

**THE APPLICATION OF “PAY WHEN PAID” PROVISIONS
IN CONSTRUCTION SUB-CONTRACT**

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THE APPLICATION OF “PAY WHEN PAID” PROVISIONS IN CONSTRUCTION
SUB-CONTRACT

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A project report submitted in partial fulfillment of the
requirements for the award of the degree of
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DEDICATION

Specially dedicated

To my parents ‘Encik Ibrahim Mohd Amin & Puan Jaradah Hj Abdul Majid’

To my sisters ‘Nadya Alina, Nadwanie Harniza, Nazlin, Nazirah’

To my brother ‘Mohd Nazriey’

To my lovely friends ‘Sakina, Hairani, Roslinda, Haizan’

..... Thank you for everything

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ABSTRACT

For years, general contractors have often enclosed a contractual provision of “pay when paid” in their subcontracts providing that payment to the subcontractor is conditioned upon the general contractor’s actual receipt of payment from the owner. “Pay-when-paid” clauses while seemingly straightforward at first glance but many are actually ambiguous. Instead of “pay when paid” arrangement waiving the right of the subcontractor to be paid, there is competing argument that this clause speaks to timing of payment. Hence, this research intends to identify whether “pay when paid” arrangement in construction sub-contract waiving the right of the subcontractor to be paid or simply a timing mechanism. This research was carried out mainly through documentary analysis of law journals and law reports. Results shows that 8 out of 11 cases identify that “pay when paid” provision in the sub-contract constitute as timing mechanism. “Pay When Paid” provision may become either as timing mechanism and waiving the subcontractor right to be paid. Most of the cases cited that wording of the contractual language in the sub-contract is critical in identify the application of “pay when paid” provision. Unambiguously and sufficiently clearly contractual language must have been used in order for a court to construe such a clause imposed payment to the main contractor as condition precedent to the subcontractor’s right to be paid, rather than limiting the time for payment. Once a judge decides that provision is ambiguous there is nothing for the jury to decide or interpret. Therefore, the subcontractor may take the legal action to challenge the enforceability of the clause to seek immediate payment when they have suffering the risk of non-payment due to the performance problems unrelated to their own work.

ABSTRAK

Selama bertahun-tahun, kontraktor utama kerap kali memasukkan peruntukan berkontrak “bayar apabila dibayar” dalam sub-kontrak pembinaan dengan memperuntukkan bahawa pembayaran kepada subkontraktor berdasarkan keadaan kontraktor menerima pembayaran sebenar daripada pemilik. Kluasa “bayar apabila dibayar” sekilas pandang jelas dan mudah maknanya tetapi kebanyakannya adalah kabur maknanya. Selain daripada provisyen “bayar apabila dibayar” mengenetepikan hak subkontrak untuk mendapat pembayaran, terdapat percaturan lain yang menyatakan bahawa klausa ini bercakap mengenai masa untuk mendapatkan pembayaran. Oleh itu, kajian ini bertujuan untuk mengenalpasti samada peruntukan “bayar apabila dibayar” di dalam sub-kontrak pembinaan mengenetepikan hak subkontraktor untuk mendapatkan pembayaran atau ianya mengenakan tempoh masa untuk membuat pembayaran. Kajian ini dijalankan melalui analisis dokumen, iaitu laporan dan jurnal undang-undang. Kajian ini menunjukkan 8 daripada 11 kes menunjukkan klausa “bayar apabila dibayar” mengenakan tempoh masa untuk membuat pembayaran. Peruntukan “bayar apabila dibayar” boleh dianggap sebagai mekanisme masa dan juga sebagai mengenetepikan hak subkontraktor untuk mendapat pembayaran. Kesuluruhan kes menyatakan bahawa bahasa kontrak adalah kritikal (amat penting) dalam menentukan aplikasi klausa “bayar apabila dibayar”. Klausa yang cukup jelas dan terang tanpa maksud yang samar adalah penting untuk memastikan mahkamah memutuskan bahawa klausa tersebut mengenakan pembayaran kepada kontraktor adalah duluan kepada hak subkontraktor untuk dibayar, selain daripada menghadkan tempoh pembayaran. Apabila hakim memutuskan apabila klausa tersebut samar maknanya adalah tiada kemungkinan untuk juri dan hakim untuk memutuskan dan mengolahkannya lagi. Oleh itu, subkontraktor boleh mengambil tindakan mahkamah dalam mencabar keberkuatkuasaan klausa tersebut dalam mendapatkan pembayaran secara cepat apabila mereka dalam risiko tidak dibayar berdasarkan masalah perlaksanaan yang tiada kaitan dengan kerjanya.

