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Another court judgment on collateral warranties? Not another one!

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By Michael Craik

Orchard Plaza Management Co Ltd v. Balfour Beatty Regional Construction Ltd (16 June 2022)

Court judgments on collateral warranties are like London buses; there are none and then two appear at the same time.

I have recently mused on the Court of Appeal's decision in ***Abbey v. Simply***, which is a decision on whether or not a collateral warranty could be a 'construction contract' within the meaning of section 104 of the Construction Act 1996. In that case, and on the wording of the warranty, the judges (by two to one) said it could, which meant Abbey could get its hands on the £900k odd that an adjudicator had awarded it.

Now I muse on the TCC's judgment in ***Orchard Plaza v. Balfour Beatty***, which concerned a collateral warranty claim by the tenants of flats affected by defective cladding, i.e. the issue (or scandal) that came to light as a result of the Grenfell Tower tragedy. In short, the judge said the tenants could pursue a claim against the building contractor for the cost of carrying out repairs rather than a loss based on a diminution in value. Their claim was not (to use legal jargon) 'remote' or 'unforeseeable', despite the fact that they were assignees of a collateral warranty originally given to the funder of the flats.

Executive summary

While the decision, like so many, is based on its own facts, the key points are:

1) The assignee of a collateral warranty can claim from the building contractor the cost of repairing defects in the works as opposed to a loss based on the diminution in value of the property;

2) As a general principle, an assignee cannot recover a loss of a kind which the assignor could not have suffered (had there been no assignment). However, the court will seek to avoid an assignee's claim falling into a legal 'black hole' if at the time of the assignment the assignor had, suffered no loss;

3) The issue of remoteness or reasonable foreseeability still applies to a claim for damages for breach of contract, even if it is brought by an assignee;

4) All of the above are subject to the express terms of the collateral warranty which, in this case, expressly allowed the assignee to recover its loss even where it was different to the loss the assignor would have been suffered;

5) Flat owners in other developments affected by defective cladding might now want to ask their own funders to assign over the benefit of a warranty, to allow them to sue the building contractor. However, they need to read what the warranty says before they do so; and

6) One assumes some professional indemnity insurers will seek to 'tweak' the wording of collateral warranties to limit the type of loss an assignee of a warranty can recover, i.e. once again, always check what your contract says and if in doubt, get advice.

The background facts

Briefly:

- During 2007 and 2008, Balfour Beatty carried out the conversion of a 1970s office block to create 115 residential apartments and two commercial units for the freeholder, Coltham. The JCT D&B building contract was executed on 1 December 2007.
- On 22 October 2007, Balfour Beatty executed a collateral warranty in favour of the funder, AIB Group. This warranty included a right of assignment.
- On 23 May 2014, Orchard Plaza (the management company) was granted a 126-year lease of the entire development.
- Separately, each leaseholder of the 115 apartments received a long lease and was a member of the management company. In addition, they received a Premier Guarantee, i.e. a form of new build insurance which is very common these days.
- In 2015 Orchard Plaza became aware of possible defects: first, the rainscreen cladding was not safe in the event of a fire due to the materials used and the method of construction; second, other non-fire-related defects in the cladding; and third, concerns regarding fire safety of the interior of the property due its design and construction.
- On 28 June 2017 the funder, AIB, assigned its rights under the warranty to Coltham which, in turn, on 10 July 2017, assigned its rights to Orchard Plaza. Notice of the assignment was given to Balfour Beatty on 22 October 2017.
- In 2020 the local authority issued an improvement notice requiring Orchard Plaza to carry out remedial works, including the replacement of the rainscreen cladding. In response, Orchard Plaza engaged contractors and started proceedings against Balfour Beatty for the cost of the remedial works.
- As part of its defence, Balfour Beatty argued that the losses claimed by Orchard Plaza were not the natural consequence of breaches of a collateral warranty relied upon by Orchard Plaza and, therefore, were too remote, i.e. could not be recovered as a matter of contract law.

The AIB collateral warranty assigned to Orchard Plaza

In the collateral warranty, Balfour Beatty warranted to AIB that:

- it had and would continue to exercise all the reasonable skill, care and diligence etc in carrying out the works, including the design, selection of materials etc; and
- it had and would continue to perform its obligations under the building contract.

AIB could assign the benefits and rights under the collateral warranty without Balfour Beatty's consent.

