

COMPARISON OF COLLATERAL WARRANTY AND INDEMNITY IN
CONSTRUCTION CONTRACT

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CONSTRUCTION CONTRACT

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To my beloved father,
mother
and siblings.
To the entire ummah.

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ABSTRACT

Construction contract is where people in a construction project are connected. Chain of numerous contractual relationship usually brings benefit to the parties to the main contract. The people who are at the extended position of the contractual chain usually face a hard time if any unfortunate events occurs in the construction project. These people are usually known as third parties. As a general rule, the third parties are not entitled to claim anything if unfortunate event occurs as they are not the parties to the main contract. This is where the concept of collateral warranty and contract of indemnity comes in. The terms collateral warranty and indemnity are used commonly to protect the right of the third parties. These two terms are used interchangeably in contracts. However, the confusion between the terms had resulted harm to third parties as it actually differs between one and another. The judgment of the lower court in the case of *MCST Plan No 1933 v Liang Huat Aluminium Ltd*[2001] 3 SLR 253 is a prove that confusion of indemnity and collateral warranty clause can result to the loss of the rights of the third parties. Therefore, this research is conducted in order to protect third party's rights. This research objective is to identify the difference of the terms of collateral warranty and indemnity. Result from the analysis, the terms of indemnity and collateral warranty indeed differs based on the interpretation of the elements that are used to establish them. Finally the result also shows that the terms of collateral warranty and indemnity do not only enables the third party to sue but also be sued.

ABSTRAK

Kontrak pembinaan adalah penghubung kepada orang-orang yang terlibat di dalam industri pembinaan. Rangkaian kontrak yang pelbagai selalunya memberi kelebihan kepada pihak-pihak kontrak utama. Mereka yang berada di akhir rangkaian kontrak sering kali menghadapi masa yang sukar jika berlaku kejadian yang tidak diingini terhadap projek pembinaan. Orang-orang ini dikenali sebagai pihak ketiga. Secara amnya, pihak ketiga tidak berhak membuat apa-apa tuntutan jika berlaku perkara yang tidak diingini terhadap projek pembinaan kerana pihak ketiga bukanlah pihak kepada kontrak utama. Di sinilah jaminan kolateral dan tanggung rugi memainkan peranan. Terma jaminan kolateral dan tanggung rugi digunakan untuk membela hak pihak ketiga. Kedua-dua terma ini digunakan secara silih berganti di dalam kontrak. Walau bagaimanapun kekeliruan terhadap penggunaan kedua-dua terma ini membahayakan hak pihak ketiga kerana sebenarnya kedua terma ini berbeza antara satu sama lain. Keputusan penghakiman mahkamah rendah di dalam kes *MCST Plan No 1933 melawan Liang Huat Aluminium Ltd*[2001] 3 SLR 253 membuktikan bahawa kekeliruan terhadap terma tanggung rugi dan jaminan kolateral boleh membawa kerugian kepada pihak ketiga. Oleh itu, kajian ini dijalankan untuk memelihara hak pihak ketiga. Objektif kajian ini adalah untuk mengenal pasti perbezaan antara terma jaminan kolateral dan tanggung rugi. Berdasarkan keputusan analisis, terma jaminan kolateral dan tanggung rugi berbeza dari segi terjemahannya hingga kepada unsur-unsur yang digunakan untuk mengenal pasti terma-terma tersebut. Keputusan akhir menunjukkan bahawa terma jaminan kolateral bukan sahaja membolehkan pihak ketiga menuntut hak mereka tetapi juga pihak yang terlibat boleh menuntut hak mereka daripada pihak ketiga.

