Rollits LLP

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Construction Focus

Is there an end in sight for Collateral Warranties?

Obtaining Collateral Warranties in a construction project can at times be an arduous task. In most construction projects contractual requirements are imposed on the Main Contractor to provide or procure warranties upon request from themselves and any sub-contractors/sub-consultants (generally restricted to those with design responsibilities) within a specified period of time.

This seems simple enough but the reality is often very different with collateral warranties at times not being provided until the project is well advanced or indeed until after practical completion has occurred. In extreme cases we have encountered instances where collateral warranties have not been provided and we are now some years down the line.

The position of the Main Contractor must be appreciated in this situation as they will most likely have other priorities, such as actually carrying out the works, which take precedence. Equally, the Main Contractor has to deal with the different requirements of their sub-contractors/consultants who will each be guided by their professional indemnity insurers.

From an Employer's perspective there are also the costs of obtaining these warranties. Whether they are obtained through the Employer's Agent or a solicitor the professional fees in obtaining what can often be numerous warranties soon mounts up. There is also the very real problem that the drawdown of funding is dependent upon obtaining warranties, which can be a significant problem if the provision of warranties is delayed. Equally, an absolute requirement on a party to supply a warranty is very difficult to give as if the particular contractor or consultant becomes insolvent then a warranty will no longer be obtainable.

So, what are the benefits of a Collateral Warranty?

The fundamental benefit of a Collateral Warranty is that it gives a third party a contractual link to the contractor/consultant. This enables the beneficiary of the warranty to take action directly against the party providing the warranty which otherwise would not most likely be possible.

The collateral warranty will also (in most cases) provide a copyright licence enabling the beneficiary to use the material prepared by the contractor/consultant and impose requirements to retain professional indemnity insurance up to a certain level for a set period of time. Importantly, the warranty will in some cases (generally for the benefit of the Employer and Funder) grant step-in rights, which enables the beneficiary to step in to the shoes of the employer under the original appointment in order to ensure that the contractor/consultant carries on with the works.

However, just because a collateral warranty has been obtained does not necessarily mean that the beneficiary has complete protection going forward. Should for example any defect in the works come to light the beneficiary of the warranty would still have to bring a claim and then risk protracted legal arguments should the responsibility and/or amount of loss be disputed.

Equally, due to the usual inclusion of wording within a collateral warranty that allows the contractor/consultant to rely on any limit of liability contained in their appointment the general rule of thumb is that the warranty is only as good as the appointment that it relates to. So, if there are exclusions or caps on liability in the main appointment then these will apply in the warranty. It is also quite common for sub-contractors to require net contribution clauses, which limit the sub-contractor's liability to the damage they have specifically caused. This means that a beneficiary has to pursue each warrantor who may have contributed to the defect.

Indeed, if the party that gives the collateral warranty enters into insolvency the likelihood is that the warranty will no longer provide any protection going forward.

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Is there an end in sight for Collateral Warranties?

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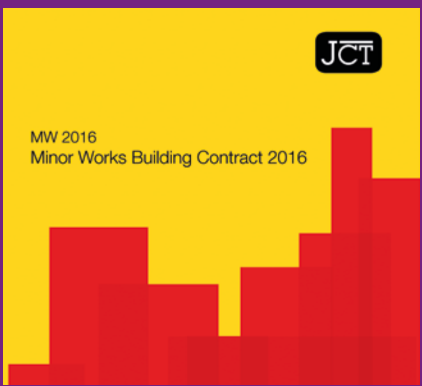
So, if collateral warranties are not the perfect solution, what are the alternatives?

Third Party Rights an underused solution?

The Contracts (Rights of Third Parties) Act 1999 provides that a person who is not a party to the contract may enforce a term of the contract if the contract expressly provides that they may, or the contract term purports to confer a benefit on them.

Third party rights are now provided for as an optional element within industry standard building contracts.