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LIST OF ABBREVIATIONS

AC	Law Report Appeal Cases
ALJ	Australian Law Journal
ALR	Australian Law Report
CA	Court of Appeal
CIDB	Construction Industry Development Board
DC	Division Court England
DLR	Dominion Law Reports
FC	Federal Court
HL	House of Lords
HKC	Hong Kong Case
HKLR	Hong Kong Law Reports
IEM	The Institution of Engineers, Malaysia
LGR	Local Government Reports
LR	Law Reports
JP	Justice of the Peace
MBAM	Master Builders Association
MLJ	Malayan Law Journal
NS	Nova Scotia
NZLR	New Zealand Law Reports
PAM	Pertubuhan Arkitek Malaysia
PWD	Public Work Development
PD	Probate, Divorce, and Admiralty Division of High Court

SLR	Singapore Law Report
UM	University of Malaya
USA	United State of America
WLR	Weekly Law Report
WR	Weekly Reports

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CHAPTER 1

INTRODUCTION

1.1 Background of Research

The modern construction project is so marvelously complex that is amazing that anything ever gets built¹. Construction projects can best be understood in the context of the whole industry. Technological complexity ranges from the familiar, well known-materials and trades through to highly complex facilities involving multiple interacting sub-systems². Besides that, it is labor intensive with manpower remaining the most important and critical resources for a construction project³. Project have multitude of

¹ Fullerton, J.D. (2008). *Changes, Delays and Other Claims*.

² Murdoch, J. and Hughes, W. (2008). *Construction Contracts: Law and Management 4th Edition*. London and New York: Taylor & Francis. Pg 3

³ Ng Chu Yin (2006). *Problems Associated With Nominated Subcontractor in Malaysian Construction Industry*. Johor: Universiti Teknologi Malaysia. Pg1

players, including owners, general contractors, subcontractors, architects, engineers, and various material suppliers and laborers⁴.

Letting work to subcontractors is a very common practice in construction industry. It is common for 80 percent to 90 percent of the work to be performed by subcontractors⁵. Subcontractor is specialized providers of particular construction services and often the necessary materials for their work. Subcontractors include masons, plumbers, electricians, painters, glaziers, roofers, and other mechanics. Traditionally, subcontractors enter into contracts with the Contractor (not the Owner) and acquire the materials necessary to perform the subcontracts from Supplier. First-tier Subcontractors often subcontract various portions of their responsibilities to lower-tier subcontractors, each of which may acquire their materials from numerous suppliers⁶. The general contractor is responsible for coordination of all these subcontractors. Variance in experience or competence in this coordination can dramatically impact a project⁷.

Subcontracting has always been important in the construction industry, particularly in building construction where the production process is divided into number of discrete. These task or activities are often carries out sequentially and may require specialized labor. Subcontractors help contractors overcome problems including the need of special expertise, shortage in resources, and limitations in finance⁸. The successful completion of construction contracts, particularly in building construction, depends in large measure on the quality and timely performance of the subcontractor.

⁴ Rippeon, Z. (2007). *Conditional Payment Clauses in Construction Contracts*. Georgia: Georgia State University College of Law.

⁵ Ng Chu Yin (2006). *Problems Associated With Nominated Subcontractor in Malaysian Construction Industry*. Johor: Universiti Teknologi Malaysia. Pg 2

⁶ McCarroll, B. (2006). *The Construction Process from Start to Finish in Texas*. Lorman Education Services, Texas. Pg4-5

⁷ Fullerton, J.D. (2008). *Changes, Delays and Other Claims*.

⁸ Ng Chu Yin (2006). *Problems Associated With Nominated Subcontractor in Malaysian Construction Industry*. Johor: Universiti Teknologi Malaysia

Contingent payment provisions are found in nearly every construction contract, particularly for commercial development⁹. A contingent payment clause is a contractual provision that makes payment contingent upon the happening of some event. In construction subcontracts, the typical contingent payment clause makes the subcontractor's payment contingent upon the payment of the contractor by the owner¹⁰. One common form is the "pay when paid" clause, which establishes a reasonable timeframe for subcontractor payment to occur, not when the relevant sum was certified by the contract administrator, but only when the general contractor actually received the money from the employer¹¹. The "pay when paid" clause does not shift the risk of owner nonpayment to the subcontractor, unless specifically and unambiguously stated otherwise¹².