In addition, Balfour Beaty expressly agreed that it would not argue that any loss claimed by an assignee could not be recovered simply because

- it was an assignee and not the original beneficiary (i.e. AIB) of the warranty; and/or
- the loss was different to the loss that would have been suffered by the beneficiary (i.e. AIB).

The wording of the collateral warranty given to AIB is identical or very similar to the wording of warranties used in commercial property developments. This is why the case is of interest.

Balfour Beatty's defence – the loss is all too remote and not recoverable

In summary, Balfour Beatty argued that because Orchard Plaza was the assignee of AIB's collateral warranty, its claim for the cost of carrying out the repair works was not a likely or foreseeable consequence of Balfour Beatty's breach of the building contract and, in turn, the warranty. It also argued that at the time it granted the warranty in favour of AIB, the losses claimed by Orchard Plaza were not a natural, likely and/or foreseeable consequence of the breach of the collateral warranty. Again, the cost of repair was too remote.

It would appear that Balfour Beatty's (or its insurers') real aim was to limit its liability to the diminution in value of the property as opposed to the cost of the repairs. Balfour Beatty said that it was this diminution in value that was in its and AIB's contemplation when executing the collateral warranty back in October 2007. In addition, the wording of the warranty did not prevent it from arguing that an assignee (Orchard Plaza) could recover no more than the assignor (AIB), i.e. the diminution in value being lower (one assumes) than the cost of the repairs.

Orchard Plaza's strike out

Orchard Plaza asked the court to strike out Balfour Beatty's defence that its claim for the cost of the repairs was too remote.

What the judge decided

After reviewing existing authorities on the measure of damages for lenders such as AIB and assignments, the judge decided:

Type of loss suffered by Orchard Plaza

- Balfour Beatty knew that AIB's warranty could be assigned to a third party because the collateral warranty expressly allowed AIB to assign it. The potential assignee was not confined to another funder and, therefore, the loss suffered by the assignee (Orchard Plaza) could be different to the loss suffered by the assignee (AIB).

- The possibility that the assignee (Orchard Plaza)'s loss could be the cost of repair (as opposed to the diminution in value) was, on the facts, within Balfour Beatty's reasonable contemplation. It was equally reasonably foreseeable that AIB would release the security on repayment of the loan and assign the collateral warranty to the borrower (Cotham) who, in turn, might assign it to another party with an interest in the property (i.e. the second assignment to Orchard Plaza).

Remoteness of AIB's loss

- As to the issue of remoteness, the loss being claimed (the cost of repairing defects in the works) was within the reasonable contemplation as being a "serious possibility" arising from a breach by Balfour Beatty of the collateral warranty. This was despite the fact that a loss by way of a diminution in value might be a more likely loss suffered by a funder such as AIB.

Clause 12.3 of the Collateral Warranty

- Clause 12.3 of the warranty provided (as many warranties do) as follows:

  The Contractor agrees with the Beneficiary not to contend or argue that any person to whom the benefit of this Deed is assigned shall be precluded or prevented from recovering under this Deed any loss or damage resulting from any breach of this Deed by the Contractor by reason of the fact that such person is an assignee only or otherwise is not the original beneficiary or because the loss or damage suffered has been suffered by such person only and not by the original beneficiary, or because such loss is different to that which would have been suffered by the original beneficiary. (emphasis added).
- This made it expressly clear that Orchard Plaza (as the assignee) could recover loss of a kind AIB (the assignor) could not or would not have suffered. Accordingly, whether or not the loss now claimed by Orchard Plaza (the cost of repair) was within Balfour Beatty's reasonable contemplation at the time of executing the warranty in favour of AIB was irrelevant.

In conclusion, the judge decided that Orchard Plaza's measure of loss (being the cost of repairing the works as opposed to the diminution in value) was not remote because such loss was, on the facts, within Balfour Beatty's reasonable contemplation when executing the collateral warranty in October 2007. The relevant parts of Balfour Beatty's defence were therefore struck out.

Conclusion

As an outsider looking in, Balfour Beatty's case looks to have been very weak, especially given the wording of clause 12.3 of the warranty, i.e. it said what it said, but not every collateral warranty is the same and this illustrates why one cannot apply the decision in Orchard Plaza to every 'defective cladding' claim. That all being said, the case does give strong support for the measure of loss being the cost of carrying out the necessary repairs rather than the loss in property value, i.e. the 'diminution in value'. In this regard, the former (cost of repair) is often considered to be greater but that may not always be the case because, as always, it depends on the particular facts.