

**LEGAL POSITION OF THE ISSUES ASSOCIATED WITH
MAIN CONTRACTOR'S INSOLVENCY**

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ABSTRACT

The East Asian Financial crisis has resulted in long-term financial difficulties, which translated into high level of insolvency especially in the sector of construction. Among the construction insolvency, the insolvency of a main contractor is the frequent occurrence. This has brought issues or problems to the sub-contractor who would become unsecured creditors in the event of main contractor's insolvency. The aim of this study is to determine the legal positions relating to issues faced by sub-contractor in the event of main contractor's insolvency. The issues that commonly arise are direct payment, retention fund, set-off, materials and goods, determination, novation etc. However, this study would only focus on the legal positions of the critical issues specifically: direct payment, retention fund, unfixed materials and goods, set-off and determination. The critical issues are those issues that are commonly arising. There are valid and invalid positions for each of the issue arise. For example, the valid position in direct payment means that the employer entitled to pay sub-contractor direct. While, invalid position is the sub-contractor not entitle to be paid directly by employer. The legal positions for each issue can protect the interaction of sub-contractor in the event of main contractor's insolvency. Therefore, the sub-contractor can use this study as guidance when dealing with those issues.

ABSTRAK

Krisis kewangan Asia Timur telah menyebabkan kesukaran kewangan yang berjangka panjang. Ini telah mengakibatkan kejadian tak solvent yang begitu tinggi. Di antara kesemua jenis tak solvent yang berlaku dalam sector pembinaan, kejadian kontraktor utama yang tak solvent adalah yang paling banyak berlaku. Kejadian ini telah mendatangkan pelbagai isu dan masalah kepada sub-kontraktor yang rendah kedudukannya serta akan menjadi pemiutang tak sekure dalam kejadian sedemikian. Kajian ini bertujuan untuk mengenalpasti keadaan perundangan bagi isu yang dihadapi yang sub-kontraktor dalam kejadian kontraktor utama yang tak solvent. Isu-isu yang dihadapi oleh sub-kontraktor adalah bayaran terus, wang tahanan, pemotongan bayaran, bahan-bahan binaan, penamatan kontrak, bon dan jaminan serta pertukaran pelaksanaan. Namun begitu, kajian ini hanya tertumpu ke atas isu-isu yang kritikal iaitu bayaran terus, wang tahanan, pemotongan bayaran, bahan-bahan binaan dan penamatan kontrak. Isu yang kritikal adalah isu yang selalunya timbul. Terdapat keadaan yang berjaya dan gagal bagi setiap isu yang timbul. Contoh, isu bayaran terus, keadaan yang boleh diamalkan adalah dimana majikan boleh bayar sub-kontraktor secara terus. Oleh itu, sub-kontraktor boleh menjadikan kajian ini sebagai panduan dalam menyelesaikan masalah kontraktor utama yang tak solvent.

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CHAPTER ONE

INTRODUCTION

1.1 Background Study

In construction contract, ordinarily, the main contractor will perform the basic operations and sub-contract the remainder to various specialist contractors¹ that possesses specialized skills.² Sub-contracts are found in most construction work, since very few contractors have the resources to carry out the whole of a project themselves.³ In construction projects, sub-contractors play a vital role in performing their specific tasks.⁴ Sub-contracting is used much more extensively in housing and building construction projects than in engineering and industrial projects.⁵

Generally, the main contract allows the practice of sub-contracting by the main contractor. This has been illustrated by the sub-letting and nominated sub-contractor clauses in clauses 17.0, 27.0 & 28.0 of the PAM Agreement and Conditions of building contract 1998 and clauses 27, 28 & 29 of PWD 203A

¹ Arditi, D., and Chotibhongs, R., "Issues in Sub-contracting Practice." (ASCE: Journal of Construction Engineering and Management, Vol. Aug, 2005), p 866-876.

² Ibid.

³ Uff, J. "Construction Law." 3rd Ed. (London : Sweet & Maxwell, 1981), p 115.