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LIST OF ABBREVIATIONS

AC	Law Reports: Appeal Cases
All ER	All England Law Reports
AMR	All Malaysia Reports
AC	Appeal Cases
Build LR	Building Law Reports
CLJ	Current Law Journal (Malaysia)
EWCA Civ	Court of Appeal, Civil Division (England & Wales)
HL	House of Lords
Lloyd's Rep	Lloyd's List Reports
LR	Law Reports
MLJ	Malayan Law Journal
PC	Privy Council
QB	Queen Bench
SCR	Session Cases Report
SLR	Singapore Law Report
WLR	Weekly Law Report

LIST OF CASES

Bank Rakyat Kerjasama Malaysia Bhd v United Fesyen Sdn Bhd (Setron Malaysia Berhad-Third Party) [2009]7 AMR 756

Ching Yik Development Sdn Bhd v Setapak Heights Development Sdn Bhd [1996] 3 MLJ 675

D&F Estates Ltd v Church Commissioners for England and Wales [1989] AC 177

Dr ST Singam v Lee Siew Leong [2007] 1 MLJ 1

Kepong Prospecting Ltd v Schmidt [1968] 1 MLJ 170

Kluang Wood Products Sdn Bhd & Anor v Hong Leong Finance Berhad & Anor [1994] 4 CLJ 141

Leong Weng Choon V Consolidated Leasing (M) Sdn Bhd [1998] 3 MLJ 860

MCST Plan No 1933 v Liang Huat Aluminium Ltd [2001] 3 SLR 253 Heilbut, Symons & Co v Buckleton [1913] AC 30

Murphy v Brentwood District Council [1991] 1 AC 398

SamaWorld Asia Sdn Bhd & Anor v RHB Bank Bhd. [2008] 6 CLJ 44

Shanklin Pier Ltd v Detel Products Ltd [1951] 2 All ER 854

Sia Siew Hong & Ors V Lim Gim Chian & Anor [1995] 3 MLJ 141

South East Asia Insurance Bhd v Nasir Ibrahim [1992] 2 MLJ 355

Tan Swee Hoe Co Ltd v Ali Hussain Bros [1980] 1 MLJ 89

Teh Khem On & Anor v Yeoh & Wu Development Sdn Bhd & Ors [1995] 2 MLJ 663

Tweddle v Atkinson (1861) 1 B & S 393

Yeoman Credit Ltd v Latter and Anors [1961] 2 All ER 294 at 296

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CHAPTER 1

INTRODUCTION

1.1 Introduction.

In construction contract, guarantees between parties to the contract can be in terms of money, for example performance bond or retention fund. It can also be in terms of contract agreement itself, for instance, indemnity or warranty. Warranty and indemnity are two terms that had been used interchangeably in the construction contract. Chow Kok Fong describe that both terms are undertakings that operate separately from the principle contract.¹ Contract administrators find these two terms difficult to be distinguished.

This research will focus on comparing warranty and indemnity based on the judgments by the judges in court law. It will cover the aspect of interpretation of the terms, and the features of each terms described that constitute the difference between them. These terms are used in construction contracts that involved third party. Failure in differentiating these terms will render the third party to lose their rights.

¹ Chow Kok Fong, Law and Practice of Construction Contract 3rd Edition, 2004, Thomson Sweet and Maxwell Asia. Pg 43

This chapter presents the research foundation including background of the study, research questions, the objective of the research, research methodology in general, scope of study and its research organization. The keys to the elements to comprehend this research are provided in this chapter.

1.2 Background of the Research

Terms of contracts are the crucial element in ensuring a good contract. There are three types of terms in contract namely; implied terms, express terms and innominate terms. Surety is one of the terms that are included in a contract. It is a must since it act as a bond for both parties to the contract in performing their part respectively.

Generally, surety terms are specifically drafted as to specify the work description and the consequences if the work is not executed. Therefore the terms are expressed terms. The usual terms in giving surety includes indemnity, collateral warranty, retention money, performance or payment bond.

In this research, only two terms that will be focused on, that is indemnity and collateral warranty. These two terms had been used interchangeably in construction contract and seemingly been confused by the parties to the contract themselves. The term of collateral warranties and indemnity both involve the act of undertaking that operate separately from the principle contract² in this research, the third party. Confusion in terms usage in contract can make the party lose their right to claim.