New JCT 2016 Edition of contracts



Later this year it is expected that JCT will be publishing new 2016 Edition contracts.

The JCT have provided some further details on what these contracts may contain including:

1. Incorporating and updating provisions relating to transparency and BIM;

2. Provisions relating to the CDM Regulations 2015 will be fully incorporated;

3. Provisions for use by public bodies, contractors and sub-contractors on public sector projects will be allowed for;

4. Changes in respect of payment, designed to reflect Fair Payment principles and to simplify and consolidate the payment provisions; and

5. The optional provisions for the obtaining of Collateral Warranties from sub-contractors will be extended to include, as an alternative, the granting of Third Party Rights by sub-contractors.

The new edition of the JCT Minor Works suite of documentation is expected first in the Summer. More details are expected to follow in due course and we will of course keep you updated.

David Myers

Effectively, provided the identity of the beneficiary is made known to the Main Contractor, this beneficiary then has the right to rely and enforce the terms of the building contract. Importantly this is without the need for both parties to go through the onerous task of preparing, executing and completing a separate document.

Currently, the JCT suite of building contracts do not provide for the provision of third party rights by a sub-contractor/consultant. However, this is anticipated to be provided in the new 2016 JCT Contracts that are expected later this year. This will accordingly allow for a simple notice process to be followed which should have the same effect as the provision of collateral warranties and in turn will dramatically reduce the administrative burden on all parties.

That is the theory. However, in practice the use of third party rights has in fact been quite limited. Indeed, it is rare that we would come across a building contract or consultant appointment that has not specifically excluded the Contracts (Rights of Third Parties) Act.

It is difficult to pinpoint precisely why there is such reticence to use third party rights. Some sources claim that it is driven by the insurance industry where it is felt that third party rights may give rise to additional liabilities. Other people point to Funders being reluctant to accept anything but collateral warranties. We feel that there is possibly some truth in both suggestions. The fact is that sub-contractors especially look to include specific caps on liability in their collateral warranties that would not perhaps be provided for in third party rights. Equally, the lack of significant case law relating to the operation of third party rights as well as the preference to a more traditional method that has been tried and tested in the court and doubts raised regarding the ability for a beneficiary to step-in to contracts under third party rights (as one can under a collateral warranty) understandably guides Funders in what is a very risk adverse climate.

So, third party rights do appear to offer similar rights as one would expect under a collateral warranty but without the often onerous paper chase. However, it is still met with skepticism and suspicion to the extent that even if an Employer and Main Contractor are happy to use third party rights they may be prohibited from doing so by the approach of the Funder and Sub-contractors.

Latent Defects Insurance – the future?

Latent Defects Insurance provides the owners of new commercial or industrial properties with protection against damage caused by a defect in the design, workmanship or materials which was undiscovered at completion.

Importantly, the policyholder does not have to prove the negligence of a third party to make a claim. When an inherent defect is discovered, the insured can simply file a claim and in turn avoid contentious discussions with the Main Contractor and/or sub-contractors/consultants in clarifying liability and responsibility for the loss. Repairs and restoration work can therefore be funded without delay (accordingly reducing the adverse impact on the business that a prolonged claim under a collateral warranty could bring).

The policy indemnifies the insured for the cost up to the total sum insured (typically the full reinstatement value) of the repairs to the damage caused or for repairs to prevent imminent damage by the defect and is typically available for between 8 and 12 years from the date of the final certificate or practical completion.

As collateral warranties are backed by professional indemnity insurance, following the insolvency of a Main Contractor or sub-contractor, in general, the policy would lapse and there would be no cover for any potential claim, which would mean that there would be no means of recovering any losses incurred as a result of a defect. A latent defects policy would not be affected by the insolvency of a Main Contractor or sub-contractor and accordingly provides a guaranteed period of protection.

Policies are generally freely assignable to any future owners, funders and tenants.