⁴ Arditi, D., and Chotibhongs, R., *ibid*.

⁵ Clough, R., and Sears, G., "Construction Contracting." (New York : Wiley, 1994).

Standard Form of Contract to be Used Where Bill of Quantities Form Part of the Contract. Those clauses discussing that the main contractor should with the written consent of the Architect or employer to sub-let any portion or the whole works to the sub-contractor.⁶

In the context of building and engineering contracts, sub-contracting includes supply only contractors, supply and fixes contractors and labour only supply contractors. The first two types of sub-contractor can be either nominated or domestic. While, both main and sub-contractor engaged labour supply only sub-contractors to supply the labour required for the works. Nominated sub-contractors are employed by employer while domestic sub-contractors employed by main contractor.⁷

An employer through the selection of contract administrator employs nominated sub-contractor.⁸ Main contracts usually contain special provisions governing the rights of the parties concerning nominated sub-contract work.⁹ Besides that, the relation between main contractor and nominated sub-contractor also set out in sub-contract which normally specified by the employer. There is different sub-contract for different type of project. In private project, the sub-contract used is PAM Agreement and Conditions of Building Sub-Contract 1998 and PWD 203N condition of sub-contract for nominated sub-contractor is for public project. However, there is different provision in the context of domestic sub-contractors.

Sub-contractors who are not nominated are sometimes called domestic sub-contractors.¹⁰ The employer plays no part in the selection of domestic sub-contractors except simply giving consent where this is required under the terms of the main contract.¹¹ For domestic sub-contractor and labour supply only sub-

⁶ See cl. 17.0 of PAM Agreement and Conditions of building contract 1998 and cl. 27 of PWD 203A Standard Form of Contract to be Used Where Bill of Quantities Form Part of the Contract.

⁷ Abdul Aziz, "Subkontraktor."

⁸ Murdoch, J. and Hughes, W., "Construction Contracts : Law and Management." 2nd Ed. (London : E & FN Spon, 1992), p 299.

⁹ Uff, J. *ibid.*, p 35.

¹⁰ Uff, J. *ibid.*, p 36.

¹¹ Murdoch, J. and Hughes, W., *ibid.*, p 287.

contractor, there is no specific standard form of sub-contract. The terms and conditions to bind the main contractor and domestic sub-contractor are in clause 17.0¹² and clause 27¹³. Besides bound with the terms in main or sub-contract, they held some obligations and rights against both parties vice versa.¹⁴

The doctrine of privity of contract means that the rights and obligations contained in each contract apply only to those who are parties to it.¹⁵ It means that only the parties to the contract can sue or be sued under it.¹⁶ For example, where there are defects in the sub-contractor's work, the employer will have a contractual remedy against the main contractor, who will in turn take action against the sub-contractor.¹⁷ There are some consequences once the link breaks.

Once the contractual links between main contractor and sub-contractor breaks, for example the insolvent of main contractor, problems will arise.¹⁸ For example, defects work caused by sub-contractor, once the main contractor goes into insolvency, the employer can therefore effectively bring action against main contractor. An employer cannot in similarly bring an action against a sub-contractor directly due to no privity of contracts.

In the context of construction, insolvency, in practical means inability to pay debts.¹⁹ The definition by Wikipedia²⁰ for insolvency is a financial condition experienced by a person or a business entity when the owner of a company's assets no longer exceed liabilities or when the person or entity can no longer meet his debt obligations when the debt come due.²¹

¹² PAM Agreement and Conditions of building contract 1998.

¹³ PWD 203A Standard Form of Contract to be Used Where Bill of Quantities Form Part of the Contract.

¹⁴ Murdoch, J. and Hughes, W., *ibid.*, p 289.

¹⁵ *Ibid.*, p 286.

¹⁶ Price, J., "Sub-contracting under the JCT Standard Forms of Building Contract." (London : Macmillan, 1994), p 16.

