

Construction Contract and Management Issues

In this 2nd quarter issue of Master Builders Journal for 2017, 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 **“Subcontracting – Issues and Implications”**, in three parts, Part 1 of 3 in this quarter and Part 2 of 3 in the next quarter.

1. INTRODUCTION

Subcontracting is a practice prevalent in many industries, both local and international, but most widespread and common in the construction industry.

Historically, subcontracting practice in the construction industry had existed since time immemorial, and it formed an integral part of building or construction projects. In Malaysia, subcontracting in its construction industry is no different, in that such practice had existed even before the colonial times.

The nature and characteristics of construction projects and the building or production process, which involve diverse work activities and tasks, require various resources and technical capabilities, often beyond that of most contractors. With limited resources and capabilities, contractors normally subcontract or sub-let their building or construction works to subcontractors, so as to reduce their project risks, including construction time and costs, thereby enhancing their overall performance and profitability.

Subcontracting practice, which usually involves a contractor, who has been awarded a construction project by an employer, getting into a subcontract with another party, either an individual or a company, often known as a subcontractor, to undertake a part or parts of the construction works. The contractor has an overall contractual responsibility and liability for its execution and completion, accordingly.

Whilst subcontracting offers many advantages or benefits, its practice is also tainted with many issues, often problems relating to work performance, time, costs, quality, variations, payments, etc. From them, arise various implications, some

with adverse consequences such as poor quality works, work delays or non-completion, lack or non-payment, works suspension or termination.

In this three parts article, BK Entrusty aims to provide readers with a better understanding of subcontracting in the Malaysian Construction Industry and its pertinent issues and implications, by the following article contents;

1. Introduction
2. What is Subcontracting?
3. Why Subcontracting?
4. Subcontract provisions
5. Pertinent issues and their implications
6. Conclusion

2. What is Subcontracting?

In the construction industry, subcontracting is the subletting of the building or construction trade/s or part/s of the construction works by the contractor of a construction project to an individual or company, often known as a subcontractor, who undertakes part/s of the works under a subcontract. Notwithstanding, the contractor still has the overall contractual responsibility and liability to the employer for the execution and completion of the construction project, accordingly.

In recent years, the word “sublet” or “subletting” has been phased out and replaced with subcontracting, as it is often confused and mistaken for subletting or sublease of property or its tenancy.

Subcontracting is not to be confused with outsourcing, as the latter usually involves cost effective substitution or replacement of internal resources by procuring, usually services or products, from an outside source. Subcontracting is also distinctly different from assignment, in that the latter requires the contracting party's written consent to assign rights, interests or benefits under the contract to another party. For example, contractors and subcontractors often assign their payment rights to financing institutions in order to secure credit facilities for their construction projects. In subcontracting, it is not just assigning of rights, but also liabilities as well. Subcontracting practice is common but often not without its issues and implications, particularly if the subcontractors are not procured and managed properly.

In essence, subcontracting is a contractual arrangement between a contractor and a subcontractor usually with a letter of award or acceptance, followed by formal subcontract documentation for the carrying out and completion of the subcontract works. It is a part of the overall construction works contracted by a contractor with an employer for a construction project, which the contractor remains legally responsible and liable for its due performance under a main contract with the employer. The contractor is also responsible and liable for any acts, defaults or neglects of its subcontractors, their representatives, agents and workmen.

Basically, subcontracting can be divided into three broad works categories, namely;

1. ordinary or traditional, being those who undertake one or more building trades such as concreting, brickwork, tiling, plastering, painting and the like.
2. specialists, often nominated, who undertake specialist works such as mechanical, electrical, landscaping, curtain walling, etc., which can include related design.
3. provision of labour only, being most common and widely practiced;

In all Malaysian standard forms of building or construction contract, subcontracting requires the Architect, Engineer or Superintending Officer ("SO"), depending on the form, to consider and give his written consent, upon request by the contractor, for subcontracting any part/s of the contract works. However, such consent, does not relieve the contractor from its contractual liabilities or obligations. Usually no consent is necessary for labour provision, material purchase and nominated subcontractors' works. In fact under PAM, labour only subcontract is expressly stated as not subcontracting (PAM-CI.18.2).

