INSTITUTION OF ENGINEERS PUBLIC FORUM ON "PAY-WHEN-PAID" CLAUSES IN CONSTRUCTION SUB-CONTRACTS – HELD ON 27 NOVEMBER 2004

1. BRIEF INTRODUCTION

It is very common for sub-contractors, especially domestic sub-contractors, although it is not unknown for nominated sub-contractors, to be required to accept "pay-when-paid" clauses in their sub-contracts. Such clauses are popularly referred to as "back-to-back" payment clauses. It is interesting to note that all current major standard forms of construction contracts have within their nominated sub-contract conditions which stipulate payment within a certain duration after certification by the S.O. This includes the P.A.M., JKR/PWD, and I.E.M. Forms. Interestingly, and by way of contrast the CIDB Form requires payment at the earlier of 7 days after certification or after receipt of payment by the main contractor.

The apparent effect of such clauses is that the sub-contractor will have to wait for his main contractor to be paid before being entitled to be paid, not withstanding the fact that the sub-contractor has been issued a payment certificate for a considerable period of time of say 120 days, which is far in excess of the period which the main contractor is required to wait from the issuance of the payment certificate under the main contract to when the main contractor is entitled to be paid. The applicable default period for honouring of payment certificates for main contracts under the I.E.M. and PAM 1998 Forms are both 30 days.

This term of "pay-when-paid" is ordinarily taken to include the right to be paid for variations under sub-contracts but this is outside the scope of a short paper like the current, and should rightfully be considered in its own forum.

This short paper will therefore seek to examine:

1. The contractual status and rights of a sub-contractor viz-a-viz his main contractor's employer;
2. The different effects various draftsmen of sub-contracts attempt to give to main contractor's payment obligations under their respective sub-contracts, and the difference between "pay-if-paid" and "pay-when-paid";
3. Whether a main contractor is entitled to hold back from a sub-contractor for deductions suffered as a result of his own defaults which have nothing to do with his sub-contractor
4. The rights of a sub-contractor who has not been paid
5. Consideration of the situations in which "pay-if-and-when-paid" payment terms are justified or otherwise – from the perspective of the relationships between main contractor and sub-contractor and the pre-award negotiations between the parties.

2. THE CONTRACTUAL STATUS OF A SUB-CONTRACTOR VIZ-A-VIZ THE OWNER

2.1 There normally exists no what one would call, in legal terms, privity of contract between an Owner and his contractor's sub-contractor. In the context of this public forum, i.e. where we are discussing the all important issue of payments to sub-contractors, an Owner is not normally liable to a sub-contractor for payment, whether or not there is a "pay-when-paid" provision in the sub-contract. The simple reason for this is that the Owner is not a party to the sub-contract. In the case of nominated sub-contracts under P.A.M. Form, it is the case that the sub-contract entered into is instructed by the Owner or by the Architect acting as an agent of the Owner, but the contractor in all such instances accept as a term of his contract with the Owner that he will enter into the sub-contract and will take the risk of non-performance by the sub-contractor. In return the contractor receives a certain percentage of the amount of the nominated sub-contract for profit and attendance but this not necessary to require the contractor to accept the

nomination or to make the contractor liable for the performance of the nominated sub-contractor.

2.2 It therefore follows that, in the absence of a special arrangement between an Owner and a sub-contractor, the Owner can never be made liable to the sub-contractor for payment. This absence of direct liability is in turn reflected by the sub-contractor's freedom of liability towards the Owner (as far as commercial liability is concerned). One objection to making an Owner liable for payment to a sub-contractor, apart from its circumvention of the contractual relationship is the fact that imposition of the liability will expose the Owner to "double jeopardy", i.e. the Owner may be liable to pay for the same thing twice, once to the main contractor, and another time to the sub-contractor.

2.3 It therefore follows from the above that a sub-contractor who accepts a "pay-when-paid" clause has to very seriously consider whether he is prepared to accept the double risk that this entails. If he does not accept the "pay-when-paid" clause, he relies wholly on the credit of his main contractor. However, if he does, he relies not only on the credit of his main contractor, but also that of the Owner. He remains reliant on the credit of his main contractor because the main contractor will still get paid first before he pays his sub-contractors. In such a situation, it is not inconceivable that the main contractor not only temporarily diverts the payment elsewhere and thus delays payment to his sub-contractor or even goes bankrupt before actually paying his sub-contractors.