¹⁷ Murdoch, J. and Hughes, W., *ibid.*, p 286.

¹⁸ *Ibid.*

¹⁹ Uff, J., *ibid.*, p 121.

²⁰ The free encyclopedia.

²¹ Wikipedia, the free encyclopedia. "Insolvency." (2006).

The term of insolvency is often incorrectly used as a synonym for bankruptcy, which is a distinct concept.²² This is due to, ordinarily, insolvency includes company and individual. Company insolvency consists of winding-up²³, receivership, and arrangement. Winding-up, or liquidation, is a collective insolvency process leading to the end of the company's existence (dissolution).²⁴ A receiver would be appointed in receivership to take control of the company's assets.²⁵ Whereas, arrangement in Companies Act 1965 is a reorganization of the share capital of a company by the consolidation of shares of different classes or by the division of shares into shares of different classes or by both these methods' again.²⁶

On the other hand, individual insolvency consists of bankruptcy. Bankruptcy is a proceeding by which possession of the property of a debtor is taken for the benefit of his creditors by the Official Assignee.²⁷ The relating provision for governing the individual insolvency is different with the company insolvency.

Unlike United Kingdom, that has an Insolvency Act 1986,²⁸ in Malaysia we do not have such act. In Malaysian legal system, the core of Malaysia's current company and corporate insolvency law is contained in the Part X of Companies Act 1965 (Act 125), whilst the bankruptcy proceeding is governed by the provisions of the Bankruptcy Act 1967.²⁹

²² Ibid.

²³ Can be known as liquidation.

²⁴ Goode, R. M., "Principles of Corporate Insolvency Law." (London : Sweet & Maxwell, 1990), p 12.

²⁵ Ibid., p 10.

²⁶ K. V. Padmanabha Rau., "Company Law of Malaysia : Shares, Meetings, Receivers and Managers." (Selangor : International Law Book Services, 2003), p 346.

²⁷ See Para 100.001 Halsbury's Laws of Malaysia, vol 6, p 4.

²⁸ The Cork Committee was appointed in 1977 with wide-ranging terms of reference covering corporate and individual insolvency. Its report in 1982 led to a government White Paper in 1984 setting out an intention to implement the bulk, but not all of the Committee's recommendation. This eventually led to the Insolvency Act 1986 – see further Sealy and Milman, Annotated Guide to the 1986 Insolvency Legislation 4th edition (1994)

²⁹ Wallace, I. N. D., "Hudson's Building and Engineering Contracts including the Duties and liabilities of Architects, Engineers and Surveyors." 10th Ed. (London : Sweet & Maxwell, 1970), p 775.

When a company is wound up, all its business is concluded by a liquidator who takes over the powers of the board.³⁰ He collects in the debts, which are owed to the company and, as far as he is able, pays off the creditors.³¹ The fundamental principle in the distribution of assets is the *pari passu* distribution.³² *Pari passu* principle is where all creditors participating in the common pool in proportion to the size of their admitted claims.³³ The distribution of assets is depending on various types of debts.

If a company is insolvent, the assets must be distributed in the following order :³⁴

- i. The cost of winding up;
- ii. Preferential debts such as rates, taxes, official levies and wages of employees;
- iii. Secured debts;
- iv. Unsecured debts;
- v. Deferred debts.³⁵

The law of winding-up companies provide for the realisation and distribution of assets, with certain debts, having priority for payment.³⁶ In building contracts, the insolvency of one party will usually bring the work to an end.³⁷ This would probably bring problems and delay to the others parties in construction project.³⁸

³⁰ Uff, J., *ibid.*, p 40.

³¹ *Ibid.*

³² Section 264 of Companies Act 1965.

³³ Goode, R. M., *ibid.*, p 59.

³⁴ Uff, J., *ibid.*, p 41.

³⁵ Robinson, N. M. and Lavers, A. P., "Construction Law in Singapore and Malaysia." (Singapore : Butterworths, 1988), p 184.

