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ABBEY HEALTHCARE – A PROMPT FOR CONSIDERING CONTRACTUAL ADJUDICATION IN COLLATERAL WARRANTIES?

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SUMMARY

An article considering the Supreme Court's decision in *Abbey Healthcare,* which decided that a typically worded collateral warranty is not a construction contract for the purposes of the Housing Grants, Construction and Regeneration Act 1996.

INTRODUCTION

The Supreme Court's decision in *Abbey Healthcare (Mill Hill) Ltd (Respondent) v Augusta 2008 LLP (formerly Simply Construct (UK) LLP) (Appellant)* [2024] UKSC 23 ("***Abbey Healthcare***") has rightly been lauded as a triumph for common sense, having overturned a previous line of authority that suggested collateral warranties could be construction contracts for the purposes of section 104 of the Housing Grants, Construction and Regeneration Act 1996 (the "**Act**"). In each case, whether or not there was a construction contract mattered in the context of the statutory right to refer disputes to adjudication.

The case has been well summarised in another BCLP Insight, but in short, the Supreme Court concluded that the collateral warranty in question was not a construction contract for the purposes of the Act and that there are "*good reasons for concluding that, in general, such warranties were not intended to fall within the scope of the 1996 Act*" and "*most collateral warranties will not be construction contracts*".

Abbey Healthcare further confirmed that the test for whether a collateral warranty will be a construction contract is as follows:

> *"(1) A collateral warranty will be an agreement "for … the carrying out of construction operations" if it is an agreement by which the contractor undertakes a contractual*

obligation to the beneficiary to carry out construction operations which is separate and distinct from the contractor's obligation to do so under the building contract.

(2) A collateral warranty where the contractor is merely warranting its performance of obligations owed to the employer under the building contract, will not be an agreement "for" the carrying out of construction operations."

The Supreme Court also noted that while the statutory adjudication regime under the Act is unlikely to extend to collateral warranties (beyond those satisfying the test above), where parties wish to refer disputes arising under a collateral warranty to adjudication, they could do so by adding a contractual adjudication clause into it.

This begs the question as to whether the market will consider doing so and what the pros and cons of such an approach might be. This article explores just that.

NATURE OF COLLATERAL WARRANTIES

First, let us recap the purpose of collateral warranties and the types of dispute that frequently arise under them. Generally speaking, collateral warranties are used to create a contractual nexus between a third party beneficiary (such as a funder, purchaser or tenant) with an interest in a project (the **"Beneficiary"**) and a contractor and/or consultant that designed and/or built a project (the "**Warrantor**").

Under a typically worded collateral warranty, the warrantor warrants to the beneficiary that it has complied, and/or will comply, with the primary contract. Therefore, collateral warranties are utilised to protect a beneficiary's interest in a project by ensuring that it can bring a claim for breach of contract against the warrantor if it breaches the terms of the collateral warranty. For example, if it fails to meet its obligations under the primary contract, such as the building contract or professional appointment, or to maintain a certain level of professional indemnity insurance. The ability to make such a claim is in addition to any claim a beneficiary may have against the party that has entered into the primary contract with the warrantor (developer), for example, the seller or landlord, under a separate agreement with them. However, a claim under the collateral warranty can be crucial where the developer has no assets or is no longer in existence.

We typically see disputes arise under collateral warranties after the project has completed and they almost always concern latent defects where a Warrantor has not carried out the design or construction in accordance with the requirements of the building contract and, in turn, the collateral warranty.

NATURE OF ADJUDICATION

It is generally accepted, and indeed referenced by the Supreme Court in *Abbey Healthcare*, that statutory adjudication is primarily used to preserve cashflow during the course of a project,

providing swift (on a temporarily binding basis) resolution of disputes until the project has completed.

This is an important requirement in the construction industry, where projects and companies are run on slim margins and cash is needed to keep projects progressing. Indeed, this was the reason that, following the *Latham Report*, a statutory adjudication regime was introduced through the Act.

However, the disputes that can be referred to adjudication (in England and Wales at least) extend far beyond the confines of payment and cashflow. Instead, adjudication has become the mainstream form of dispute resolution for most kinds of dispute arising from a construction contract – including liability for defects.

Interestingly, beyond the statutory regime, multiple contract forms have developed their own models of contractual adjudication (including NEC and FIDIC), which the parties can operate even if the contract or dispute is not caught within the scope of the Act. It will be interesting to see if parties address the findings of the *Abbey Healthcare* decision by adding adjudication drafting to their collateral warranties. We consider the pros and cons of doing so below.