3. DIFFERENT FORMS OF DRAFTING OF "PAY-WHEN-PAID" CLAUSES

3.1 It is instructive to note the following extracts from sub-contracts which the writer has had the opportunity of handling:

Sub-Contract 1

Progress payments - *"Subject to any deductions or set-off which the Contractor may make, the Contractor shall pay to the Sub-Contractor the amount certified by the Supervising Consultants under the Turnkey Contract in respect of the Sub-Contract Works within fourteen (14) days of receipt of such payment from the Employer. For the avoidance of doubt, the Contractor shall not be liable in any way to the Sub-Contractor in the event of any delay or non-payment by the Employer …"*

Final account - *"Within three (3) months after the completion of the Sub-Contract Works … … the Sub-Contractor shall submit to the Contractor his final accounts … … Subject to any set-off which the Contractor may make, the Contractor shall pay to the Sub-Contractor the amount certified by the Supervising Consultant … … within fourteen (14) days of receipt of such Certificate/Acceptance of Sub-Contract Works from the Supervising Consultant."*

It is clear from the above that whilst the Sub-Contractor is required to wait for the receipt by his Main Contractor of the corresponding progress payment, there is no such requirement in regard to his entitlement to be paid under the final account. It therefore appears that the Sub-Contractor is entitled to be paid such shortfalls in payment which he may have suffered as a result of the Contractor's non-payment by the Owner in regard to any progress claims under the main Contract. It seems that if the Main Contractor wishes to make his obligation to pay the Sub-Contractor under the Sub-Contract fully "back-to-back" with his receipt of payment under the Main Contract, the payment under the final account clause will need to be redrafted to for example entitle the Sub-Contractor to payment only after the later of a certain number of months after the issue of certificate of

making good defects, the finalization of the Main Contract Accounts, and the payment of the final payment, whichever is the latest.

Sub-Contract 2

The payment clause is couched in similar wording whilst the provision on final account and final payment is as follows:

"*…, the Statement of Final Account shall for the Sub be prepared and issued by the Contractor to the Subcontractor within fourteen (14) days from the date of finalisation of the Main Contract Accounts. The Final Payment shall be made by the Contractor to the Subcontractor within fourteen (14) days from the date the Statement of Final Account is signed by both the Contractor and the Subcontractor …*"

Again, the effect of the above clause is to entitle the Subcontractor to be paid all shortfalls in payment suffered as a result of the "pay-when-paid" effect of the interim progress payments.

This writer's experience with a fair number of sub-contract forms is that the above situation is the norm. The effect is that the sub-contractor finally gets his full entitlement, and the adverse consequence on the sub-contractor is limited to cash flow and less on the final bottom line, although this by itself normally has quite weighty implications.

3.2 From the above, the difference between "pay-when-paid" and "pay-if-paid" can be clearly seen. For a clause to have a strictly "pay-if-and-when-paid" effect, the drafting has to be very clear and be not confined only to the progress payments and should include also the final account.

4. IS A MAIN CONTRACTOR ENTITLED TO WITHHOLD PAYMENT WHEN HE SUFFERS A DEDUCTION DUE SOLELY TO HIS OWN DEFAULT?

4.1 It often happens that a main contractor would suffer liquidated damages as a result of his own default or that of one of a number of his sub-contractors. The question which arises in such a situation is whether the main contractor is entitled to deduct the liquidated damages recovered by the Owner from sub-contractors who did not contribute to the delay?

4.2 The academic opinion and the judicial decisions differ slightly in this respect. In this regard I will deal first with the academic opinion, with which I tend to concur as it has been cogently expressed and well argued.

4.2.1 *Hudson's Building and Engineering Contracts 11th Edition*[1] holds the view that a main contractor is not entitled to withhold payment in such a situation for the following reasons:

i. The deduction of, for example, liquidated damages or a sum for defective works amounts to a cross-claim or set-off which should count as credit given to the main contractor. In other words the work done by the main contractor and hence all sub-contractors are still being recognized and accordingly the relevant sub-contractors should be paid;

ii. The application of the "business efficacy" and "officious bystander" tests would favour the view that a sub-contractor had not agreed to withholding of payment when he did not cause his main contractor to suffer for example, liquidated damages. But as the parties to contracts can agree to whatever positions they may wish to take, it is open to the parties to agree otherwise; and

iii. The "prevention principle" implies that a main contractor should not gain from his own negative act, i.e. default in say, completing the works in a timely

[1] See Paragraph no. 13-115

manner, and thus take advantage of the same to deny his sub-contractor from being paid.