³⁶ Uff, J., *ibid.*, p 121.

³⁷ *Ibid.*

³⁸ Wright, H. "Bankruptcy, the Unexpected Storm." (Columbus : Bricker & Eckler LLP, Vol III Issue 6 June, 2002), p 2.

1.2 Problem Statement

The East Asian financial crisis was a financial crisis that started in July 1997 in Thailand and affected currencies, stock markets, and other asset prices in several Asian countries that were considered as “East Asian Tigers”.³⁹ Malaysia was one of the countries in East Asia that was hit by the East Asian financial crisis and this had brought a long-term of economic difficulties.⁴⁰ It is suggested that down economies often translate into high levels of insolvencies.⁴¹

One of the consequences of the financial crisis was the insolvency of some of the major construction companies such as Renong, UEM, System Transit Aliran Ringan Sdn. Bhd., Prolink Development Sdn. Bhd. and Linkedua Bhd.⁴² As the number of construction insolvency continues to rise, the risk is that either the developer, main contractor or one or more of the specialist sub-contractors will become insolvent during the course of the project.⁴³

Although the number of construction insolvency continues to rise,⁴⁴ the insolvency of a main contractor is a relatively frequent occurrence.⁴⁵ By referring to the *Archivent Sales & Developments Ltd v Strathclyde Regional Council*⁴⁶ case, sub-contractors and suppliers would become unsecured creditors in the event of main contractor’s liquidation. In liquidation, an unsecured creditor is a person who is not entitled to any priority towards settlement of the debt owing to him and may include

³⁹ Wikipedia, the free encyclopedia, “East Asian Financial Crisis.”

⁴⁰ Wikipedia, the free encyclopedia, “East Asian Financial Crisis.”

⁴¹ McCarter & English attorneys at law, “Commercial Litigation – Debtor/Creditor.”

⁴² These companies were under Corporate Debt Restructuring Committee jurisdiction. See Bank Negara Report on the Closure of the CDRC : Status at 15 August 2002 for a complete list.

⁴³ Newman, P. and Barrister, “Insolvency in the Construction Industry.” (Trett Consulting : Trett Digest Issues 10 Article 4, Autumn 1993); See also *Schindler Lifts (Singapore) Pte Ltd v People's Park Chinatown Development Pte Ltd (In Liquidation)* [1990] 3 MLJ 406.

⁴⁴ Ibid.

⁴⁵ Bagnall, B., “Contract Administration for Architects and Quantity Surveyors.”, 6th ed. (London : Collins, 1986), p 85.

⁴⁶ [1984] 27 BLR 98.

a judgment creditor.⁴⁷ An unsecured creditor of the insolvent company has to share the assets of an insolvent company through the applicable of *pari passu* principle.⁴⁸

In the *pari passu* principle is a rateable distribution among creditors is rarely achieved. There are several reasons for this, first, the principle is in general confined to assets of the company and does not affects creditor-having rights in rem. These include secured creditors, fixed charges, suppliers of goods and third parties for whom the company holds assets on trust. The effect of these rights in rem is substantially to reduce the corpus of assets available for unsecured creditors. These embrace:

1. Expenses of the liquidation
2. A range of debts which are preferential

When all these have been satisfied, the dividend produced by what is left is often pitiful small.⁴⁹

Besides that, the complexity and the sophistication of the sub-contract,⁵⁰ together with the less attention given to insolvency rules in the sub-contract, have led to greater problems to other parties in a construction project.⁵¹ The issues or problems faced by the sub-contractor in the event of main contractor's insolvency include :-

- **Direct payment,**⁵² direct payment held to contravene to the *pari passu* principle of asset distribution.⁵³

⁴⁷ S Kalyana Kumar and Pereira, P., "Bankruptcy Handbook." (Kuala Lumpur : Malayan Law Journal Sdn Bhd, 1998), p I 34.

⁴⁸ Rajah & Tan advocates & solicitors.