1.2 Problem Statement

Contractors and subcontractors in the construction industry know the real meaning of the famous phrase "cash flow is the lifeblood of the industry". A contractor, who pays a subcontractor before being paid by the employer, is effectively funding the project. Add to this the cost of pursuing the employer for non-payment and the precarious nature of construction becomes obvious. Insolvency of the employer in that

⁹ Rippeon, Z. (2007). *Conditional Payment Clauses in Construction Contracts*. Georgia: Georgia State University College of Law.

¹⁰ Hill, K.B. & Ritter (2008). *Contingent Payment Clauses in the 50 States*. Ohio: Foundation of the American Subcontractors Association

¹¹ Murdoch, J. and Hughes, W. (2008). *Construction Contracts: Law and Management 4th Edition*. London and New York: Taylor & Francis. Pg 276

¹² Rippeon, Z (2007). *Conditional Payment Clauses in Construction Contracts*. Georgia: Georgia State University College of Law.

situation can threaten the continued existence of the contractor. In the Government-Inspired Banwell Report in 1964¹³, Sir Harold Banwell commented that:

“The operation of the payment system is not always smooth. Payments to the main contractor by the clients are often slow and uneven, with consequential delays in payment to suppliers and subcontractors. This has an adverse effect on the efficiency and stability of the whole industry ...”

A recent survey done by the Construction Industry Development Board (CIDB) in collaboration with the University Malaya (UM) ‘merely’ formally documents what many in the construction industry already know is there is a chronic problem of delayed and non-payment in the Malaysian construction industry affecting the entire delivery chain¹⁴. Master Builders Association (MBAM) has long been lamenting on the problems of delayed and non-payment in the construction industry.

Industry form documents can be used to create a fair contract for both parties. Those same documents, however, can also be manipulated to gain unbalance the agreement. While there are a multitude of clauses that can cause substantial and unexpected financial trouble for the company, one of the most flagrant is the payment clause¹⁵. In every construction contract, the general contractor and its subcontractors must allocate the risk that the owner of the project either cannot, or will not, pay for the work performed. The allocation of the risk can have a significant impact on the profitability of the project for all parties, and can lead to protracted litigation¹⁶.

¹³ Pettigraw, R. (2005). *Payment under Construction Contracts Legislation*. Thomas Telford Ltd: London. Pg 2

¹⁴ Sr Nourshad Ali Naseem Ameer Ali (2006). A “*Construction Industry Payment and Adjudication Act*”: *Reducing Payment-Default And Increasing Dispute Resolution Efficiency In Construction*. Master Builders Journal 3rd Quarter 2006. Pg 4.

¹⁵ Russell, R. (2003). *The Right Contract Means Preserving Cashflow*. Builder Exchange Magazine Vol 8 Issue 03

¹⁶. Goodin, P.W. and Dickinson, J.C. (2002). *Who Bears the Risks of Owner Non-Payment?* Midwest Construction Law, Contracts and Claims.)

General contractors sometimes try to avoid being stuck with liability for subcontractor claims which can be passed through by writing “pay-when-paid” clauses into their contract. These clauses attempt to pass the risk of the owner not paying on to the subcontractor. This is something that may be missed by the subcontractor and can work unfairly, especially where the subcontractor is in no position to assess the financial strength of the owner¹⁷. In the absence of any such clause, if an owner fails to pay the contractor for the work performed by the subcontractor, the main contractor is still responsible for making any contractual payments due to the subcontractor¹⁸.

Dealing with contingent payment clauses is a frequent headache for subcontractors. Contingent payment clauses make subcontractors bear numerous risks completely unrelated to their own performance. Delayed approval of applications for payment by the architect, cash flow problems, pending and unpaid claims, and defective performance by other subcontractors all may prevent payment to the general contractor through no fault of the subcontractor. The resulting delay in payment impairs the subcontractor's credit rating, depletes operating capital and lines of credit, and hurts the subcontractor's relationships with its own trade creditors. Even worse, contingent payment clauses compel subcontractors to continue to work even though they have not been paid¹⁹.