It thus follows from the view expressed in *Hudson's* that the deduction from any payment due to a main contractor, when the withholding is caused by a default of the main contractor that has no connection with a sub-contractor, does not entitle the main contractor to offset from payment due to the sub-contractor.

4.2.2 The judicial position is however less clear. All the reported cases revolve around the issue of whether it is proper for judgment to be given in favour of a sub-contractor whose payment has been withheld or deducted by his main contractor who his been imposed liquidated and ascertained damages by the Owner in an application for summary judgment. An application for summary is normally granted when a plaintiff's claim against a defendant's case is obvious and the defendant does not have any defence, and puts up nothing more than a bare denial. An example of when a plaintiff claims on cheque issued. One of the few situations in which a defendant can succeed in resisting such a claim is when there has been a total failure of consideration.

In all three Commonwealth cases[2], on appeal, it was held that it is not proper to decide in an application for summary judgment on the effect of such "pay-when-paid" clauses. However in one of the three cases, the court of first instance did decide the point definitively in favour of the sub-contractor[3] on the same bases as above those put forward in *Hudson's* and referred to in 4.2.1 above.

4.2.3 It can be seen from the above that there has been no definitive judicial pronouncement in regard to the current question. This therefore gives the writer

[2] Hong Kong cases of *Hong Kong Teakwood Works Ltd. v. Shui On Construction Co. Ltd.* [1984] H.K.L.R. 235, *Schindler Lifts (Hong Kong) Ltd. v. Shui On Construction Co. Ltd.* [1984] H.K.L.R. 340, and in Singapore in *Brightside Mechanical & Engineering Services Group Ltd. v. Hyundai Engineering & Construction Co. Ltd*

[3] *Schindler Lifts (Hong Kong) Ltd.*

license to state his opinion on this matter, which is that a sub-contractor is entitled to be paid in the circumstances, and for the following reasons:-

i. The decision of the High Court of Hong Kong in the *Schindler Lifts* case. The case has no binding effect at all, even in Hong Kong (as it had be overturned on appeal by the Court of Appeal of Hong Kong); and

ii. The very sound reasoning in *Hudson's.*

It may therefore be possible to argue in an application for final (as against summary) judgment that a sub-contractor is entitled to put forward the position that in having a deduction made by the Owner, the main contractor is in fact receiving payment as credit is effectively being given to the main contractor.

In this regard, it is interesting to note that the Singapore Institute of Architects 1980 Form contains this provision as Clause 30(2):-

*"For the purposes of sub-clause (1)(a) of this Condition, the Contractor shall be deemed to have received pay*ment *from the Employer of some or all of the amounts as due to any such Designated or Nominated Sub-Contractor or Supplier as follows:*

(a) If the sole reason for non-receipt from the Employer of some or all of the amounts certified by the Architect in favour of a Designated or Nominated Sub-Contractor is a defence, set-off, counterclaim or deduction by the Employer against the Contractor not related to that Designated or Nominated Sub-Contractor or Supplier, the amounts shall to that extent be treated as having been paid to the Contractor."

The effect of this is unambiguous, i.e. if there is a deduction by an Employer due for example to liquidated and ascertained damages, or deduction for work carried out by another contractor as a result of the Contractor's failure to carry out the

Works in compliance with his contractual obligations, then any such deduction shall for the purpose of determining the payment due to a Sub-Contractor (who did not cause or contribute to the Contractor's default) under the "pay-when-paid" conditions of the S.I.A. Form be ignored and the Sub-Contractor shall be entitled to receive his payment without deduction.

5. THE RIGHTS OF A SUB-CONTRACTOR WHO HAS NOT BEEN PAID

5.1 In order for a sub-contractor to be entitled to consider his sub-contract as being repudiated by his main contractor, the main contractor must have evinced a clear intention not to be bound by the payment terms of the sub-contract.

5.2 In such a context, a single instance of a delay in payment of a few days beyond a payment due date would not suffice. The writer would even venture to speculate that a delay of say up to a week over a few consecutive payments would not suffice. The default must such as to be clear and unambiguous. *Hudson's Building and Engineering Contracts*[4] gives as examples a clear indication of an inability or refusal to pay future and repeated failure to pay on time in response to repeated warnings as justifying repudiation. *Hudson's* also cites in the latter example an additional requirement to be coupled to the repeated failure an intention to pay late habitually so as to derive financial advantage. The writer respectfully begs to differ with this requirement as the main test should be the objective one of whether there has been in substance a clear breach of the contractual obligation. The benefit derived should not be a consideration in determining the sub-contractor's right to consider the main contractor as having repudiated the sub-contractor.