⁴⁹ Goode, R M. Ibid. p 60-61

⁵⁰ Newman, P. and Barrister, ibid.

⁵¹ Ibid.

⁵² Ibid.; Anderson, A. J., Brickford-Smith, S., Palmer, N. E. and Redmond-Cooper, R., "Emden Construction Law." 8th Ed., (London : Butterworths, 1990), p IV 177-241; *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 All ER 390

⁵³ *Joo Yee Construction Pte Ltd (In Liquidation) v Diethelm Industries Pte Ltd & Ors* [1990] 2 MLJ

- **Unfixed Materials and goods**,⁵⁴ sub-contractor have not received any payment from main contractor, yet cannot recover the materials and goods supplied.⁵⁵
- **Set-off**,⁵⁶ can be exercised in the payment due when main contractor in financial difficulties.⁵⁷
- **Retention fund**,⁵⁸ held by main contractor cannot be claimed back during the insolvent of main contractor.⁵⁹
- **Determination**,⁶⁰ the employment of sub-contractor automatically determined once the employment of main contractor under main contract has been determined.
- **Bonds and Guarantee**,⁶¹ can the sub-contractor claim back their bonds when main contractor filed for liquidation.
- **Novation**,⁶² the main contract has been novated to another party when main contractor went into insolvency.

Among the issues arise, the critical issues arise in relating to the sub-contractor in the event of main contractor's insolvency are direct payment, materials and goods, retention fund, and set-off.

Direct payment has been illustrating in the case of *Joo Yee Construction Pte Ltd (In Liquidation) v Diethelm Industries Pte Ltd & Ors*⁶³, the sub-contractor applied for direct payment from the employer. The liquidator of the main contractor rejected this provision as contravening the insolvency law.

The issue of materials and goods has been discussing in *Schindler Lifts (Singapore) Pte Ltd v People's Park Chinatown Development Pte Ltd (In*

⁵⁴ *Archivent Sales & Developments Ltd v Strathclyde Regional Council* (1984) 27 BLR 98; *Dawber Williamson Roofing Ltd. v Humberside County Council* (1979) 14 BLR 70

⁵⁵ *Archivent Sales & Developments Ltd v Strathclyde Regional Council* (1984) 27 BLR 98.

⁵⁶ Anderson, A. J., Brickford-Smith, S., Palmer, N. E. and Redmond-Cooper, R., *ibid.*, p IV 177-241.

⁵⁷ *BMC Construction Sdn Bhd v Dataran Rentas Sdn Bhd* [2001] 1 MLJ 356.

⁵⁸ Newman, P. and Barrister, *ibid.*; Anderson, A. J., Brickford-Smith, S., Palmer, N. E. and Redmond-Cooper, R., *ibid.*, p IV 177-241.

⁵⁹ *Re Jartray Development Ltd* (1982) 22 BLR 134.

⁶⁰ Newman, P. and Barrister, *ibid.*

⁶¹ Newman, P. "Bonds, Guarantees and Performance Security in the Construction Industry."

⁶² Newman, P. and Barrister, *ibid.*

⁶³ [1990] 2 MLJ 66.

Liquidation)⁶⁴. In that case, the sub-contractor succeeded in recovering for the unfixed escalators, which yet received payment from the main contractor.

Based on the issues or problems discussed above, the sub-contractor, as an unsecured creditor in the event of main contractor's insolvency, should be getting familiar with the legal position of those issues, so that, they can deal with it when it occurred. Therefore, it comes to an objective of study.

1.3 Objective of Study

The objective of this research is to determine the legal positions relating to issues faced by a sub-contractor in the event of a main contractor's insolvency.

1.4 Scope and Limitation of Study

This research study those issues, that arise which faced by both nominated and domestic sub-contractor during the insolvency of main contractor and its legal position. Although there are many issues arise, this study only focus on those critical issues: direct payment, retention fund, set-off, unfixed materials and goods and determination.

