

# Public Forum on “Back-To-Back” and “Pay-When-Paid” Clauses in Sub-Contracts

By: Ir. Wong See Foong and Ir. Fathullah Razzaq

It is a common misconception that in all instances when the main contractor does not get paid or that if payment is held back for some reasons, the sub-contractor consequently need not be paid as a result of which sub-contractors often have to bear with “back-to-back” arrangements.

Set against this backdrop, the IEM Sub-Committee on Engineering Contracts organised a Public Forum on Saturday, 27 November 2004 to enable the main players in the construction industry to meet and exchange their views on this very important issue. The main players are the project owners (principals/employers), the contractors, the consultants, and the sub-contractors.

The public forum held at Kolej Bandar Utama (KBU) received a rousing response from over two hundred and ten (210) participants. Seven speakers with diverse backgrounds from a legal practice, consultancy firm, Society of Construction Law (SCL), Electrical and Electronics Association of Malaysia (TEEAM), Master Builders Association (MBA), Institution of Surveyors Malaysia (ISM) and Pertubuhan Arkitek Malaysia (PAM) delved on various aspects of the issue. The panelists of the forum were Ir. Oon Chee Kheng (Chairman), Mr. Daniel Tan Chun Hao and Mr. Sundra Rajoo.

## I. “Pay-When-Paid” Clauses in Construction Sub-Contracts by Ir. Lim Eng Chong.

Ir. Lim Eng Chong in his paper analysed the topic from four aspects i.e.:

- The contractual status and rights of a sub-contractor vis-à-vis the employer;
- The different effects various draftsmen of sub-contracts attempt to change the main contractor’s payment obligations;
- Whether a main contractor is entitled to hold back from a sub-contractor for deductions suffered as a result of his (main contractor’s) own defaults; and
- Situations in which “pay-if-and-when-paid” payment terms are justified.

## II. “Back-To-Back” And “Pay-When-Paid” Clauses in Construction Sub-Contracts by Ir. Oon Chee Kheng.

Ir. Oon Chee Kheng expressed that Back-To-Back’ and ‘Pay When Paid’ are broad and

loose terms with no defined legal meanings and analysed his subject from the perspectives of literal and non-literal construction.

He detailed the alternative approaches in construing the above clauses in sub-contracts and provided a critique of the literal construction based on his analysis from first principles and the fact that these clauses are essentially condition precedents that have to be complied prior effecting payment.

In his opinion, “pay-when-paid” clause could not be legally supported, and can only serve (if they could be upheld) to postpone payment for a reasonable period of time.

It was his view that the higher judiciary should shed a more definitive meaning to and application of these clauses.

## III. “Sub-Contracting-Fundamentally Flawed?” by Ir. Ho Kin Wing.

Ir. Ho Kin Wing approached the issue from the perspective of sub-contracting within the context of the construction industry in Malaysia, its ills and challenges and expressed the following views.

At the initial stages of development of the construction industry, the main contractors were usually competent in most trades and execute the construction works themselves. The introduction of privatisation in the 80s saw sub-contracting practices being more dominant until today, where the main contractors assume roles more as management contractors.

Some of the issues pertaining to the ills or malpractices in the construction industry were :

1. practice of awarding projects due to patronage and not on meritorious grounds thus leading to:
  - a. poorer quality product or work as the multi-layer sub-contracting does not add any value but rather it dilutes the profit margins;
  - b. extended time of construction, disputes; and
  - c. abandonment of projects due to financial difficulties.
2. clients/main contractors squeeze the sub-contract price and still expect world class quality unlike 20-30 years back when contractors and sub-contractors were getting reasonable contract prices;

3. practice of either innocently or intentionally incorporating or importing contract terms and conditions without due regard to its effects and consequences; and
4. main Contractor’s lack of experience or knowledge to manage and administer the sub-contracts

Some of the proposed way forward were as follows:

- a. resolve the ills and challenges at the fundamental level with more proactive measures rather than reactive measures such as putting in more legislation;
- b. promote the understanding and good practice of effective construction process management ;
- c. construction industry players and practitioners to be professional and ethical in carrying out their duties;
- d. contractors and sub-contractors be more commercially astute such as calculating their risks; and
- e. implementing contractual and commercial approaches of a win-win nature.

## IV. “Pay-When-Paid”-from the sub-Contractor’s View Point? by Ir. Ng Khoon Hwa, Steven.

Ir. Steven provided interesting insights from the sub-contractors’ perspective. He observed that in many occasions, developers were usually one time players whereas main contractors and subcontractors were repeat players as business entities. Sub-contract is a legal expression of a relationship just like a marriage, involving client, main contractor and nominated sub-contractor/ sub-contractor.

Main contractor acted more of coordinator in specialist works and as critical conduit for money flows. Emphasising that cash flow is the lifeblood of the construction industry, he opined that mindset has changed and trust is a timed honored word of the yesteryears, consequently making the genuine and honest businesspersons suffer.

