

## CONSTRUCTION CONTRACT & MANAGEMENT ISSUES

In this third quarter issue of Master Builders Journal for 2013, BK Burns & Ong Sdn Bhd, a subsidiary of **BK Asia Pacific**, an international construction consultancy group providing project, commercial and contractual management services joins with **Entrusty Group**, a multi-disciplinary group, collectively named **BK Entrusty**, to present a **new series of construction contract and management articles** in areas related to project, commercial, contracts, risks, quality, value and the like. This article on *“The Impending Demise of Conditional Payment Clauses in the Malaysian Construction Industry”* will be in three parts. Part One is published in this quarter and Parts Two and Three in the following quarters.

### INTRODUCTION

In the Malaysian construction industry it is a common practice that many contractors sub-let their works to subcontractors on 'pay-when-paid' or 'pay-if-paid' basis. That is to say unless the Contractor receives payment from the Employer, the Sub-Contractor will not receive its corresponding payment. Unfortunately, subcontractors are often burdened and suffer financially as a consequence of such practice, particularly when non-payment by the Employer to the Contractor bears no relation to the Sub-Contractor's payment entitlement for its sub-contract works.

In many cases, when the Contractor is related to the Employer directly or indirectly, such payment provision is often introduced into their sub-contracts, with ulterior motive and/or ill-intent of delaying or not-paying the sub-contractors. Unfortunately, the courts which have been deciding on such payment provisions on payment disputes by the contracting parties, have so far ruled and decided in favour and enforced them accordingly.

With the advent of Construction Industry Payment and Adjudication Act (“CIPAA”) 2012 which was gazetted on 22<sup>nd</sup> June 2012 coming into force soon, such bad practices will soon no longer be applicable in Malaysia. CIPAA primary objective is to address cash flow problems in the construction industry by *“removing the pervasive and prevalent practice of conditional payment (‘pay when paid’, ‘pay if paid’ and ‘back to back’) and reduces payment default by establishing a cheaper and speedier system of dispute resolution in the form of adjudication”* (KLRC, 2012).

In this three parts Article, BK Entrusty aims to provide readers with an appreciation of the past and present payment practices and provisions of conditional payment in Malaysia in the First Part, review the payment provisions and their implementation and practices in countries such as United Kingdom, Australia and Singapore, which have statutory Adjudication Act in the Second Part and introduce CIPAA, its pertinent features and provisions, including the issues, challenges and implications in the Third/Final Part.

The following are the main sub-headings of this three parts Article's contents:

#### Part One

- ◆ Introduction
- ◆ Past and present construction payment provisions and practices in Malaysia
- ◆ Payment provisions in United Kingdom, Australia and Singapore

#### Part Two

- ◆ Introduction
- ◆ Post Adjudication scenarios in United Kingdom, Australia and Singapore.

#### Part Three

- ◆ Introduction
- ◆ Pertinent features and provisions of CIPAA
- ◆ Issues, challenges and implications
- ◆ Summary/Conclusion
- ◆ References/Bibliography

With the above Introduction, Part One of this three parts Article, is presented below.

### PAST AND PRESENT CONSTRUCTION PAYMENT PROVISIONS AND PRACTICES IN MALAYSIA

In Malaysia, all construction standard and bespoke sub-contracts contain payment provisions. It is best for us to first examine these payment provisions in our standard forms of construction sub-contracts for nominated sub-contractors (“NSC”).

#### PAM Sub-Contract 2006

PAM Form contains basically a ‘pay-when-certified’ provision. Clause 26.3 requires the Contractor, within 7 days after the Period of Honouring Certificate to make payment to the Sub-Contractor less any retention, set off and amount previously paid. If the Contractor fails to make payment to the Sub-Contractor, who has requested for it, the Architect shall issue a certificate stating the amount of non-payment. The Employer may, but not obliged to, pay such amount directly to Sub-Contractor and deduct the same from the amount due or to become due to Contractor.

#### IEM Conditions of Sub-Contract (1990)

IEM Sub-Contract Form, similar to PAM is basically a ‘pay-when-certified’ provision. Clause 31(c) requires the Contractor to notify and pay 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.

### PWD Form 203N (2007) for Nominated Contractor

PWD form is similar to PAM and IEM Subcontract on 'pay-when-certified' basis, in that under Clause 34, after certification of Contractor's Interim Payment by Superintendent Officer and within the period of honouring certificates, the Government shall pay the amount certified to the Sub-Contractor directly.