There should be none of the drafting issues one finds in collateral warranties surrounding limitations on liability and circumstances where there are members of the team who simply haven't provided warranties will no longer be a problem.

This is common practice internationally, especially in countries such as France. Indeed, it is used as standard in the UK for residential projects through the likes of NHBC cover. However, this type of insurance in non-residential projects remains relatively rare and one must consider why this is the case?

As with any insurance policy there are exclusions which will vary according to each insurance provider. In general one would expect to see the following which would not be covered in the policy:

a. Defects in non-structural works and equipment – although it may be possible to extend the policy to include mechanical and electrical fittings;

b. Defects due to structural alterations after completion;

c. Earthquake, storm, flood, fire, war, etc.;

d. Defects known prior to the commencement of the policy;

e. Defects due to lack of maintenance or misuse;

f. Economic loss or Consequential losses (furniture, process equipment, stocks, etc.) – However, cover for loss of rent can be included in a policy and some policies may allow additional consequential losses to be covered; and

g. Subsidence heave or landslip unless due to an inherent defect

There are circumstances where a collateral warranty will provide greater advantages to a beneficiary. For example, unless a specific cap or net contribution clause is agreed, there will be no limitations on liability in the warranty whereas an insurance policy will be limited to the maximum sum insured. Yes, this sum will generally be the reinstatement value, but there may be additional costs that arise directly from the breach that exceed this reinstatement cap. Equally, as noted above, the policy will specifically exclude certain losses, whereas warranties generally cover all losses attributable to defective workmanship and/or negligent design.

As one would expect, an insurance policy would also represent a significant upfront cost which would generally exceed any cost implications imposed on an Employer by the Main Contractor for the provision of collateral warranties.

However, there are clear benefits to a policy of insurance, especially with the removal of the administrative burden and timing issues surrounding the supply of collateral warranties as well as the security offered by a policy of insurance that will remain in place irrespective of which parties enter into insolvency. One would also anticipate a flexible approach by most insurers to the extent that they may be willing to negotiate over certain exclusions (at a price).

Despite these benefits latent defects insurance remains a rare occurrence in non-residential construction projects. A significant shift in attitudes by all parties within the construction industry would be required to change this. Perhaps more openness from insurance companies is needed in order to see real cases where claims have been brought and the speed and amount ultimately paid out. This may cause some difficulties regarding confidentiality but we do feel that this is needed in order for a potential customer to get over what can be a long list of exclusions. Equally, funders would need to be persuaded that such a policy will provide sufficient cover equal to that of collateral warranties and this may need to involve discussions at a high level between insurers and banks in order to change the standard instructions provided to solicitors.

Conclusion

Collateral Warranties are not perfect. They can involve turgid negotiations over their terms and can take some time to obtain. Equally, if the warranty provider was to enter into insolvency then the benefit of such a warranty becomes negligible.

Third party rights should remove a significant amount of the administrative burden associated with obtaining collateral warranties. However, there remain concerns in the eyes of insurers and funders to the extent that an Employer is currently unlikely to solely request third party rights. Rather, they may be allowed for as an optional extra in addition to the provision of collateral warranties.

Latent defects insurance does offer benefits above and beyond that of a collateral warranty, particularly in relation to not needing to prove negligence for any claim and the ability to bring a claim irrespective of whether any party of the construction team has entered into insolvency. However, a policy will also come with a list of exclusions and requirements and a significant initial cost attached to it which currently appears to put off large parts of the construction industry.

So, is there an end in sight to collateral warranties? In short, no. A significant change in attitudes is required in order to achieve this and at present we don't see an appetite for this. All parties need to play a part in this change, from the solicitor to the Employer, Insurer, Funder and Contractor. Whether we are all ready and/or willing to do this remains open to debate.

