

# **PERTUBUHAN AKITEK MALAYSIA**

## **CPD Continuing Professional Development Seminar**

### **PAY WHEN PAID and BACK TO BACK Clauses in Sub Contracts**

The effect of Pay-when-Paid clauses in PAM 98 & 2006 Standard form of Sub-contracts  
Prepared by Chan Seong Aun

1. INTRODUCTION
2. CONTRACTURAL & LEGAL ISSUES
  - 2.1 PAM 98 Main Contract
  - 2.2 PAM 98 Sub-contract
  - 2.3 PAM 2006 Main Contract
  - 2.4 PAM 2006 Sub-contract
  - 2.5 Effects of Pay-when-paid on Sub-contractors
  - 2.6 Effects of Pay-when-paid on Main Contractors
  - 2.7 Effects of Pay-when-paid on Employer
  - 2.8 Legal & Judicial Views
3. MORAL & ETHICAL ISSUES
  - 3.1 Sustainable Relationships
  - 3.2 Effects of Pay-when-paid on Sub-contractors
  - 3.3 Effects of Pay-when-paid on Main Contractors
  - 3.4 Effects of Pay-when-paid on Employer
  - 3.5 Other points of view
4. STATUTORY & OTHER ISSUE
  - 4.1 Entitlements to Payment
  - 4.2 Claims by Contractors
  - 4.3 Enforcement of Claims
  - 4.4 Statutory Banning of Pay-when-paid practices
5. THE WAY FORWARD

## 1. INTRODUCTION

This CPD seminar will offer a review of the Public Forum organized by The Institute of Engineers Malaysia on 27-11-2004. This public forum was initiated by the Electrical & Electronic Contractors who found their contractual position increasingly being threatened by the frequent inclusion of Pay-when-paid, pay-if-paid and back-to-back conditions into their sub-contractors by main contractors. These are very controversial issues for which there is still varying views.

I will also draw from another seminar entitled “Contractors’ payment problems and insolvency” organized by The Malaysian Bar Council, The Society of Construction Law and the Chartered Institute of Arbitrators (Malaysia) on 22-03-2005.

Most of the standard sub-contracts in Malaysia have “**pay-when-certified**” clauses. This means the main contractor must pay the nominated sub-contractor within the specified number of days when an interim certificate is issued by the Superintending Officer – NOT from when the Main Contractor is paid. This is as in Clause 27.3 of the PAM form.

## 2. CONTRACTURAL & LEGAL ISSUES

What are the rights and obligations of Main Contractors and Sub-contractors under the PAM 98 Standard Forms? Existing Standard Contracts have adequate provisions for dealing with Non payment by either the Employer or the Main Contractor.

### 2.1 PAM 1998 Main Contract

PAM 1998 Main Contract for example has the following clauses to safeguard the Contractor and Sub-contractors.

1. Clause 26.1(i) Determination by Contractor upon non payment by Employer
2. Clause 27.3 Payment by Contractor to NSC
3. Clause 27.4 Failure of Contractor to pay NSC
4. Clause 27.6 Final payment to NSC before Final payment to Contractor

NOTE : Clause 27.7 No contract between Employer and NSC

## **2.2 PAM 1998 Sub-contract**

The PAM 1998 Sub-Contract also has adequate provisions protecting the Sub-contractors

1. Clause 11.3 Contractor's Obligation to pay Sub-Contractor
2. Clause 11.7 Sub-Contractor's Right to suspend works upon failure to pay
3. Clause 11.8 and 11.9 Contractor to pay final payment certified to Sub-Contractor
4. Clause 11.11 Contractor is fiduciary as Trustee of Sub-Contractor's Retention Monies
5. Clause 20.1 Sub-Contractor may determine the sub-contract for the following reasons.
  - a) Main contractor suspend works unreasonably
  - b) "Obstructs" sub-contractor's works unreasonably
  - c) Fails to pay Sub-Contractor without reasonable cause

## **2.3 PAM 2006 Main Contract**

PAM 1998 Main Contract for example has the following clauses to safeguard the Contractor and Sub-contractors.