### CIDB Form of Sub-Contract for Building Works (2002)

CIDB Sub Contract Form is a combination of 'pay-when-paid' with 'pay-when-certified'. Sub-clause 28.3 requires the Contractor to pay the Nominated Sub-Contractor the amount due in the said certificates within 7 days:

- Upon the expiry of Period of Honouring Certificate, or
- Upon the Contractor having received the Employer's payment whichever is earlier.

Sub-clause 28.3(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.

### Bespoke Sub-contracts

The following are typical payment provisions adopted by contractors in the bespoke sub-contracts:

#### a) Pay-if-Paid :

*"You have agreed that payments will be made to you within Forty Five [45] days after the receipt by the Contractor of main contract payment from the Employer."*

#### b) Pay-when-paid :

*"The period of honouring certificate of payment to Main Contractor shall be thirty (30) days from the date of Interim Certificate of Payment. Payment to Sub-Contractor shall be made within seven (7) days upon honouring of certificate of the Main Contract."*

#### c) Back-to-back payment :

*"The Contractor agrees to make monthly progress payments to the Sub-contractor, subject to the Main Contractor receiving from the Employer corresponding amount for the workdone by the Sub-contractor, less retention and previous payment made, on mutatis mutandis basis."*

The above examples are the past and current common conditional payment provisions practices in the Malaysian construction industry. However, with advent of CIPAA, such conditional payment provisions will no longer be allowed nor enforceable as the statutory adjudication will soon be implemented to deal with the aforesaid conditional payment provisions, accordingly.

### Interpretation and Position by the Courts on "Conditional Payment" Provisions

The common terms used for conditional payment are 'pay-when-paid', 'pay-if-paid' or 'back-to-back'. However, are there any distinction between these terms and the courts' interpretation and position on them? The following are recent court decisions relating to such conditional payment provisions or clauses;

*In Pernas Otis Elevator Co Sdn Bhd v Syarikat Pembinaan Yeoh Tiong Lay Sdn Bhd & Anor [2004] 5 CLJ*, the Court interpreted 'pay-when-paid' clause in sub-contract that reads, as follows:

*"Payment in respect of any work, material or goods comprised in the subcontract shall be made within seven (7) days after receipt by the Contractor from the Employer."*

The Court further interpreted the clause, as follow:

*"Clause 2.3 is clear and unambiguous, in that the defendant (the main contractor) is only liable to pay the plaintiff (the subcontractor) when the defendant had received the said payment or sum from the Employer and the payment to the plaintiff must be made within seven days after the receipt of the said sum by the defendant..... A "pay when paid" clause in one contract may be worded differently from another. Clauses such as cl. 2.3 in our present case, are common industry clauses, which must be accepted by the parties with knowledge of the attendant risks."*

The Court literally interpreted the 'pay-when-paid' clause as above and rejected the argument of the clause being unfair.

However, in the case of *Antah Schindler Sdn Bhd v Ssangyong Engineering & Construction Co. Ltd [2008] 3 MLJ 204*, the Court of Appeal strictly interpreted a similar 'pay-when-paid' clause to be unenforceable as it did not restrict a claim by the Sub-Contractor but merely imposed a time limit of the payment from Main Contractor to Sub-Contractor. This decision referred to a New Zealand case of *Smith & Smith Glass Ltd v Winstone Architectural Cladding Systems Ltd [1992] 2 NZLR 473*, where Master Towle made the following observations:

*"While I accept that in certain cases it may be possible for persons contracting with each other in relation to a major building contract to include in their agreement clear and unambiguous conditions which have to be fulfilled before a subcontractor has the right to be paid, any such agreement would have to make it clear beyond doubt that the arrangement was to be conditional and not merely governing the time for payment. I believe that the contra proferentum principle would apply to such clause and that he who seeks to rely upon such a clause to show that there was a condition precedent before liability to pay arose at all should show that the clause relied upon contain no ambiguity."*

Despite the Appeal Court making a stand on the Antah Schindler case, subsequent cases of *Asiapools (M) Sdn Bhd v IJM Construction Sdn Bhd [2010] 3 MLJ* and *Seloga Jaya Sdn Bhd v UEM Geisys Sdn Bhd [2010] 3 MLJ 721* have also interpreted 'pay-when-paid' clause as enforceable.

Recently in *Rira Bina Sdn Bhd v GBC Construction Sdn Bhd [2011] 2 MLJ*, the High Court went further to make a distinction between ‘pay-when-paid’ and ‘pay-if-paid’ clauses, as follows:

“68. In this regard the authorities clearly make a vital distinction between:

- (a) a ‘pay when paid’ condition, which merely means the contractor can delay payment until the same is received from the employer of the main contractor up to a reasonable time; and
- (b) a ‘pay if paid’ clause which grants the contractor absolute protection against payment to the subcontractor until and unless payment is made by the employer of main contractor, as pointed out in *Engineering & Construction Contracts Management – Post Commencement Practice*, (2002), LexisNexis by Ir Harbans Singh KS at pp 385-392.