The Employer may for instance withhold payment because of default by the contractor or other subcontractors. Not surprisingly, contractors argue that “pay-when-paid” clauses are a valid and legitimate protection against these risks. The subcontractor on the other hand has an equally valid argument against “pay when paid” clauses. If he has properly carried out the work, he argues, he should be entitled to be paid; otherwise

¹⁷ Logan, J.M. *Pay-When-Paid Clauses-Construction Law*. Canada. Pg1

¹⁸ Beckwith, A (2002). *Pay-When-Paid Clauses: Risk Allocation and the need for Careful Drafting*. Miller Thomson Construction Law Newsletter Summer 2002, Miller Thomson LLP:Washington DC, Pg 1

¹⁹ Nadine, H. G. and Patrick, C. B. (1999). *Waiting to Get Paid: Pay When Paid Provisions a Matter of When or If*. The Florida Bar Journal Volume LXXII No.9, October 1999, pg 64

he will run the risk of continued existence instead of the contractor. He should not become involved in disputes between the employer and contractor, which may have nothing at all to do with his work²⁰.

Huxtable (1988) cited that, the way in which “pay when paid” clauses shift the risks on to subcontractors has for a long time been criticized as unfair but they are still in everyday use in standard form of sub-contracts in the countries of South-East Asia (Murdoch, 2008). Therefore, it is no surprise that the courts have struggled. From the cases of *Timbro Development Ltd. v. Grimsby Diesel Motors*²¹ and *Arnoldin Construction & Forms Limited v. Alta Surety Co.*²², there are two lines of arguments. The first is that if a clause indicates that the subcontractor will be paid when the contractor is paid, that is a clear indication that “*unless and until the contractor is paid the subcontractor has no right to be paid and the risk of non payment by the owner is borne by the subcontractor.*” The competing argument is that the “pay-when-paid” clause speaks to the timing of the payment but is not conclusive right to be paid. In other words, in the ordinary course “*the subcontractor will have to wait until the contractor is paid but does not give their right to recover against the contractor in the event the owner never pays the subcontractor*²³.” Therefore, the issue is whether a payment clause is a true “pay when paid” arrangement waiving the right of the subcontractor to be paid which payment to the subcontractor is condition precedent to payment by the owner to the main contractor or is simply a timing mechanism.

Throughout the country, courts have differed on the interpretation of “pay-when-paid” clauses which purport to make a general contractor’s duty to pay a subcontractor conditional on its receiving payment from the owner. Some courts maintain that these clauses should be loosely construed to mean that the general contractor’s obligation to

²⁰ Atkinson, D (2001). *Payment-Pay-When-Paid Clauses*. England: Daniel Atkinson Limited.

²¹ *Inc. et. al.* (1988) 32 C.L.R. 32 (Ontario Court of Appeal)

²² (1995) 19 C.L.R. (2d) 1 (Nova Scotia Court of Appeal)

²³ Logan, J.M. *Pay-When-Paid Clauses- Construction Law*. Pg 1

pay is not excused in the event of nonpayment by the owner²⁴. Courts in Hong Kong and Singapore have treated “pay when paid” clauses as valid and enforceable, at least to the extent of protecting the main contractor’s cash flow by merely delaying the obligation to pay the subcontractor²⁵. Courts in several jurisdictions have followed the reasoning of *Dyer*²⁶ to conclude that such a clause merely establishes a reasonable time in which contractor can delay payment, but that it does not completely excuse payment. The Michigan Court of Appeals in the case of *Markel & Co. Contractors vs. Christian Co*²⁷ has held that such provisions are enforceable and that they indefinitely suspend the contractor’s obligation to pay subcontractors until it has received payment from the owner. However, such a provision may be excused under some circumstances, and they may be unenforceable.

“Pay-when-paid” provisions may vary widely from state to state. Just because a contractor presents a subcontractor with a contract provision does not mean that provision is legally enforceable²⁸. So, this research is looking to identify the application of “pay when paid” clauses in construction sub-contracts, either “pay when paid” arrangement in construction sub-contracts waiving the right of the subcontractor to be paid or simply a timing mechanism. To what extent the “pay when paid” provisions constitutes as a timing mechanism and as waiving the right of subcontractor to be paid.

²⁴ Reeves, G.D. (1999). *Enforceability of Conditional Payment Provisions in Construction Subcontracts*. CAM Magazine August 1999 Edition

²⁵ *Schindler Lifts (Hong Kong) Ltd v. Shui On Construction Co Ltd* (1984); *Nin Hing Electronic Engineering Ltd v. Aoki Corporation* (1987); *Brightside Mechanical & Electrical Services Group Ltd v. Hyundai Engineering & Construction Co Ltd* (1988)

²⁶ The 1962 6th Circuit United States Court of Appeal decision in *Thomas J Dyer vs. Bishop International Engineering Co*. 303 F 2d 655 (1962). The approach taken principles in mind, which has been followed by most courts, is to examine the principles in mind: (1) the clear intention of the parties’ control; (2) ambiguous contracts should be construed against the drafter; and (3) conditions precedent is generally disfavored.