Despite the aforesaid contractual provision, contractors are often ignorant in getting written consent from the employer or its consultant/s. The fact that many employers and consultants also do not enforce such contract provision, makes subcontracting, in particular domestic subcontractors, a norm and acceptable practice in the construction industry.

3. Why Subcontracting?

The nature and characteristics of construction projects and their building or production process, make it rather unique compared to other industries and their processes. Unlike most

industries, whereby their production process is in confined or controlled environment, most construction works are carried out in open environment, often susceptible to weather conditions, sometimes adverse.

Construction projects are characterized by the diverse work activities and tasks, which require numerous resources, including technical and skilled capabilities. As most contractors, only have limited core resources and capabilities, they have to resort to subcontract or sub-let their construction works to subcontractors and manage them properly and efficiently. In doing so, they reduce their project risks, including construction time and costs, thereby enhancing their overall performance and profitability.

Provided suitable and competent subcontractors are employed for the appropriate subcontract work by the contractor of the construction project, the common advantages or benefits in subcontracting are;

- a. risks mitigation and/or transfer;
- b. diversity in work resources and/or skills;
- c. reduce direct workforce employment;
- d. increase work performance and/or productivity;
- e. improves efficiency and profitability;
- f. quality assurance and improvements;
- g. lower site overheads and costs;
- h. provide flexibility and adaptability;
- i. better focus on core resources and/or competencies;
- j. achieves project objectives.

Whilst the positive aspects in subcontracting usually far outweigh direct contracting, inevitably there are pitfalls in subcontracting practice, especially when insufficient or no consideration is given in the appointment of suitable and competent subcontractors for the subcontract works of the construction project.

These subcontracting pitfalls, can include;

- a. disruption and/or delay;
- b. costs overrun;
- c. poor quality and workmanship;
- d. lack of skills or competencies;
- e. payment disruption and/or delays;
- f. variations or changes;
- g. unnecessary claims;
- h. defective works;
- i. reputation loss.

4. Subcontract provisions

In Malaysia, the subcontracting provisions can be found under the following standard forms of main building or construction contract ("MC"):

- a. PAM 2006 - Clause 17 & 27;
- b. PWD/JKR 2010 - Clauses 47, 60 to 63;
- c. IEM CE 2011 - Clauses 54 & 57;
- d. CIDB - Clause 40 and Option Module C.

All the aforesaid main contract forms have their respective standard subcontract forms containing a comprehensive subcontract terms and conditions. It is not the intention of this article to describe nor discuss them. However, in terms of the

related standard nominated subcontract forms (“NSC”), the relevant subcontract provisions relating to pertinent issues and implications in subcontracting, are tabulated below;

| Pertinent Subcontract Provision | PAM | IEM | JKR | CIDB |
|--|-------------------|-------------|-------------|-------------|
| Sub-Contractor’s Obligations/Liabilities | Cl. 2 & 3 | Cl. 3 | Cl. 6 | Cl. 5 & 6 |
| Instructions | Cl. 5 | Cl. 4 | Cl. 7 | Cl. 4 |
| Variations | Cl. 12 | Cl. 16 & 17 | Cl. 20 & 21 | Cl. 16 |
| Commencement and Completion | Cl. 15 | Cl. 25 | Cl. 29 | Cl. 17 |
| Practical Completion | Cl. 17 | Cl.25(b) | Cl. 29.2 | Cl. 17.2 |
| Insurance | Cl. 20 | Cl. 20 – 23 | Cl. 24 – 27 | Cl. 23 – 25 |
| Extension of Time | Cl. 21 | Cl. 26 | Cl. 30 | Cl.19 |
| Loss and/or Expenses | Cl. 22 | Cl. 35 | Cl. 32.2 | Cl. 26 |
| Damages for Non-Completion | Cl. 16 | Cl. 27 | Cl. 31 | Cl. 20 |
| Certificates and Payment | Cl. 26 | Cl. 31- 33 | Cl. 35 – 37 | Cl. 28 – 30 |
| Set-offs | Cl. 26.13 & 26.14 | Cl. 34 | Cl. 38 | Cl. 28.3 |
| Defective Works | Cl. 17 | Cl. 18 | Cl. 22 | Cl. 21 |
| Arbitration | Cl. 29 | Cl. 36 | Cl. 40 | Cl. 34 |

