable a funder to assume the role of the developer and complete a project, or to assume the role of the contractor and assume the employment of sub-contractors (and/or consultants), if either the developer or contractor become insolvent or commit a material breach of the contract.

## Assignment

Beneficiaries may require to have unlimited rights of assignment although Warrantors will generally wish to restrict the number of assignments which may occur. It has become industry standard for a collateral warranty to be assignable once or possibly twice without the consent of the Warrantor, with all further assignments being subject to consent.

## Duration of collateral warranty obligations

Finally, as a Warrantor, you will need to consider the duration of your collateral warranty obligations. In the absence of any express terms which affect the position, the duration of collateral warranty obligations will depend upon when the warranty is entered into, when the development is completed and the limitation period which applies (either 6 years or 12 years). Because remedies under collateral warranties are contractual in nature, time starts to run under a warranty from the date of breach, (unless, exceptionally, there is an element of wrongful concealment, in which case time will run from the date the breach of duty becomes reasonably apparent).

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