1. Clause 26.1(a) Determination by Contractor upon non payment by Employer
2. Clause 27.5 Payment by Contractor to NSC
3. Clause 27.6 Failure of Contractor to pay NSC
4. Clause 27.7 Final payment to NSC before Final payment to Contractor
5. Clause 30.7 Suspension of works for non payment
6. Clause 30.8 Compulsory suspension of works

## **2.4 PAM 1998 Sub-contract**

The PAM 1998 Sub-Contract also has adequate provisions protecting the Sub-contractors

1. Clause 26.2 Sub-Contractor's payment
2. Clause 26.15 Suspension of Sub-Contractor works for non payment.
3. Clause 26.16 Suspension of Main Contractor works by the Contractor under the main contract.
4. Clause 26.17 Interest
5. Clause 26.7 Final payment
6. Clause 24.1 Sub-Contractor may determine the sub-contract for the following reasons.
  - d) Main contractor suspend works unreasonably
  - e) "Obstructs" sub-contractor's works unreasonably
  - f) Fails to pay Sub-Contractor without reasonable cause

## **2.5 Effects of Pay-when-paid on Sub-contractors**

What is the effect of a Pay-When-Paid insertion on the contract?

All the above 5 clauses listed above that protect the rights of the sub-contractor to receive payment are rendered ineffective and no longer apply when the Main Contractor does not receive payment! The Main Contractor can elect not to pay and it would be legally binding on the sub-contractor who no longer can stop work on non-payment.

The obligations and liabilities of the Sub-contract however remain in total as the clause will have no effect on them.

1. Clause 2 Sub-contractor's obligations
2. Clause 7. Damages for Non-completion

## **2.6 Effects of Pay-when-Paid on Main Contractors.**

Obviously all the rights and obligations of the Main Contractor under the Main Contract will not be affected since there are no alterations to the clauses in the main contract.

What about the rights and obligations of the Main contractor under the Main Contract when there is no payment from the employer.

1. Clause 26.1(i) Determination by Contractor upon non payment by Employer. His rights remain under this clause.
2. Clause 27.3 Payment by Contractor to NSC. His obligations to pay under the Main contract remain but have been rendered "redundant" by the overriding clause under the sub-contract.

The rights of the Main Contractor are greatly enhanced while his obligations have been reduced under the following clauses.

1. Clause 11.3 Contractor's Obligation to pay Sub-Contractor has been removed when there is no payment fro the Employer
2. Clause 11.7 Sub-Contractor's Right to suspend works upon failure to pay. There is no more "failure to pay" when there is no more requirement to pay
3. Clause 20.1 Sub-Contractor may determine the sub-contract for the following reasons – (iii) Fails to pay Sub-Contractor without reasonable cause. Sub-contractor has to continue to work as the "reasonable cause" has been removed.

The net effect is that the Main Contractor has "passed his obligation" under the contract to his sub-contractors while retaining his rights

## **2.7 Effects of Pay-when-Paid on Employers.**

Does the insertion of Pay-When-Paid clause have any effect on the rights and obligations of the Employer?

1. Clause 27.7 of the Main Contract - No contract between Employer and NSC
2. Clause 2.4 of the Sub-contract – No-Privity of Contract between the Employer or Any Other Sub-Contractor

## **2.8 Legal & Judicial Views.**

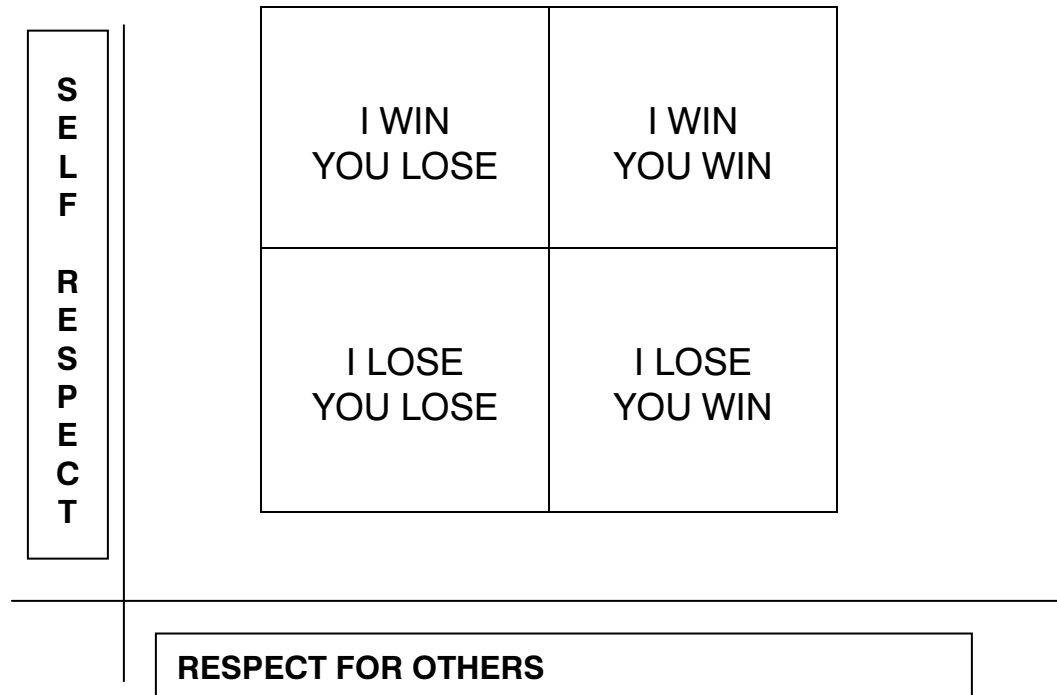
The first two speakers Ir Lim Eng Chong and Ir Oon Chee Kheng, both Engineer – Advocate & Solicitors give very extensive views from the judicial and legal points of view citing many cases which had gone through the courts. Oon CK in particular draws the following conclusions.