² Chow Kok Fong, Law and Practice of Construction Contract 3rd Edition, 2004, Thomson Sweet and Maxwell Asia. Pg 43

This occurred in the case of *MCST Plan No 1933 v Liang Huat Aluminium Ltd*³. LP Thean JA stated at page 256:

“The High Court dismissed the claim on the ground that the claim by the MC under the deed is one for an indemnity and such claim has not arisen and that the MC is not entitled to the claim damages for breach of contract.”

Collateral can simply be described as an agreement that is attached to a main agreement. Warranty can be defined as an assurance given in the course of negotiation.⁴ Therefore collateral warranty can be said as a contractual link enabling a person A (the warrantee) to sue person B (the warrantor) even though they do not have a direct service relationship.⁵

The definition of indemnity can be found in the Contract Act 1950, Section 77. The section defines indemnity as a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person. It can simply be said an undertaking made by the indemnifier to indemnify any loss incur in the future.

1.3 Statement of issue

The case of *MCST Plan No 1933 v Liang Huat Aluminium Ltd* [2001] 3 SLR 253, marks the attempt on differentiating the terms of collateral warranty and

³ [2001] 3 SLR 253

⁴ *Tan Swee Hoe Co Ltd v Ali Hussain Bros* [1980] 1 MLJ 89

⁵ *Construction Law Handbook* 2007 Edition, Institution of Civil Engineers. Pg 196

indemnity for the first time. One of the issue was regarding a deed; whether it was a collateral warranty of indemnity.

Two judges of the Court of Appeal found in favour of the MCST, ruling that the deed was not only an indemnity but a warranty as well.⁶ The deed is as follows:

2. *in the event of any deterioration or defects (as shall be determined by the Employer) in the workmanship, quality of materials, installation, watertightness or deterioration appearing in the Works, the Contractor shall forthwith upon notice given to either of them and within such time as the Employer may direct, effect remedial works to the defective area or areas and shall make good to the absolute satisfaction of the Employer all damages to surface finishes including but not limited to plaster, panelling, tiling and other similar works, mechanical, electrical or other installations or other property arising directly or indirectly out of the said defects.*
3. *In the event that remedial works undertaken by the Contractor or the Sub-Contractor prove ineffective as determined by the Employer whose decision shall be final and conclusive, or are not to the satisfaction of the Employer, the Contractor and the Sub-Contractor shall effect such additional works in such manner and within such time as the Employer may direct and shall carry out all test, as directed by the Employer until all the defects have been remedied to the absolute satisfaction of the Employer.*
4. *Should the Contractor or the Sub-Contractor fail to perform their obligations under Clause 2 and 3 above within the time directed by the Employer or in the absence of such direction within a reasonable period, the Employer shall [sic] entitled to remedy the said defects and the Contractor and the Sub-Contractor shall forthwith on demand reimburse the Employer all costs and expenses incurred by the Employer for making good the said defects including all legal*

⁶ Court Considers Difference Between Warranties and Indemnities. Accessed on 24th July 2013 <http://www.internationallawoffice.com/newsletters/detail.aspx?g=5a782f01-ef3b-40e1-89e3-65109c61c08a>

costs on a Solicitor and Client basis incurred by the Employer in enforcing this Clause.

The deed was held as an indemnity agreement as based on clause 2 and 3 that underlines the liability for the contractor to do remedial works in cases where defect arise. Even though the deed itself was entitled ‘INDEMNITY FOR ALUMINIUM & GLAZING WORKS’, nevertheless the majority judge held that the title is just a label and does not have effect on the deed itself. What makes the deed indemnity was the clauses, not the title.

This was similarly decided in the case of *Sia Siew Hong & Ors V Lim Gim Chian & Anor.*⁷ Gopal Sri Ram JCA stated that even though the label of the document was guarantee, the content of the clause as a whole was indemnity. The judgment was made after considering several features of the agreement; 1) the definition in the Contract Act 1950 section 77, 2) obligation; upon whom it falls and the objective of the agreement. Furthermore, the honourable judge added that the effect of the contract agreed was to be an indemnity.

