

As an Engineer, you may sometimes be asked to enter into Collateral Warranty agreements. A Collateral Warranty is an agreement between a third party beneficiary of a project who isn't part of the primary project, for example a financier, purchaser or a tenant and the consultant or a contractor. It will create a legal relationship that would not otherwise have existed. It creates a contractual link, where there is no commercial agreement; between the third party and the consultant or contractor that acknowledges a duty of care that the consultant or contractor has to the third party upon the completion of the project. Entering into a Collateral Warranty can have implications in respect of your Professional Indemnity insurance because you may be opening yourself up to a wider remit of liability than you would otherwise have had.

Here, RPC LLP whom are the Howden Engineering Scheme's appointed law firm, provide guidance on entering into a Collateral Warranty.

Guidance on entering into Collateral Warranties

You are not legally obliged to enter into a Collateral Warranty but your client may put you under commercial pressure to do so. If the terms of your Appointment stipulate that you are to enter into a warranty, these should therefore be very carefully checked at the outset and you should bear in mind that:

- Agreeing to a Collateral Warranty will increase your potential liability by increasing the range of potential claimants who may bring a claim against you.
- If you enter into a Collateral Warranty you should notify your Insurance Broker who will, in turn notify your insurer.
- Agreeing to a Collateral Warranty may require you to extend your Professional Indemnity (PI) cover. Cover will be impacted in the year in which you agree to the Collateral Warranty and for as long as you are bound by the terms of the warranty; generally 12 years as it's usually executed as a deed.
- Extending your PI cover may have an upward impact on your Professional Indemnity premium.
- If you enter into a Collateral Warranty you should buy Professional Indemnity cover up to the value of the Collateral Warranty
- If you are planning to retire or cease trading run off cover must be purchased to comply with the terms of the Collateral Warranty entered into.

Policy restrictions

The standard terms and conditions of Professional Indemnity policies generally contain limitations on the extent to which claims arising from collateral warranties will be covered. Whilst the scope of these limitations will vary, policies will often stipulate that you are not covered in respect of claims arising out of collateral warranties that:

1. warrant fitness for purpose;
2. provide greater and longer lasting benefit than given to the party with whom you originally contracted under the Appointment;
3. provide for any express guarantee of performance or contractual penalty for liquidated damages;
4. provide benefit under assignment to more than two parties.

Set out below is some guidance on the interpretation of these limitations. In every case however, you should carefully check the terms of your insurance cover, as well as the terms of your appointment and the warranty.

Policy Restriction 1 - *“Fitness for purpose”/absolute obligations*

If your policy contains this limitation, it is important that you do not assume an obligation under a warranty that your design will, come what may, be fit for its purpose. In other words, that your design will definitely work or satisfy a certain standard/specification.

A professional designer should only ever warrant that it has exercised reasonable skill and care in the performance of its design services, not any more onerous an obligation. If a designer fails to exercise that standard of skill and care and is consequently sued for negligence, then the claim is more likely to be covered (subject to the terms and conditions of the insurance policy).

If, however, a designer warrants that its design will be fit for its purpose and, for any reason, it is not, it will be in breach of contract. This is in spite of the fact that the designer may have exercised reasonable skill and care, the cause of the design not working being beyond its control. In this set of circumstances, insurers may refuse to cover the claim because the designer has not been negligent. The only reason it is in breach of contract is because it voluntarily assumed a higher duty of care than that which is usually expected of a designer.

You should therefore check every clause in a warranty carefully to ensure that it does not contain an absolute obligation. It is also best practice to insert the following clause into every warranty into which you enter:

“Notwithstanding any other provision in this Warranty or the Appointment, in performing its services in relation to the works the Consultant shall have no greater duty than to exercise reasonable skill and care.”

Policy Restriction 2 - *Not to provide greater and longer lasting benefit than given to the party with whom you originally contracted under the Appointment*

This policy restriction effectively requires your obligations and liabilities under a Collateral Warranty to be back-to-back with those obligations/liabilities under your Appointment. This is a common requirement in professional indemnity policies.

It is therefore important, if your policy includes this limitation, that you carefully cross-refer the terms of your Appointment with the warranty. If any clauses in the warranty provide additional benefits to the beneficiary over and above those given to your client under the Appointment, those clauses should be deleted. For example, if there is a clause in the warranty requiring you not to specify deleterious materials, you should ensure that there is a corresponding provision in your Appointment. To take another example, if the limitation period in your Appointment is 6 years, but it is proposed to execute the warranty as a Deed (which would make the warranty limitation period 12 years), that would confer a longer lasting benefit on the beneficiary and again breach this policy restriction. The limitation period for the warranty would also have to be 6 years (or less).

To assist compliance with this policy restriction, the following clause should be inserted into each warranty:

“Notwithstanding any other provision of the Appointment or this Warranty, the Consultant’s obligations and liabilities to the Beneficiary hereunder shall be no greater and of no longer duration than the obligations and liabilities which he would owe to the Beneficiary had the Beneficiary been named as joint Employer under the Appointment.”

Policy Restriction 3 - *Not to provide any express guarantee of performance or contractual penalty for liquidated damages*

It is unusual for a liquidated damages clause or an express guarantee of performance to be included in a consultant’s contract (whether it be an Appointment or a warranty). Needless to say, if such clauses are included, they must be deleted.

Guidance note on Collateral Warranties for Engineering firms

This guidance note governs the insurance-related consequences of entering into a collateral warranty



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Policy Restriction 4 - Assignment

It is commonplace for warranties to be capable of assignment to other parties. However, Professional Indemnity policies usually require that the number of assignments is limited to a maximum number of two.

Often assignment clauses also say that assignments between group/associated companies are not to be counted as an assignment. Please note Professional Indemnity policies usually make no distinction between associated/group companies and other third parties. Accordingly, you should amend any such clause to make it clear that only two assignments are permitted in total, regardless of the identity of the assignee.

An acceptable assignment clause would be as follows:

"This Agreement may be assigned twice by the Beneficiary by way of absolute legal assignment to another person taking an assignment of the Beneficiary's interest in the Premises without the consent of the Client or the Consultant being required and such assignment shall be effective upon written notice thereof being given to the Consultant. No further assignment shall be permitted."

RPC LLP

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RPC LLP is a leading specialist in professional indemnity claims, with a proven track record in defending claims against Engineers and other professionals in the property and construction industries. Recognised as one of the UK's leading insurance law firms ("One hell of an insurance player. It does the work in spades." Chambers UK 2010), the legal directories describe RPC as a professional negligence powerhouse ("Reynolds Porter Chamberlain combines a business - savvy awareness with high-quality technical ability." Chambers UK 2009).

Their partners and lawyers have gained experience in private practice, in-house at surveying practices and within the claims departments of insurers, which gives them a real breadth of experience not available to many others when considering claims. For further information please contact Tom Green on 020 3060 6536.

Howden Insurance Brokers have operated in the Engineering Sector for over 15 years and look after the Professional Indemnity insurance requirements of over 400 engineering firms. If you wish to discuss your insurance requirements please contact Joanne Robinson or Taurai Ushe on 020 7645 9323 / 020 7645 9312 or by email jrobinson@howdengroup.com or tushe@howdengroup.com.

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