The case analysed, included Malaysia, Singapore, United States, and English cases. There is no limit for the cases chosen in terms of period.

⁶⁴ [1990] 3 MLJ 406.

1.5 Significance of Study

The conclusion of this study will determine the legal position of the issues faced by a sub-contractor in the construction industry in the event of the insolvency of a main contractor.

All the issues arise in the event of main contractor's insolvency will affect the employer's obligation and rights. This study will bring benefit for the employer to strengthen their rights in the event of main contractor's insolvency. It can be used as guidance to deal with the issues. For liquidator, it can help the liquidator in the position where the liquidator can claim back the payment, which has been directly made by the employer to the sub-contractor.

This study, of course, will give the sub-contractor an idea about his legal position in comply with the issues in main contractor's insolvency, they can act more reasonably while such event occurred. At last, it can help to avoid the disputes in construction industry.

1.6 Research Methodology

A systematic of research process has been adopted to achieve the objective of study. Generally, this research process consisted of five stages, which involved identifying the research issue, literature review, data collection, data analysis, and conclusion.

1.6.1 First Stage: Identifying the Research Issue

The most important step in a research is identification of the research issue. Normally, the issue established by reading the various related materials in journals, books, and articles. Based on the research issue on the insolvent of main contractor, the objective of study has been identified. There is to determine the legal positions relating to issues faced by sub-contractor in the event of main contractor's insolvency.

1.6.2 Second Stage: Literature Review

The stage of literature review is an important stage in achieving the aim and objective of this study. The literature review will give the reader the brief concept of the related field in this study. Therefore, the literature review has been divided into 3 chapters which are reviewing of the sub-contracting, insolvency and issues arise in relating to sub-contractor in the event of main contractor's insolvency. The materials used to carry out the stage of literature review are books, articles, journals, and court cases. The referred books are Halsbury's Law of Malaysia, Construction Contract, Construction Law, Principle of Insolvency Law, Company Law of Malaysia, Winding-Up Handbook, Sub-Contracting, Building Contract, Hudson's Building and Engineering Contracts, Emden Construction Law etc. The articles are from the author: Paul Newman, Abdul Aziz, Harry Wright, and other solicitors. Whereas, journals are Journals of Construction Engineering and Management, Trett Digest etc. The court cases are collected from the electronic database: Lexis-Nexis Legal Databases.

1.6.3 Third Stage: Data Collection

After setting out the background of study and relevant issues, the data been collected. The data consists of case from Malayan Law Journal and other commonwealth jurisdiction such as United Kingdom, Australia, New Zealand, Singapore, Canada etc.

1.6.4 Fourth Stage: Data Analysis

Following that, the stage of cases study has been carried out on the related court cases. Case study research calls for selecting some examples of the phenomenon to be studied. By closely examining a relatively small number of examples or court cases, comparing and contrasting them, the features have been identified based on different circumstances.

The case study process started through reviewing and clarifying the facts of the cases. Once the issues presented have been focus, comparison and discussion on different circumstances can be done. Consequences of each curse of action been studied and points and arguments had been developed.

1.6.5 Fifth Stage: Conclusion and Recommendations

In this stage, a reviews of the whole research process will be reviews entirely to identify whether the research objectives has been achieved. After that, a

conclusion based on the findings been done and further research can be recommended.

