

Should A Sub-Contractor Sign A Sub-Contract With Pay-When-Paid Clause?

By the Entrusty Group

The Entrusty Group, a multi-disciplinary group of companies, of which, one of their specialisations is in project, commercial and contractual management, has been running a regular contractual question-and-answer section for MBAM members in the Master Builders Journal.

In this instalment of the series, the Entrusty Group will provide the answer to the frequently asked question above.

It is common in the Malaysian construction industry that many Contractors sub-let their works to their Sub-contractors on pay-when-paid/pay-if-paid basis. That is to say, unless the contractor receives payment from the Employer or client, the Sub-contractor/s will not receive theirs, correspondingly. Often, the Sub-contractors are burdened and suffer financially as a consequence of such practices, particularly when non-payment by the Employer bears no relation to the Sub-contractors works.

In the United Kingdom, the UK Housing Grants, Construction and Regeneration Act 1996 under Section 113(1)¹ has outlawed such pay-when-paid provisions, except in the case where the employer has become insolvent. Other Commonwealth jurisdictions have also followed suit or in the midst of doing so².

Let us examine the position in Malaysia in relation to our standard forms of construction Sub-contracts for nominated sub-contractors.

STANDARD FORMS OF SUB-CONTRACT (RELEVANT CLAUSES)

PAM Form of Building Sub-Contract

PAM Form contains a basically pay-when-certified provision.

Clause 11.3 requires the contractor, within 14 days of receipt of any certificate or duplicate copy thereof from the Architect, to notify and pay to the Sub-contractor the total value certified for the Sub-Contract Works including any authorised variations and any amounts ascertained under Clause 9.4 (Loss and Expense) less retention and amount previously paid.

In the event if the Contractor fails to make payment to the Sub-contractor and such failure continues for seven (7) days after the Sub-contractor's written notification, the Sub-contractor may (but without prejudice to any right or remedy) suspend the further execution of the Sub-Contract Works until such payment is made.

The said period of suspension is deemed an extension and be added to the period/s from completion as provided in the Appendix to the Sub-Contract. It shall not be deemed a delay which the Sub-contractor is liable.

Any extension of time granted to the Sub-contractor due to the Contractor's failure to pay does not entitle the Contractor to a reciprocate extension of time under the Main Contract.

Under the Main Contract, Clause 27.3 is consistent with the aforesaid sub-contract provision.

JKR/PWD Form of Sub-Contract

JKR Form was originally a pay-when-paid provision.

Clause 30(c) – unamended requires the Contractor to notify and pay to the Nominated Sub-contractor the sum allowed for in payment by the Government within fourteen (14) days of its receipt from the Government under the Main Contract which includes a sum in respect of the Sub-contract Works.

However, the amended Clause 30 (c), provides for the Government to pay the Nominated Sub-contractors direct within the period of honouring payment certificates.

Under the Main Contract, the amended Clause 28 (e) is consistent with the above amended provision.

IEM Conditions of Sub-Contract

IEM Sub-Contract Form, similar to PAM, is basically a pay-when-certified provision.

Clause 31 (c) requires the Contractor to notify and pay to the Nominated Sub-contractor his sum within thirty (30) days from the date of certification by the Engineer under the Main Contract which includes a sum in respect of the Sub-contract Works.

Under the Main Contract, Clause 28 is consistent with the aforesaid sub-contract provision.

CIDB Form of Sub-Contract for Building Works

CIDB Sub-Contract Form, is a combination of pay-when-paid with pay-when-certified.

Sub-clause 28.3 (b) requires the Contractor to pay the NSC the amount due in the said certificate within 7 Days:

¹ <http://www.hms.gov.uk/acts/acts1996/96053—p.htm#113>

² New Zealand : Construction Contracts Act 2002; Building and Construction Industry Security of Payment Amendment Act 2002 (NSW); Australia : Royal Commission into the Building and Construction Industry [Cole Royal Commission] - Building and Construction Industry Security of Payments Bill 2003 (Cth) (draft Bill)

- upon the expiry of Period of Honouring Certificate as stated in M-C Appendix, or
- upon the Contractor having received the Employer's payment; whichever is earlier.