69. A ‘pay when paid’ clause has never been interpreted to be an absolute bar to payment. On the other hand a ‘pay if paid’ clause must be clear and unambiguous in its effect before the court will lend credence to it...”

The battle of ‘pay-when-paid’ and ‘pay-if-paid’ clause interpretation in the courts have yet to end as they do not consistently agree on the interpretation not take a common position on such provision.

Nevertheless, the argument and enforceability of ‘pay-when-paid’ and ‘pay-if-paid’ will eventually come to an end when CIPAA is implemented, which is expected to be very soon in Malaysia.

CIPAA, its aim, objectives and pertinent features and provisions will be discussed in Part Three of this Article.

## **PAYMENT PROVISIONS IN UNITED KINGDOM, AUSTRALIA AND SINGAPORE**

### ***United Kingdom***

Adjudication was first implemented in United Kingdom to address the cash flow problems due to non-payments in its construction industry. In 1998, United Kingdom launched Housing Grants Construction and Regeneration (HGCR) Act 1996 and supplemented by the Scheme for Construction Contracts (England and Wales) Regulation 1998. HGCR Act has been applied to all construction contracts which defined under Section 104 of the said Act but limited to written contracts as defined under Section 107.

Under the HGCR Act Section 110, a party may withhold a payment provided he has given an effective notice of intention to withhold payment. Such a notice must be given no later than the prescribed period before the final date for payment and must specify:

- a) the amount proposed to be withheld and the ground for withholding payment, or

- b) if there is more than one ground, each ground and the amount attributable to it.

However, under HGCR Act Section 112, a party (“payee”) has the right to suspend the work if the sum due is not paid in full by the final date for payment and no effective notice to withhold payment has been given by the payer. Notice of intention to suspend performance is condition precedence for the suspension. The right to suspend performance ceases when the party in default makes full payment of the amount due.

HGCR Act Section 113 clearly stated that conditional payment is ineffective, as follow:

“A provision making payment under a construction contract conditional on the payer receiving payment from a third person is ineffective, unless that third person, or any other person payment by whom is under the contract (directly or indirectly) a condition of payment by that third person, is insolvent.”

HGCR Act Section 108, allows adjudication of disputes under construction contract, to:

- a) enable a party to give notice at any time of his intention to refer a dispute to adjudication;
- b) provide a timetable with the object of securing the appointment of the adjudicator and referral of the dispute to him within 7 days of such notice;
- c) require the adjudicator to reach a decision within 28 days of referral or such longer period as is agreed by the parties after the dispute has been referred;
- d) allow the adjudicator to extend the period of 28 days by up to 14 days, with the consent of the party by whom the dispute was referred;
- e) impose a duty on the adjudicator to act impartially; and
- f) enable the adjudicator to take the initiative in ascertaining the facts and the law.

In addition, the adjudication decision is binding unless the dispute is brought to arbitration or litigation, subsequently. In any case, the adjudicator is not liable for anything done or omitted in the discharge of his functions as adjudicator unless the act or omission is in bad faith.

### ***Australia***

The first legislation on the construction industry payment and adjudication in Australia was implemented by New South Wales. The act was named as Building and Construction Industry Security of Payment Act 1999 (BCISP Act). In over a decade since BCISP Act was implemented, all states and territories have introduced similar security of payment legislation in an attempt to

remedy and recover delay of payments and improving cash flow throughout the Australian construction industry. Coggins, Elliot and Bell (2010) revealed that all the said legislations allowed for statutory adjudication scheme but differ in the adjudication procedures and process.

In this part article, we will only focus on BCISP Act adopted by New South Wales as an example of statutory payment adjudication act and implementation in Australia.

BCISP Act is modeled from HGCR Act and apply to any party that contracts to carry out construction work or supply related goods or services, as listed in the Section 5, 6 and 7 of BCISP Act. The said Act covers written contracts, oral or partly written and partly oral ones. Its objective is to ensure the contracting party promptly receives all payments that are due, including final payment and retention monies.