5.3 Upon a sub-contractor rescinding the sub-contractor after the repudiation his main contractor, the sub-contractor will be released from further obligations under the sub-contract. Thus for example there will be no defects liability period but of

[4] 11th Edition at paragraph 4.221

course the main contractor will be able to set-off from any moneys due to the sub-contractor the costs of repairing any defects. The sub-contractor will be entitled to claim not only for works done up to the rescission of the sub-contractor, but also for financing costs, and loss of profit.

6. CONSIDERATION OF THE SITUATIONS IN WHICH "PAY-WHEN-PAID" ARRANGEMENTS ARE JUSTIFIABLE, AND CONSIDERATION OF OPERATIONAL PERSPECTIVES

6.1 When parties enter into a strictly "pay-when-paid" arrangement, they are in effect entering into joint venture agreement whereby the sub-contractor agrees to finance his main contractor for his portion of the main contract works.

6.2 A good example of this would be a tender for a process engineering contract such as for example a power station, or a water treatment plant, both of which require substantial inputs of both civil engineering and mechanical engineering elements. In such a situation the civil and mechanical contractors may agree that rather than entering into a joint venture, they would instead allow the contractor who executes the bigger component of the works to be the main contractor and the other will be his sub-contractor. Here, it is clear that both will finance their own portions of the works, and there cannot be any reliance on the other for financing.

6.3 The same concept in 6.2 can be extended to include other less obvious but still applicable situations such as for example an established and reputable main contractor who is in a bad cash flow situation who relies on his regular sub-contractors for their support. In such a situation it would be unfair to allow the sub-contractor who has agreed to support his main contractor when it suits him to desert his main contractor when the situation takes a turn for the worse.

6.4 On the other extreme end is the obvious example of suppliers of dayworks workers or "kungsi kung" sub-contractors whom no main contractor would ever hold to be "pay-when-paid" sub-contractors. Likewise with suppliers, although it is not impossible if the parties intend to make payment obligation/entitlement "back-to-back".

6.5 A general guide on the situation when "pay-when-paid" obligations would be a suitable arrangement take into account the following operational factors:

i. the past dealings between the parties – this is a factor taken into account under common law to decide the applicable terms between two parties where not expressed when two parties to a contract have a long course of dealings;

ii. the relative size of the main and sub-contractors – the bigger the sub-contractor the more sensible it is that the arrangement is "back-to-back". In Malaysia it is not uncommon for a main contractor with lobbying strength to be a much smaller contractor than his "total sub" sub-contractor. It is also not unknown that sub-contractors are taken on board for the sole reason of financing a project when for cash flow reasons a main contractor is unable to do so;

iii. it follows from ii. that trade and specialist sub-contractors are normally not on "pay-when-paid" arrangement;

6.6 <u>What happens when an Owner is unable to pay?</u>

In such a situation a main contractor and his sub-contractors will have to confer and agree to determine the main contract, especially where the sub-contractors are on "pay-when-paid" arrangements.

An interesting question in such a situation is whether such a sub-contractor is entitled to determine his employment. On the one hand, he has no contractual relationship with the Owner and on the other he has accepted the "pay-when-

paid" arrangement with his main contractor and the main contractor has not committed any breach.

No doubt, the main contractor in a complete "pay-when-and-if-paid" arrangement bears no legal liability and the only loss he has to bear would be the profit which he would otherwise be earning. The main contractor in such an arrangement bears very little risk, whilst his sub-contractor bears the risk of the costs to be incurred which would be about 90% of the contract price. In such a situation, the main contractor should morally bear some of his sub-contractor's losses.

6.7 Right to suspend for non-payment – part of the solution?

It is always the dilemma of contractors and sub-contractors who don't get paid or whose employers or main contractors are habitual late payers whether they should carry on. If they carry on, they may get deeper and deeper into the hole. If they don't, it is often the case that the contractor/sub-contractor will get paid, if he gets paid at all, only after a long battle lasting 5, 6, or more years, and after a long battle in arbitration and in the courts. The writer knows personally of a case of a sub-contractor who received almost no complaints from his main contractor being slapped with a counter claim on the basis of back charges for because the sub-contractor was allegedly incompetent and could not deliver to the specifications!

The only solution to this would be to allow the contractor/sub-contractor to suspend works after a certain number of delays in payment. In this the CIDB is to be congratulated for having incorporated such a provision in their form of contract.