Under sub-clause (c), it entitles the Contractor to deduct or set-off against any NSC's payment due, the amounts he is liable to pay to the Contractor under the Sub-Contract, provided SO is notified of the amounts and reasons for deductions/ set-off.

Sub-clause (d) is basically a deemed payment clause, which requires the Contractor to pay the NSC within 7 days even if no payment is actually made by the Employer arising from his set-off on Contractor's payment.

Under the Main Contract, Option Module C - Clause C3 is consistent with the aforesaid sub-contract provision.

Relevant Case Law

In *Timbro Development Ltd v Grimsby Diesel Motor Inc. (1988) 32 CLR 32(Ont.CA)* the Ontario Court of Appeal in denying the leave to appeal considered the pay-when-paid clause in a sub-contract work and held that the sub-contractor clearly assumed the risk of non-payment by the owner to the contractor and, since the owner did not pay Timbro, it was not obliged to pay its sub-contractors.

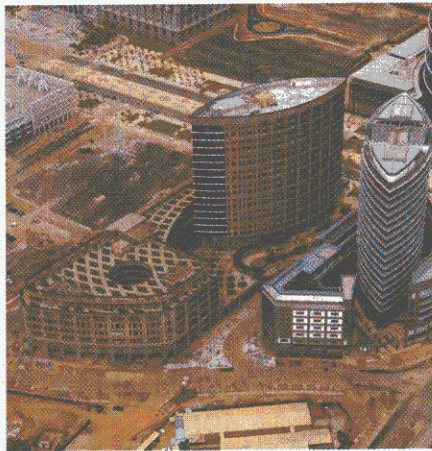
The clause concern is as written as follows:

"Payment will be made not more than thirty (30) days after the submission date of ten (10) days after certification or when we have been paid by the owner"

Accordingly, general jurisprudence on "pay-when-paid" clauses provides that in order to insulate the contractor from having to pay its sub-contractor (when the contractor has not been paid), the clause must clearly specify a condition governing the legal entitlement to payment and not merely the time of payment.

Conclusion

Whether a sub-contractor should sign a sub-contract with pay-when-paid clause would depend on several factors to consider:



- The likelihood of non-payment by the Employer (his financial standing);
- Relationship between the Contractor and Employer (if any);
- Any likelihood of the Employer assigning or novating the main contract;
- The Sub-contractor's financial standing and cash flow management;
- The bargaining power of the Sub-contractor;
- The standing and/or attractiveness of the sub-contract work;
- The Sub-contractor's risk analysis and management;
- Other commercial considerations.

A pay-when-paid provision serves to protect the Contractor from financial risks arising from the Employer's financial

difficulties by spreading such risks with the sub-contractors.

In general, it is more risky financially for a sub-contractor to sign a sub-contract with pay-when-paid clause with the Contractor as he is then exposed to the risks of both the Contractor and Employer.

Commercially, sub-contractors should not sign a sub-contract with pay-when-paid clause if possible unless they are willing to assume the risks of non-payment. However the business environment might not allow the sub-contractor to do so unless he is the only specialist contractor available for that particular type of work.

It is advisable for a sub-contractor to negotiate with the Contractor to limit his financial risks and cash flow exposures, either through some payment guarantee/ assurance or an agreed period of payment from the Contractor, similar to CIDB Sub-contract Form.

Under the current environment in the local construction industry, where there are many more sub-contractors than jobs or projects available, it makes these sub-contractors 'hungry' or desperate for the limited projects available and therefore signing such sub-contracts are common. The attitude of sub-contractors is to take on the projects under such conditions and "worry later". However be warned!

The next issue will be providing the answer to the question, **Is final account final? If not, what are the circumstances that allows revision to be made?**



The **Entrusty Group** includes Entrusty Consultancy Sdn Bhd (formerly known as J.D. Kingsfield (M) Sdn Bhd), BK Burns & Ong Sdn Bhd (a member of the Asia wide group BK Asia Pacific), Pro-Value Management, Proforce Management Services Sdn Bhd / Agensi Pekerjaan Proforce Sdn Bhd and International Master Trainers Sdn Bhd. Apart from project, commercial and contractual management services, the group also provides risk, resources, quality and value management, recruitment consultancy services and corporate training programmes to various industries, particularly in construction and petrochemical, both locally and internationally.

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