In his opinion, “Pay-When-Paid”-clause was a good example of clauses which could be extremely unfair to a sub-contractor because the sub-contractor may have completed works satisfactorily but not paid. This may be due to the owner/employer not being satisfied with the main contractor’s performance and executed set offs or impose

on the main contractor the Liquidated Ascertained Damages (LAD).

As advice to the sub-contractors, Ir. Steven reminded them that:

- a. sub-contractors should beware and take opportunity to study the conditions of the contract before bidding – particularly the payment terms. Once a sub-contract is effected, there is usually little useful recourse, if any;
- b. suspension and/or termination of sub-contract is both time consuming and costly. Legal recourse are lengthy and outcome uncertain. Justice delayed is justice denied;
- c. typically, the smaller sub-contractors vanquished before the case is even mentioned; and
- d. most payment issues were backward looking whereas project issues are forward looking.

#### V. "Pay-When-Paid" Clause In Construction Sub-Contracts? by Ms. Tan Swee Im.

Ms. Tan Swee Im approached the topic by mooting hard questions that appeared to deserve in depth deliberation. In relation to the above clause, she pointed out that the construction industry has seen projects being jammed resulting in a lot of disputes and distress. One of the fundamental problems in the disputes and distress was payment-be it non-payment, late payment or under payment.

Ms. Tan Swee Im believed that there should be resolution of fundamental issues including that of "Pay-When-Paid" clause. All parties should focus on deliberating on where the construction industry should go and how to get there.

#### VI. "Back-To-Back" And "Pay-When-Paid" Clauses In Construction Sub-Contracts by Mr. Noushad Ali Naseem Ameer Ali.

Mr. Noushad explored the topic by discussing the fundamentals of contracts, the provisions pertaining to "Back-To-Back" And "Pay-When-Paid" clauses and their variants. It was also mentioned that several advanced countries such as USA, Australia, New Zealand and Singapore have banned the provisions pertaining to "Back-To-Back" And "Pay-When-Paid" Clauses and their variants. He also reiterated an earlier emphasis that cash flow is the lifeblood of the construction industry and described typical payment problems and their present remedies available in the contracts. Those remedies were further elaborated in his paper.

Arbitration and litigation were still mooted as means to resolving payment disputes. Nevertheless, Mr. Noushad

expressed his views on key criteria for "successful" binding dispute resolutions.

He concluded that there would be no need to introduce new dispute resolution methods if the current dispute resolution mechanism had the "successful" key criteria mentioned. However, improvements could be made if the opportunity arose and if newer



Forum speakers exchange their views on "Back-to-Back" and "Pay-When-Paid" issues in sub-contracting work

resolution methods were consistent with the key criteria or complemented the current resolution mechanism.

#### VII. The Effect Of "Pay-When-Paid" Clause In PAM 98 Standard Forms Of Sub-Contracts by Ar. Chan Seong Aun.

Ar. Chan Seong Aun touched on three major aspects i.e. moral and ethics, statutory requirements and contractual issues. Based on PAM 1998 Main Contract, and in the context of rights and obligations of main contractors and sub-contractors. The Effect of "Pay-When-Paid" Clause to the relevant parties were illustrated as follows:

- The employer has no privity of contract between employer and nominated sub-contractor (NSC); and
- The main contractor's obligations and liabilities to pay the sub-contractor have been greatly reduced, pay only when paid; and he has "passed his obligation" under the contract to his sub-contractors while retaining his rights.
- The sub-contractor's rights under relevant clauses are rendered ineffective if there is no payment by the employer; while obligations and liabilities still remain.

In the aspect of moral and ethics, he was of the view that the only sustainable long term relationship is a win-win relationship. To this end although there is no direct contract between employer and sub-contractor, the employer has social responsibility to ensure all under his "organisation" are treated equitably and he is putting his project at risk of becoming abandoned when financial resources of sub-

contractors are exhausted. He also has moral responsibility to ensure his "employees" are paid.

The Main Contractor has lost his Self Respect if he entered into contract where he is not sure of being paid but yet not willing to carry financial risk by taking advantage of his position to unethically bully Sub-contractors

into carrying his Financial responsibilities. With this, the Main Contractor has absconded on his social responsibility to protect the rights of those working under him; and his unethical practices are damaging the industry he depends on.

Sub-contractors are placed in a no-win situation in a position where they can not protect their rights. Sub-contractors are "taught" that construction business is an "unethical" business and that they cannot trust anybody in construction. The Sub-contractors effectively are financing the project.

In the aspect of statutory requirements, he envisaged that although there is no direct contract between employer and sub-contractor employer has social responsibility to ensure his project complies with all statutory requirements – unpaid sub-contractors are not likely to comply; and Quality, Safety and Health issues would plague a project where sub-contractors remain unpaid.

The main contractors have very little or no control over sub-contractors they did not pay – quality and safety issues would arise often; and no one would trust or respect those who did not fulfill their financial obligations.

Un-paid sub-contractors would more likely to cut corners and produce low quality work and would usually "go slow" resulting in time cost exceeding saved "financial cost". The un-paid sub-contractors would eventually abandon the project, and would more likely to take higher risks and produce works not compliant to by-laws. ■