David Myers

The health and safety revolution

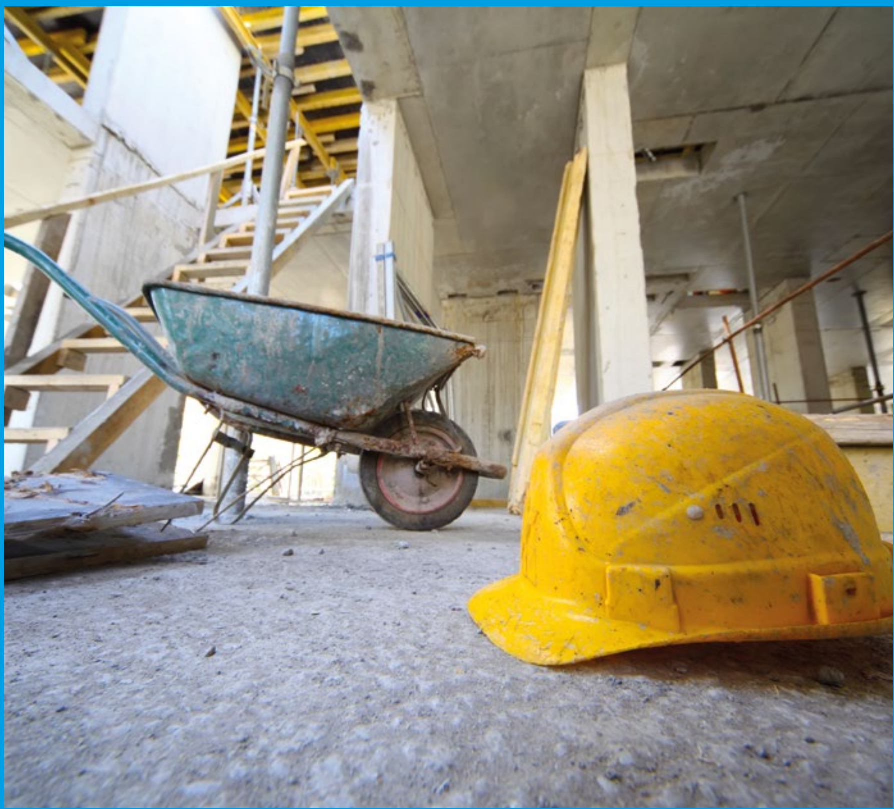
1 February 2016 marked the day when new guidelines were implemented resulting in the financial penalties for Health and Safety offences rising to an unprecedented level. The guidelines apply to all organisations as well as individuals responsible for Health and Safety.

In 2014/2015 there were 65,000 self reported non fatal workplace injuries and 35 workers fatally injured in the construction sector. Given these statistics it is imperative that all businesses take note of the new guidelines.

In appropriate cases the Court can, and will, now impose a financial penalty even where it is acknowledged that it could lead to the financial collapse of the organisation. Fines are now to be calculated proportionately based on an organisation's turnover. As an example, if a serious injury occurs at a "medium" sized organisation (categorised as having a turnover of between £10 million and £50 million) the Court will, depending upon the circumstances of the case, now consider a fine of between £220,000 and £1.2 million.

This change forms part of the Government's drive to ensure that it is not cheaper for an organisation to ignore its Health and Safety responsibilities and just pay a fine if it is prosecuted, than it is to properly comply with its duties. The impact has already been felt: cases which would previously have resulted in a fine of less than £20,000 have seen fines of more than £250,000 imposed.

Jennifer Sewell



Case studies

The University of Hull student accommodation

Work is now well under way in the construction of a 560 bed student accommodation block for the University of Hull. The new building is part of a wider investment, including the major redevelopment of the Brynmor Jones Library and the refurbishment of Middleton Hall.

Sewell Construction has been appointed as principal contractor on the project. The development will boast contemporary architecture along with the latest technology and infrastructure. Features also include en-suite facilities to all rooms and social/learning areas. The new accommodation will primarily consist of eight-bed flats, with a small number of deluxe four-bed flats and one-bed apartments also available. Wheelchair accessible flats will be included on the ground floor, whilst the deluxe flats will occupy a key location at the centre of the site.

