



## Collateral warranties – what are they, what to look out for and what to avoid

### What are collateral warranties?

Despite the availability of other options which provide similar security without the hassle of obtaining signed documents, the popularity of collateral warranties continues to endure. But what are collateral warranties, what should parties look out for, and what should parties avoid?

Collateral warranties are necessary because of the doctrine of privity of contract which is a fundamental feature of English law – the general rule is that a legal person that is not party to a contract cannot sue for breach of that contract.

For example, a typical relationship in a construction project is as follows:

- There is a main contract between the Employer and the Contractor; and
- There is a sub-contract between the Main Contractor and the Sub-Contractor.

In that instance, suppose the Sub-Contractor breached his sub-contract, which caused loss to the Employer. The general rule is that the Employer cannot sue the Sub-Contractor for the breach of the sub-contract, because the sub-contract is not between the Employer and the Sub-Contractor – the Employer is not a party to the sub-contract.

Instead, the Employer would have to sue the Contractor for a breach of the main contract. The Contractor would then in turn sue the Sub-Contractor for breach of the sub-contract, or join the Sub-Contractor into the proceedings brought by the Employer.

Now consider what happens in the above example if the Contractor becomes insolvent and is wound up. In that instance, the Employer has no remedy for the breach of the sub-contract, despite it suffering a loss from the associated breach of the main contract. In that instance, if the Employer is the beneficiary of a collateral warranty from the Sub-Contractor, then the Employer can rely on that warranty to obtain a remedy for the breach of the sub-contract.

Collateral warranties are also often given to other interested parties such as purchasers, funders and tenants of the work, and they rely on them in a similar way.

## What to look out for and what to avoid

The points that most frequently come up when considering collateral warranties are:

- The collateral warranty should not give the beneficiary any greater rights than the original party to the contract already has (using the example above, the Employer should not have greater rights than the Contractor has under the sub-contract).
- Set-off clauses – the set off clauses in particular must be checked, as collateral warranties often provide for set-off rights that are not included under the contract.
- Collateral warranties extend the number of parties that can potentially sue a party under a contract. A party signing up to a collateral warranty should always seek that the collateral warranty or the benefit of it can not be assigned on more than two occasions, which will limit this risk.
- Step in rights, which allow the Employer to “step in” to the shoes of the Contractor, usually in the case of insolvency, are often included in collateral warranties. These provisions must be checked to see how they would work in practice. For example, we have seen provisions in collateral warranties which mean that if the Contractor gets kicked off the job for any reason and thus brings the sub-contract to an end, the Sub-Contractor has to keep working until the Employer takes it on directly – which the Employer is not obliged to do. This can mean that no-one is liable to pay the Sub-Contractor for the extra work that it carries out.
- There are often provisions that affect a party's right to terminate its contract and / or suspend its work. For example, a collateral warranty may require that notice is additionally given to the Employer and set out long time-frames for the giving of such notice.
- Limitations of liability – parties signing up to collateral warranties should try and include as many limitations of liability as they can.
- Back to back collateral warranties – the form of collateral warranties under a sub-contract will often be dictated by the main contract because it requires the sub-contractor collateral warranties in a specific form. However, if it contains undesirable terms it is always worth the sub-contractor's while to try and negotiate them out – if you don't ask, you don't get!

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