Pertinent Issues and Implications

The Malaysian construction industry, in terms of its nature and characteristics, is no different, in fact very similar to most other construction industries around the world. The following pertinent issues and their implications in subcontracting are discussed around the relevant subcontract provisions of the aforesaid NSC forms for subcontract works;

- i. Obligations and Liabilities
- ii. Commencement and Completion;
- iii. Instructions and Variations;
- iv. Extension of Time;
- v. Damages for Non-Completion;
- vi. Loss and/or Expense;
- vii. Payments and Set-offs;
- viii. Defective works.

i. Obligations and Liabilities

Subcontracting may be procured on different basis, namely nominated, named or designated and domestic between the contracting parties.

For nominated basis, the employer and/or its consultants nominate the subcontractors at the outset of a construction project, usually called “nominated subcontractor” using a prescribed standard form of nominated subcontract. In named or designated basis, the subcontractors are usually pre-selected and named or designated in the main contract by the employer/consultants for the contractor to appoint as “named or designated subcontractors”.

By far the most common basis is the “domestic subcontractors”, who are selected and engaged unilaterally by the contractor, with no employer’s or consultant’s involvement, except in giving consent under the main contract, if required. The subcontract documentation between a contractor and a subcontractor, called “domestic subcontract”, is usually not standard, but ad hoc or bespoke subcontract terms and conditions, which include amongst others, quality of works, payment, variation, liquidated damages, defects liability period imposed by the contractor or negotiated between the contracting parties. Many a times, these terms and conditions are on *mutatis mutandis* or “back-to-back” basis with the necessary changes made to the main contract.

Whether it is nominated, named/designated or domestic basis, there is usually no privity of contract between a subcontractor

and an employer, but only with the contractor concern, unless there exist a collateral warranty or parallel contract between the subcontractor and the employer. In other words, subcontractors are not contractually nor legally responsible or liable to the employer, except when there is a separate or parallel contract with them, in addition to their subcontract with the contractor.

Privity of contract means that a subcontractor cannot be made directly liable to the employer for a breach of the main contract. Neither can the employer in principle claim damages from the subcontractor for its breach, as the employer is not a party to the subcontract. Despite no privity of contract, the parties can create an additional contractual link through direct warranty or separate collateral agreement. Otherwise, the recourse for both the employer and domestic subcontractor is to claim against the contractor under the main contract and subcontract, respectively.

In terms of rights and liabilities, subcontractors are responsible and liable to the contractor, who engage and appoint them via subcontract arrangement, usually after tender or price negotiation for the subcontract works. These subcontract prices then get “mark-up” by the contractor to include an overhead and profit percentage in the main contract between the contractor and employer. Any subcontractor who breach its subcontract will be liable to the contractor for damages depending on the latter’s own losses and expense which it in turn has to pay to the employer under the main contract.

The typical obligations and liabilities of subcontractors can be found under PAM Main Contract, clause 27.2, which are summarized, as follows;

- a. *Carries out and completes subcontract works according to satisfaction and requirements of the Contractor/Architect;*
- b. *Observes, performs and complies with contract provisions which relates to Subcontract works;*
- c. *Indemnifies the Contractor against same liabilities;*
- d. *Indemnifies the Contractor against his own negligence, omission or default and shall insure against such claims;*
- e. *Sub-contract works completion within specified period;*
- f. *If the Nominated Sub-Contractor fails to complete within specified or extended time, he shall allow or pay the Contractor for the loss/expense suffered;*
- g. *Receives payment from the Contractor for works, materials or goods by the Nominated Sub-Contractor within stipulated period;*
- h. *Gives access to Nominated Sub-Contractor’s workshops, etc. as required by Architect and the Contractor.*

Notwithstanding, the contractor is still responsible and liable to the employer contractually and legally for the subcontractors’ performance (or otherwise) of their subcontract works, whether be it time, cost and/or quality. In short, subcontracting practice is at the contractor’s sole risks.