1. The terms “back-to-back” and “pay when paid” are broad and loose terms of industry usage and they have no defined legal meanings.
2. It cannot be said that the law in this area is well setteled. The final words on these “pay when paid” clauses await inputs from the higher judiciary or from the legislature.

### 3. MORAL & ETHICAL ISSUES

#### 3.1 Sustainable Relationships

Our success in Business and in life in general depends very much on how we conduct our relationships with others. This in turn is grounded in our own self respect and our respects for the rights of others. We can generally conduct our relationships in four different ways as shown in the diagram below.



We have to remember that the only sustainable relationship is a “WIN-WIN” relationship. With this in mind we then examine the moral and ethical issues of imposing pay-when-paid clauses on others.

#### 3.2 Effects of Pay-when-paid on Sub-contractors

1. Sub-contractors placed in a no-win situation
2. Sub-contractors put in position where they can not protect their rights
3. Sub-contractors “taught” that construction business is an “unethical” business and you can not trust anybody in construction. History has shown that High Trust Societies thrive while Low Thrust Societies eventually become poorer
4. Sub-contractors effectively are financing the project.

### **3.3 Effects of Pay-when-Paid on Main Contractors.**

1. Main Contractor has lost his Self Respect. Should not have entered into contract where he is not sure of being paid but not willing to carry financial risk
2. Main Contractor has taken advantage of his position to unethically bully Sub-contractors into carrying his Financial responsibilities
3. Main Contractor has absconded on his social responsibility to protect the rights of those working under him
4. Main Contractor promoting unethical practices – damaging the industry he depends on

### **3.4 Effects of Pay-when-Paid on Employers.**

5. Although there is no direct contract between Employer and Sub-contractor Employer has Social responsibility to ensure all under his “Organization” are treated equitably
6. Employer putting his project at risk of becoming abandoned when financial resources of sub-contractors are exhausted
7. Employer has moral responsibility to ensure his “employees” are paid.

### **3.5 Other points of view.**

Ir Ho Kin Wing was of the view that there is nothing legally or contractually that prevents the practice of sub-contracting with ‘back-to-back’ arrangements provided that the contracts are not for illegal activities or contravene public policies. Ho KW does not think it is the sub-contracting practice with ‘back-to-back’ provisions or arrangements that is of any particular challenge but the issue of the ‘malpractices’ of the construction industry that is actually the challenge. The ‘malpractices’ include

1. Awarding of contracts due to patronage
2. Multi layer sub-contracting
3. Ease of forming a construction firm with no minimum technical, management or financial qualifications.
4. Squeezing of sub-contract prices and still demanding world class quality
5. Operating with a ‘dog-eat-dog’ mentality
6. Incorporating contract terms into standard contracts without due regard to its effect
7. Entering sub-contracts ‘blindly’ without reviewing the Main contract conditions.

Ir Ng Khoon Hwa gave the views of a long practicing sub-contractor.

1. Once a sub-contract is effected there is little useful recourse
2. Suspension or termination of a sub-contract is both time consuming and costly
3. Legal recourse are lengthy and outcomes uncertain
4. Smaller sub-contractors are vanquished before their case is even mentioned in court
5. Most payment issues are backward looking whereas project issues are forward looking.
6. Construction is a multifaceted business with long gestation periods. The risk factors can be high
7. Today despite voluminous contract documents, new management methods, things just do not work out in time. Cheating ways often come into play – Genuine business people suffer.