Pros

- Adjudication, by comparison to lengthier alternative dispute resolution ("**ADR**") processes (such as arbitration) or court litigation, offers parties a swift, cost-effective form of resolving disputes. Studies have repeatedly confirmed the benefits of this with adjudication now being the mainstream form of dispute resolution for the construction industry. Why shouldn't that extend to the determination of liability in respect of latent defects under a collateral warranty when the same process can be utilised under the construction contract?

- Contractual adjudication offers parties inherent flexibility to determine the powers of the adjudicator, procedure, timetable and the effect of the decision (i.e. if it is temporarily or finally binding). If the parties elect for the decision to be temporarily binding, the risk of a flawed decision from an adjudicator is mitigated by the ability to refer the dispute for final determination by the Court or in arbitration.

- It can also add a layer of certainty; parties are free to choose the individual(s) who determine the dispute, allowing them to select adjudicators with specific qualifications and professional backgrounds that might be necessitated by the nature of the underlying project or dispute.

- As with other ADR processes, the adjudication process is (subject to the confidentiality provisions of the collateral warranty) likely to remain private. This can be key advantage for both parties.

- In practice, it is unlikely that the Warrantor will want to pursue claims for negative declarations (i.e. a declaration to the effect that it is not liable) under the collateral warranty (and probably

less still by adjudication), so including an adjudication clause could be helpful for Beneficiaries in this regard.

Cons

- However, while the parties to a collateral warranty are free to determine whether any contractual adjudication process is final, this is likely to be an area of tension. The lack of finality in statutory adjudication is justified by the mutual focus on maintaining cash flow, leaving matters to be reviewed and resolved (if necessary) at the end of the project. However, collateral warranty disputes are most likely to arise after the completion of the project, when cashflow is not (so much) a relevant consideration. This means a lack of finality is of little benefit.

- If parties consider that an adjudicator's decision should be final, another issue arises: adjudication processes (even lengthened beyond statutory requirements) are not likely to consider matters in detail, making them inappropriate for complex defects claims more appropriately addressed in full scale arbitration or through proceedings at the Technology and Construction Court. The parties may not make significant cost savings where the adjudication process needs to be adapted.

- On a related point, defect claims typically involve a period of (ideally joint) inspection and testing and process of expert meetings to evaluate the nature and extent of a defect and what scope (and methodology) of works are required to remedy that defect – and the reasonable costs of doing so. A good illustration of this point might be the number of building safety defect claims (especially those where remedial works are still to be done) being referred to adjudication. We suspect there are precious few and suggest that this is because parties are reluctant to submit important questions regarding building safety risks and regulatory compliance, and the appropriate scope of long-term remedial solutions for building safety defects, to an adjudication process which has inherent uncertainties and produces a temporarily binding decision.

- Adjudication limits the parties' ability to join other parties to the dispute. This is pertinent (again with defect claims specifically in mind) where either party wishes to join a sub-consultant or sub-contractor to the process to advance claims for contribution. Contractual drafting can provide for this ability, but the position can become complex where related contracts (i.e. the sub-contract) are subject to differing disputes mechanisms.

- Finally, where parties pursue adjudication, they will not be able to recover legal costs unless that is explicitly provided for in the drafting of the contractual adjudication clause.

COMMENT

It remains to be seen how the market might adapt following the decision in *Abbey Healthcare*. Catering for contractual adjudication in collateral warranties may be tempting given the popularity of adjudication proceedings and the increased need to avoid excessive costs. The majority of perceived pitfalls of doing so can be resolved by express contractual drafting that the parties can adapt to their needs. The fact that collateral warranties do not fall within the Act allows for more flexibility in terms of what can be agreed. That said, parties can elect to pursue more standard adjudication processes to avoid the uncertainty of bespoke provisions, as well as the possibility of heavy negotiation over them.

Instead, parties might take this *Abbey Healthcare* juncture to consider whether court litigation is the best option, or whether they are content to consider other ADR processes to settle disputes under collateral warranties. One might look to the extent to which parties have thus far adopted adjudication for the resolution of disputes regarding latent defect claims as a bellwether for the market's appetite to build adjudication provisions into collateral warranties of the future. We predict adjudication of those disputes (as opposed, say, to use of the Pre-Action Protocol in advance of any court proceedings) will be comfortably in the minority. It is telling that prior to the *Abbey Healthcare* litigation there had been no clamour in the market to include express adjudication provisions in collateral warranties and we suspect this position will not change following it. However, perhaps this is not a good enough reason not to consider an alternative approach.

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