Under the Malaysian standard forms, PAM-CI.27.9 obligates the contractor to be fully responsible its nominated subcontractors to carry out their sub-contract works in accordance with the nominated subcontract.

The employer is usually not liable to the nominated subcontractors. In the PAM Subcontract, clause 16.1 requires the subcontractor to pay to the contractor a sum equivalent to any loss or damage suffered by the contractor when the subcontractor fails to complete its subcontract works within the specified period or extended period under the said Subcontract. The other standard subcontract forms, IEM-CI.27, JKR-CI.31(a) and CIDB-CI.20.1 are similarly worded, in this respect.

For the employer, any relationship with the subcontractors, notwithstanding the existence of subcontracts between the contractor and its subcontractors, the employer may exercise his rights or remedies, or be subjected to liabilities, as between the employer and the subcontractors through collateral or direct warranties and/or in tort of negligence.

Unlike domestic subcontractors, whose relationship with the employer is not sufficiently 'proximate' to carry with it a legal duty of care, nominated subcontractors may incur direct liability to the employer in tort of negligence, example for defective work.

For domestic subcontractors who negligently cause physical damage, either to the contract works or property of the employer or third party, a different legal problem can arise. In the case of *Norwich CC v Harvey (1989) 1 ALL ER 1180*, which involved constructing an extension to a swimming pool complex, the domestic subcontractor negligently caused a fire, damaging the contract works and existing structure. The main contract, let under JCT 1963 (similar to old PAM 69 form) which provided for all damages from fire at the sole risk of the employer. The Court of Appeal held that the domestic subcontractor could not directly take benefit of the main contract provision, since it is not a party to the main contract. However, against this contractual risk allocation, the Court ruled that it would not be 'just and reasonable' to impose a duty of care upon the said subcontractor, who escaped liability for its negligence.

As to the domestic subcontractors' legal rights, they are generally against the contractor, except some rights against the employer such as payment and certain remedies for breach of contract.

A subcontractor's payment demand is often challenged by the contractor due to delay, defective work or other breach of contract either through express contractual provision or common law right to set off. In the absence of any such

express provision, it can be implied that if the contractor commits a serious breach under the main contract, causing the employer to remove both parties, both the employer and subcontractor can recover damages from the contractor. In the case of *Dyer v Simon Build (1982) 23 BLR 23*, where ICE form of contract was used, the main contractor was expelled from the site after the engineer had certified that it failed to proceed with due diligence. The main contractor argued that he is entitled to terminate its subcontract with the subcontractor (plaintiff) and to pay the plaintiff only what was due under the sub-contract conditions, excluding the plaintiff's loss of profit. It was held that, since the main contract had not been 'determined' by the employer's action, the sub-contract condition did not apply and the plaintiff was entitled to recover damages, including their lost profit.

The lack of direct contractual link between employer and subcontractor (or supplier) can mean an employer is not liable to pay directly for work done or materials supplied as evident from the case of *Hampton v Glamorgan CC (1917) AC 13*, when the contractor failed to pay the full amount to heating specialist contractor. The latter sued the employer for the balance. It was held that the contractor's overall obligation included providing the heating apparatus within the provisional sum, hence the employer was therefore not liable to the heating specialist for the balance of the price.

Even if the employer promised to ensure outstanding payment to the subcontractor due to the contractor in liquidation, this did not create any legal obligation on the employer's part to pay [*Victorian Railway Commissioners v James L Williams Pty Ltd (1969) 44 ALJR 32*]. In general, once the ownership of the materials or goods has passed from the subcontractor to the contractor, any lien or similar right on the subcontractor's part would have come to an end. That said, the recent Construction Industry Payment Adjudication Act (2012), allows the subcontractor to get direct payment from the employer if the contractor fails to pay any adjudicated amount due to the subcontractor in payment related disputes. ■

In the next issue of the MBAM journal, this article on "Subcontracting – Issues and Implications" continues with its Part 2 of 3

BK Asia Pacific

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