Clause 4 of the agreement was a consequential clause of clause 2 and 3 that enables the party to proceed with rectifying and making goods such defects and claim reimbursement for the cost and expenses incurred that is a part of warranty. Even clause 2 and 3 are indemnity clauses, it does not invalidate the warranty in clause 4. Thus the deed contains clauses of both indemnity and warranty.

Still, the dissenting judge in this case held that the deed was indeed an indemnity based on the intention of the employer that was shown before on their rejection of discussion on warranty with the defendant. Chao Hick Tin JA opined

⁷ [1995] 3 MLJ 141.

that the intention of the employer played a big role in construing the deed therefore making the deed crystal clear an indemnity as stated on the title.

These judgments open a space for further arguments on collateral warranty and indemnity. Both terms are regarding undertakings but the type of each term differs and consequently leading to a non-common effect. There is no precise interpretation for Collateral warranty and indemnity. Thus, this does not only made the judge to have to interpret the terms in each case, but also put the position of the third party involved in jeopardy.

We can see that the confusion of the term of indemnity and collateral warranty may lead to the violation of third parties right. Even though the Court of appeal of Singapore had reach a majority decision, the dissenting judgment shows that the differentiation of both terms is uncertain and arguable. What are the differences and how far the differences can protect the third party's right? These are the questions that will be answered in this research.

1.4 Scope of the Research

As mentioned before, this research focused on the interpretation of indemnity and collateral warranty and features used by judge to establish it. The features can either based on grounds of judgment, or the circumstances that lead to the judgment itself. The cases will be narrowed to contracts between the main party; either the contractor or employer, and the third party. Although in section 77 of the Contract Act 1950, the term of indemnity are defined, the concept of the indemnity is narrower than the concept established under the English Law.⁸

⁸ V.K Agarwal, Law of Contract, Principles and Practice, International Law Book Services. Pg 409.

The cases used will be not only limited to the cases of construction contract but other cases from different field as well such as sale and purchase, leases, loans, and also insurance. The jurisdiction of the case taken will also not be limited in Malaysia also, but also includes cases from other jurisdiction such as United Kingdom, Australia, Hong Kong and India. However, the time frame of the case is unlimited. The case can be as recent as in 2013 or as old as in the 1980's. The reason is that even some cases are old, the judgment is still relevant and used by the latter cases as precedents by the judges in their judgment.

1.5 Objective of the Research

The objective of the research is:

1. To determine the differences between the terms of collateral warranty and indemnity in order to protect the right of third parties in construction contract.

1.6 Research Method

There are several stages that had been adhered in order to achieve the research objective. The stages are as follows:

Stage 1: Identifying Research Issue

Identifying the research issue is the initial stage of the whole research. This stage involves gathering resources, either primary or secondary. Sources such as law textbooks, cases, journals and articles are gathered and read to give the understanding and certainty on the issue itself.

Stage 2: Literature Review

Literature review is the second stage of the research. This involved the cases, statutes and analysis of the topic as a whole in summary.

Stage 3: Research Analysis

The detailed analysis of the research is in this stage. This stage determines whether the objective of the research is achieved or not. Details and arguments of the research is also be presented in this stage.

Stage 5: Conclusion and Recommendations

Conclusion and recommendations is the final stage of the research. The results of the research is presented in this stage as well as recommendation of further research that could be done regarding the topic.

1.7 Chapter Organization

This research contains five (5) chapters and the organization of it is as follows:

Chapter 1: Introduction

This chapter sets the background of the study, statement of issue, objective of the research, scope of the research, research methodology, the organization of the chapters, and the research flow.