²⁷ Reeves, G.D. (1999). *Enforceability of Conditional Payment Provisions in Construction Subcontracts*. CAM Magazine August 1999 Edition

²⁸ Danner, P.D. *Enforceability of Pay-When-Paid and Pay-If-Paid Clauses May Vary From State to State*.

1.3 Objective of Research

Following the issues stated above, this research attempts:

1. To identify whether “pay when paid” arrangement in construction sub-contract waiving the right of the subcontractor to be paid or simply a timing mechanism.

1.4 Scope and Limitation of Research

The approach adopted in this study is case law based. The court cases referred in this study include Malaysia, Singapore, Hong Kong, Florida, Ohio, Ontario, Illinois and English cases. There is no limit to the cases chosen in terms of time frame, as long as it has not been overruled by higher court and establishes a good law.

1.5 Significance of Research

Basically, this study is expected to answer some of the uncertain issues that arise in “pay-when-paid” provisions in construction sub-contract. In accordance to that, issues will be analysed based on the judge interpretation and judgment by the courts in various state. Thus, by identifying the application of “pay when paid” arrangement either waiving the right of the subcontractor to be paid or is simply a timing mechanism, it is hope that this study would contribute toward enhancement of the subcontractor’s knowledge and more understanding on how to defense their rights and take the legal action to challenge the enforceability of the clause to seek immediate payment when they have suffering the risk of non-payment due to the performance problems unrelated to their own work. Finally, hopefully it assists in avoiding unnecessary disputes while assuring the success and better relationship among the contractual parties.

1.6 Research Methodology

In order to achieve the objectives of this study, a systematic process of conducting this study had been organized. Basically, this study process comprised of five major stages, which involved identifying the study issue, literature review, data collection, data analysis, conclusion and recommendations.

1.6.1 Stage 1: Identifying the Research Issue

The study issue arises from intensive reading of books, journals and articles which can be attained from the UTM library and from internet. At the same time, discussion with supervisors, lecturers, as well as friends, were held more ideas and knowledge relating to the topic could be collected. Based on the study issue, the objective of the study has been identified. In addition to that, this research is executed to review the relevant court decisions, with the intention of identifying and determining the application of “pay-when-paid” arrangement, either merely as timing mechanism or a true “pay when paid” arrangement waiving the subcontractor(s) rights to be paid. To what extent the court judgment tend to held that the application of “pay when paid” provisions constitutes as a timing mechanism and waiving the right of subcontractor to be paid.

1.6.2 Stage 2: Literature Review

Afterward, a research outline will be prepared in order to identify what kind of data will be needed in this research. Collection of various documentation and literature regarding the study field is of most important in achieving the research objectives. Besides, secondary data is collected from reading materials in printing form like books, journals, research paper, magazines, reports, proceedings, seminar paper as well as information from internet and also by referring to standard contract forms (the PAM 1998 Form, PAM 1998 Sub-Contract Form, JKR PWD Form 203A and JKR PWD Form 203N).

Books, articles and journals relating to sub-contracting, “pay-when-paid” clauses, and payment under construction contract will be read to know depth the theories relating to the research field. All sources are important to complete the literature review chapter.

1.6.3 Stage 3: Data Collection

Data will be collected mainly through documentary analysis. All collected data and information were recorded systematically. Data collected to analyse mainly from Malayan Law Journal, Hong Kong Law Report, Singapore Law Report, Building Law Report, All England Law Report, and other law journals via UTM library electronic database, namely Lexis-Nexis Legal Database. All the cases relating to the research topic will be sort out from database. Important cases will be collected and used for the analysis at the later stage.

1.6.4 Stage 4: Data Analysis

Once the previous related court cases are collected, it will be conducted by reviewing and clarifying all the important facts of the cases and critical issues and judgments. The application of “pay when paid” arrangement where the judges tend to held that the contingent payment provision on “pay when paid” clauses in construction subcontract merely as a timing mechanism or as waiving the subcontractor(s) rights to be paid will be determined from the relevant cases. After issues presented by each cases, thorough discussion and comparison will be done in order to achieve objectives of this study.

1.6.5 Stage 5: Conclusion and Recommendations

The last stage of the research mainly involves writing up and checking the writing. In this stage, reviews on the whole process of the study will be made with the intention to identify whether the study objective has been achieved. Conclusion and recommendation were made based on the findings during the stage of analysis.