Under BCSIP Act, progress payment is defined as *“a payment to which a person is entitled under section 8, and includes (without affecting any such entitlement):*

- a) *the final payment for construction work carried out (or for related goods and services supplied) under a construction contract, or*
- b) *a single or one-off payment for carrying out construction work (or for supplying related goods and services) under a construction contract, or*
- c) *a payment that is based on an event or date (known in the building and construction industry as a "milestone payment").”*

Section 8 of BCISP Act gives a statutory right to a party normally Contractor or Sub Contractor (“Payee” or “Claimant”) to make progress payment claims and receive payments, even if the contract has no provision for progress payments. If the other party whom payment claim is served (“Payer” or “Respondent”) claims to have reasons for not paying a claim or paying less than scheduled amount, under Section 14 of BCISP Act, the Payer must indicate such reason/s in the payment schedule.

In the event of the Payer fails to pay the whole or part of amount claimed or the Claimant disputes the reasons for withholding payment, as given by the Respondent in the payment schedule, the Claimant can make an adjudication application in relation to the payment claim or serve notice on the Claimant’s intention to suspend the work.

Similar to HGCR Act, BCSIP Act also prohibited ‘pay-if-paid’ and ‘pay-when-paid’ clauses, even if they are included in the contract. BCISP Act also provides for the definition of ‘paid-if-paid’ and ‘pay-when-paid’ as follows;

- a) *“that makes the liability of one party (the **"first party"**) to pay money owing to another party (the **"second party"**) contingent on payment to the first party by a further party (the **"third party"**) of the whole or any part of that money, or*
- b) *that makes the due date for payment of money owing by the first*

*party to the second party dependent on the date on which payment of the whole or any part of that money is made to the first party by the third party, or*

- c) *that otherwise makes the liability to pay money owing, or the due date for payment of money owing, contingent or dependent on the operation of another contract.”*

Other than prohibitions by the above provision, the following contract provisions are also void under the said BCISP Act;

- a) any provision which would limit interest on late progress payments (Section 11.1);
- b) any provision that are inconsistent with the Act (Section 34.2(a));
- c) any provision that attempt to “contract out” of the Act (Section 34.1); and
- d) any provision aimed to deter a person from taking action under the Act (Section 34.2(b)).

### **Singapore**

Singapore enacted a Building and Construction Industry Security of Payment Act 2004 (“SOP Act”) modelled from BCISP Act adopted by New South Wales Act, Australia in 2005. The SOP Act is supplemented by the Building and Construction Industry Security of Payment Regulations (2006 Revised Edition). The SOP Act objectives are to facilitate cash flow and resolve payment disputes in the construction industry by introducing statutory adjudication.

Similar to BCISP Act, SOP Act focuses on tackling issue on outstanding progress payment by adjudication. In Part 1 of the SOP Act, the Act focuses on providing the interpretation and definition of terms especially definition of construction work (Section 3) which is broadly defined. Further in Parts 2 and 3, they describe right to progress payments and mechanism of payment. While, from Sections 4 until 6, they cover the procedures, costs and effects of the adjudication.

SOP Act is applied to all construction contracts (construction works and supply of services) and supply contracts (including supply of goods) but limited to written contract which is broadly defined under Section 4. In addition, under Section 4.2 of SOP Act, it does not apply to construction projects or sites outside Singapore, residential properties (if building control approval not required) and an employee under an employment contract for carrying out construction work and/or supply related goods and services.

Under Section 9 of SOP Act clearly prohibited ‘pay-when-paid’ provision or provision with similar meaning. It further provides the definition of “pay-when-paid” provision as follow:

- a) that makes the liability of one party (referred to in this definition as the first party) to pay money owing to another party (referred to in this definition as the second party) contingent or conditional on payment to the first party by a further party (referred to in this definition as the third party) of the whole or any part of that money;
- b) that makes the due date for payment of money owing by the first party to the second party contingent or conditional on the date on which payment of the whole or any part of that money is made to the first party by the third party;
- c) that otherwise makes the liability to pay money owing, or the due date for payment of money owing, contingent or conditional on the operation of any other contract or agreement; or
- d) that is of such kind as may be prescribed.

Other than 'pay-when-paid' provision, there are other contract provisions that are void under SOP Act which as follow:

- a) any contract provision which attempt to avoid on imposing interest on late progress payments (Section 8.5(b));
- b) any contract provision which attempt to "contract out" of the Act (Section 36.1);
- c) a provision under which the operation of this Act or any part thereof is, or is purported to be, excluded, modified, restricted or in any way prejudiced, or that has the effect of excluding, modifying, restricting or prejudicing the operation of this Act or any part thereof (Section 36.2(a));
- d) any contract provision that aimed a person from taking action under the Act (Section 36.2(b)).

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**Part Two and Part Three of this Article will be published in the subsequent two quarters of the MBAM Journal.**

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