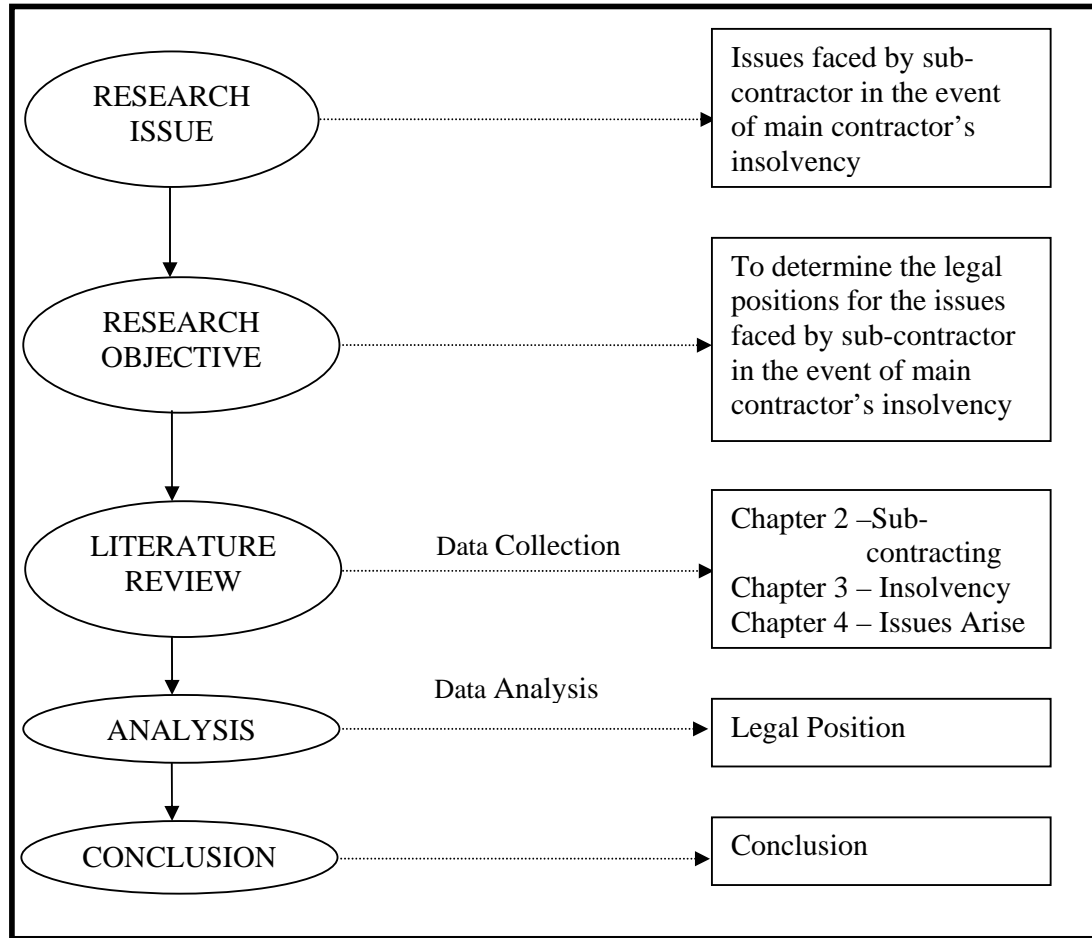


Figure 1-1: Flow Chart of the Research Methodology.

1.7 Chapter Organisation

Chapter 1 set the background of study identified the research issues, determined objective, scope and limitation of study, research methodology and the organisation of chapter.

Chapter 2 explained on the principles of sub-contracting in construction project. This included the reasons for sub-contracting, the contractual chain, the relation in between the main contractor and sub-contractor and in between the employer and sub-contractor as well as the important terms in sub-contract also been discussed in this chapter.

Chapter 3 explained the concepts and the general principles of insolvency (i.e. liquidation, receivership, and arrangement), principles of property distribution included the priority of distribution the property and the construction insolvency.

Chapter 4 analysed the cases relating to the issues arising in the event of main contractor's insolvency faced by the sub-contractors. The analysis is focused on the critical issues arises such as direct payment, set-off, retention fund and so on. Based on the issues arise which has been identified. The legal position for those issues arise can be easily determined which would be discussed on the following chapter.

Chapter 5 set out the legal position for those issues analysed in Chapter 4. All the related court cases had been reviewed to determine the legal position for those issues faced by the sub-contractor during the insolvent of main contractor.

Chapter 6 concluded the findings for the whole research. Recommendation for further study had been stated as well in this chapter.

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