## **4. STATUTORY & LEGAL ISSUES**

During the SCL seminar, Dr Philip Chan of the NUS explained that the Contractors payment problems can be divided into 3 parts.

1. Entitlement to Payment
2. Claim
3. Enforcement

### **4.1 Contractors and Sub-contractor's Entitlement to Payment**

Dr Philip Chan explained that the Contractors problems entitlement to payment was safeguarded through

1. Certifications under Contract. No certificate – No entitlement to payment
2. Statute. This is available only in UK, NZ, Australia and Singapore, where SOP (Security of Payment Act) enactments have been legislated. A SOP Act is now under consideration by Malaysia under a recommendation by CIDB

### **4.2 Claims by Contractors.**

The basis for making claims are as follows

Legal Basis

1. Under contract – Contractor must make a claim first before a certificate can be issued.
2. Statute – if there is a SOP law in place

Non-Legal Considerations

1. Goodwill
2. Speed and Cost

### **4.3 Enforcement of Contractor's Claims.**

Contractor can enforce his claims through 2 ways.

Enforcement Based on Contract

1. Suspension for Architect's failure to issue certificate
2. Termination for Employer's failure to pay
3. Termination for Employer's improper or fraudulent interference or obstruction of issue of certificate

Enforcement Based on SOP Act

1. Lien on unfixed Goods
2. Suspension of works
3. As a judgement form Arbitration or Adjudication

#### **4.4 Statutory Banning of Pay-when-Paid practices**

In Noushad Ali's paper he found that while generally pay-when-paid and pay-if-paid clauses are increasingly being used in the Malaysian construction industry – particularly between main contractors and 'domestic' sub-contractors, pay-when-paid provisions have generally been outlawed in several countries – typically through a 'construction contracts act' such as that in the UK, some states in the USA and Australia, New Zealand and more recently Singapore (Effective 1<sup>st</sup> APRIL 2005)

Whilst the concept of freedom of contract is still preserved in these countries, particularly in commercial relationships, they have felt it unjust that a party (a sub-contractor) who has done work for another (a main contractor) should be deprived of payment as a result of a breach on payment under the main contract with a client with whom he has no contract and thus no privity to take legal action against.

## 5. THE WAY FORWARD

Noushad Ali, who headed the Malaysian Construction Industry Master Plan Working Group on Payment gave a number of proposals to resolve the payment problems which are plaguing the Malaysian Construction industry and the main reasons for the 'back-to-back' clauses cropping up in contracts.

1. Maintain right to terminate the contract for non-payment
2. Include the right to suspend works for non-payment in all standard contracts
3. Introduce Statutory right to suspend works through a 'construction contracts act' for non-payment
4. Include right to interest for late payment in standard contracts
5. Consider the right to interest from late certification.
6. Introduction of 'construction contracts act' to ban 'pay-if-paid' and similar clauses.

CIDB Malaysia has since 2005 been working with the construction industry to introduce the CIPAA – Construction Industry Payment and Adjudication Act.

The CIPAA contains the following components:

1. This Act shall **apply to every construction contract whether made in writing or otherwise**
2. Any provision in a construction contract which excludes, modifies or restricts the operation of this Act is void.
3. Adjudication of Disputes
4. **Prohibition of conditional payment**
  - (a) the obligation of one party to make payment is conditional upon that party having received payment from a third party; or
  - (b) the obligation of one party to make payment is conditional upon the availability of funds or drawdown of financing facilities of that party.

Lim Chong Fong in his paper on "Getting paid through enforcement & security" listed the following avenues which have been used to secure and enforce payments in the construction industry.

1. Payment of stipulated interest
2. Suspension of works or going slow
3. Banning of "pay when paid" clauses
4. Adjudication
5. Liens on Land title – Available in USA & Canada only – Lending Banks and Employers make sure sub-contractors are paid as under a lien statute unpaid sub-contractors can encumber the land title
6. Trust – Available in Canada – operates on premise that any party receiving money holds the whole or part of it on trust. This trust is created at every level of contract.
7. Payment Bonds

	UK	Australia NZ	USA Canada	Singapore
<b>CONTRACTURAL REMEDIES</b>				
Interest	Yes	Yes	Yes	
Suspension of works	Yes	Yes	Yes	
<b>ENFORCEMENT</b>				
Special Courts	Yes			
Arbitration	Yes			Yes
Adjudication	Yes			Yes
Mareva Injunction	Yes	Yes	Yes	Yes
<b>SECURITY</b>				
Liens			Yes	
Trusts			Yes	
Payment Bonds				Yes