Chapter 2: The Concept Of Collateral Warranty And Indemnity

Chapter 2 contains the general understanding on the terms involved in the research; collateral warranty and indemnity. The definition by law textbooks, statutes and judges in cases. Other subject that is related to this research such as Contracts (Rights of Third Parties) Act 1999 is included.

Chapter 3: Collateral Warranty And Indemnity In Construction Contract.

This chapter focuses on the application of collateral warranty and indemnity in construction contract. It will elaborate on the types of contract that used the terms and how the terms are presented in a contract.

Chapter 4: The Comparison Of Collateral Warranty And Indemnity

Chapter 4 is the chapter that contains analysis of both terms based in judgment of decided cases. The interpretations made by judges and the grounds of it have been analysed and compared.

Chapter 5: Conclusion and Recommendations

This chapter is the final chapter where the conclusion of the research is made. The impact of the comparison of the terms is included. Recommendation for further research is also made in this chapter.

1.8 Research Flow

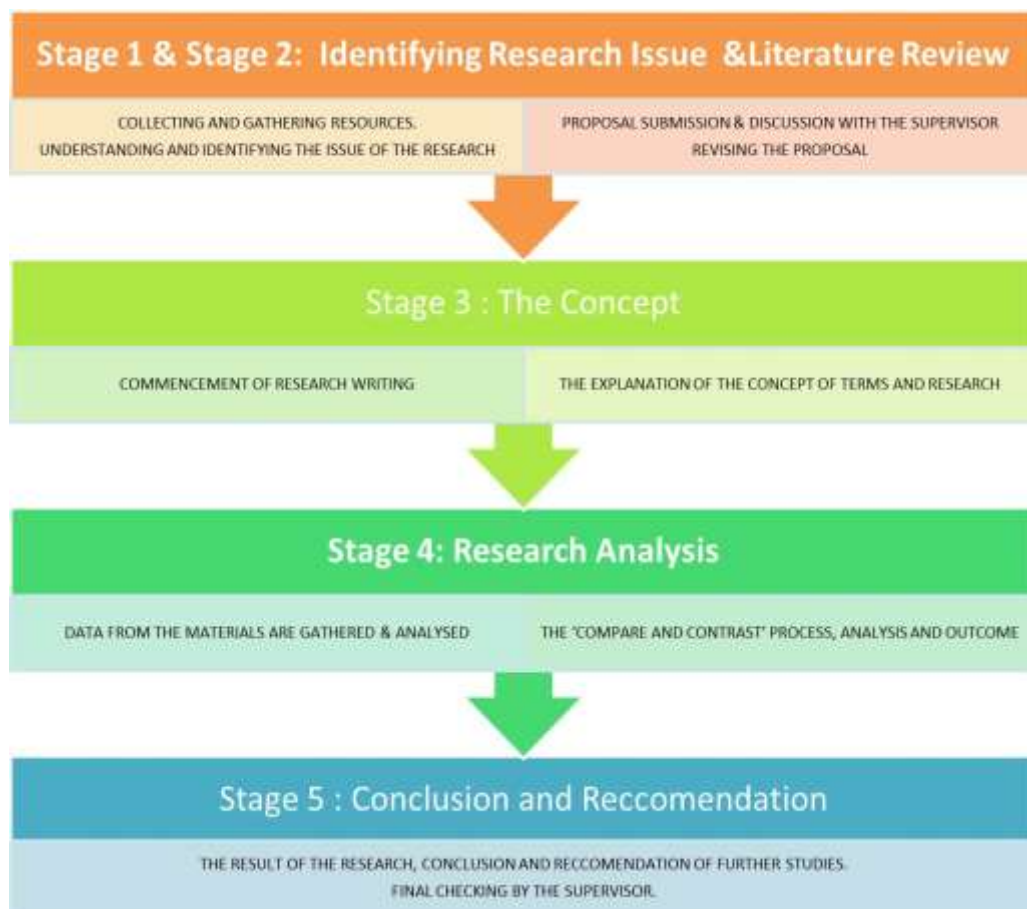


Diagram 1 : Research Flow

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