Rollits LLP were able to assist the University in the preparation of the building contract as well as associated consultant appointments.

Colten Care Limited new care home at Chichester

Colten Care Limited, a high quality nursing and residential home provider, has just completed the construction of a 72 bedroom care home in Chichester, which represents the company's largest home to date. The site was part of the former Roussillon Barracks and was subsequently acquired by the Homes and Communities Agency. The care home forms part of a wider redevelopment of the Barracks undertaken by Zero C Holdings Limited.

Rollits LLP assisted Colten Care in all legal aspects of the development, including the preparation of planning and infrastructure agreements, construction documentation and sale contracts.

Apprenticeships – a new era

In the 2015 Conservative manifesto the Government promised to deliver 3 million apprenticeships over the next 5 years. As part of that process, from April 2017 will see the introduction of the Apprenticeship Levy. With the concern of a skills gap within the construction sector this would seem to be an opportune moment for all businesses within the sector to review their training needs and in particular, their requirements for apprenticeships.

The Apprenticeship Levy will be 0.5% of the pay bill and will be collected through the PAYE system from April 2017. There will be an allowance of £15,000 to offset any against levy liability and therefore in practice, the levy will only apply to employers with a pay bill of more than £3 million per year.

For all those employers paying the levy, they will be required to set up Digital Apprenticeship Account into which all their levy contributions will be paid and from which they will pay for their apprenticeship training. The onus will be on the employer to engage apprentices in order to utilise their levy fund and if there are any unused funds within the digital account after 18 months, these funds will expire.

For those employers who do not have a pay bill of more than £3 million per year and are therefore "non levy paying employers" the cost of employing apprentices will be co-funded between the employer and the Skills Funding Agency ("the SFA"). At the present time, the SFA have not provided any funding rates although they are hoping to release indicative funding rates in June to enable consultation to take place before they are finalised in the autumn. The concern for the SFA is at what level they set the rates. If they set them too high, the risk is that employers will not take on apprentices with the result that not only will the Government not meet their 3 million target but also businesses could suffer in the long term with a lack of young and enthusiastic workers in the sector. The Government has confirmed that for SME's, unlike the levy paying employers, they will not be required to sign up to the Digital Apprenticeship Service account until at least 2018. This will enable employers more time to prepare for the new system.

So what does this mean for employers now?

Given the introduction of the levy in April 2017 Colleges and other external training providers are being encouraged to prepare for this change by speaking with local employers in their areas to discuss their training needs and, in particular, any plans for the recruitment of apprentices. Similarly, this is an ideal opportunity for employers who traditionally have taken on apprentices or those who are considering apprentices for the first time to be proactive and to get in touch with their local College or training provider and discuss their requirements to enable the Colleges to prepare and plan their future provision.

Inevitably, whether the Government will meet their 3 million target will, to a large extent, be dependant upon how successful the new scheme is. Let's hope it is a success and the sector will see a new wave of apprentices who can develop their skills and contribute to the construction sector.

Caroline Hardcastle

Information

If you have any queries on any issues raised in this newsletter, or any construction matters in general please contact David Myers on (01482) 337257 or email david.myers@rollits.com

This newsletter is for the use of clients and will be supplied to others on request. It is for general guidance only. It provides useful information in a concise form. Action should not be taken without obtaining specific advice.

We hope you have found this newsletter useful. If, however, you do not wish to receive further mailings from us, please write to Pat Coyle, Rollits, Citadel House, 58 High Street, Hull HU1 1QE.

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Hull Office
Citadel House, 58 High Street,
Hull HU1 1QE
Tel +44 (0)1482 323239

York Office
Rowntree Wharf, Navigation Road,
York YO1 9WE
Tel +44 (0)1904 625790

rollits.com

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