

Security of Payment in Malaysian Construction Industry: Eradication of Sub-contract's Contingent Payment

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Abstract: - In Malaysia, the sub-contractors have to bear with the current structure of payment mechanisms in the standard forms of contract, which are payment upon certification, direct payment from the employer, and contingent or conditional payment. However, with the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act), contingent payment will be no longer valid. This paper, though, is to disclose the findings on legal cases and sub-contractors' perspective on contingent payment, by preliminary analyzing the quantitative questionnaire survey to the first 79 from the identified 1,500 sub-contractors throughout the country. Before that, from 186 cases, only 3 selected cases are analysed that thoroughly addressed the main issue of contingent payment. It is found out that the particularly small sized subcontractors are definitely benefited from payment provisions in the proposed Act. However, they need to enhance their knowledge of the so-called the 'Security of Payment' Regime to benefits from the proposed Act.

Key-Words: - Malaysia, legal readiness, sub-contractors, security of payment, construction industry

1 Introduction

In any country's progress development, an essential function is acted by the construction industry which is both growth-initiating and growth-dependent [6]. Buildings and infrastructure works is established by the industry which give to the large economic increase required for social economic development. Disposal incomes which generate extra construction activities will be further guided to a raise by the achievement of economic development [11].

In usual engineering and construction contracts in relation to the contract entered into by the parties, it is the contractor's consideration to deliver the works, e.g. construction, installation, material supply, etc. This represents his piece of the bargain or the promise made. In reciprocation, the employer should maintain his essential consideration or part of the his bargain by furnishing the which is in the most cases in the shape of money [7].

Payment has been believed to be the life-blood of the construction industry. However, payment default particularly delayed and non-payment, is known by the industry to stay as a main problem [10]. May & Siddiqi [2] states that well-timed run of money is required for the achievement of a construction project, commencing the owner in the direction of the contractor downwards to the subcontractors, sub-subcontractors, suppliers, and vendors. However, they further added that in the subcontract, contractors frequently try to transfer the risk of the owner's non-payment to subcontractors. This is done by including contingent payment provisions, for instance pay-when-paid or pay-if-paid clauses.

2 Payment for Sub-contractor

There has been no widely local study, in the Malaysian environment, on security of payment regime. Instead, the study undertaken is on the likely introduction of a Malaysian Construction Industry Payment and Adjudication Act [10] and attention to the Malaysian Government on the choices for its requirements [1]. This

study in the perspective of the Malaysian construction industry, given the lack of study relating to this matter, has the prospective to offer a realistic understanding and better theoretical of the probable usefulness of the security of payment regime [8].

2.1 Principle Methods of Paying Sub-contractor

There are three principle methods of paying the subcontractor in consideration for the work executed: 'payment upon certification', 'direct payment', and 'contingent payment'. Even though the main contractor disbursing the required payment to the sub-contractor in the first and third methods, the second method is only an employer and sub-contractor deal. As much as the payment of the amount due is concerned, the main contractor being a sheer concerned third party or 'bystander' in the second method [7].

2.1.1 Payment upon certification

Under this payment regime, the receiving of the interim payment certificate by the main contractor is the conditions precedent for the sub-contractor's right to payment, as well as the after that lapse of the distinct 'window-period' for payment. The main contractor not having received from the employer the supposed amount or his honouring period to repay the sub-contractor is longer than the grace period being specified to him is irrelevant. The clock starts ticking against him once he receives the pertinent certificate, in view to his obligation to pay [7].

2.1.2 Direct payment from the employer

Under this payment regime, payments are paid straight to the sub-contractor concerned by the employer, even though the payments payable to the sub-contractor are incorporated in the Interim and/or Final Certificates to the main contractor. This is due to the fact that such payments are unpaid, as in the conventional way, through the main contractor. However, the main contractor is disbursed only the pertinent profit and attendance for the supposed sub-contractor [7].

2.1.3 Contingent payment or conditional payment

Contingent payment' is a third ordinary method available for paying sub-contractors, which encompasses a numeral of labels such as 'pay if paid' clauses, 'pay when paid' clauses, and 'back-to-back' clauses" [7]. May & Siddiqi [2] state that the risk may not be efficiently transferred by a generally drafted contingent-payment terms to the degree projected by the contractor. Most courts differ very much on their keenness to put into effect contingent payment provisions, and such enforcement depends on the exact phrasing of the clause.

However, the construction afforded to the understood type of contingent payment clauses under dissimilar jurisdictions does not demonstrate some uniformity. Furthermore, the instant the circumstances is so gloomy that no common main beliefs can be distilled. In sight of the present vague point of the whole understanding procedure, it is maybe helpful to glance at the related case law and/or authoritative pronouncements to shed some illumination on this subject and give several direction to practitioners" [7].

2.2 Proposed Malaysian Construction Industry Payment and Adjudication Act (CIPA Act)

In 2003 and 2004, at meetings chaired by the Malaysian Minister of Works, captains of the Malaysian construction industry jointly gathered by the Construction Industry Development Board Malaysia (CIDB). A Malaysian 'Latham Report equivalent' was well thought-out and 10 areas of main concern were recognized and working groups produced. Technology, human resources, health and safety, industrialised building systems, productivity and quality, and payment were amongst the areas of main concern recognized [9].

Under strategic thrust 2 of 7 (Strengthen the construction industry image), at present, by working jointly with the industry, the *Construction Industry Payment and Adjudication Act* (CIPA Act) is built up [5]. One of the contents of the CIPA Act [10] is the prohibition 'pay-when-paid' and 'pay-if-paid' clauses in construction contracts. At the moment since its introduction in 2006, the proposed CIPA Act is still under development and the draft can be seen in CIDB website. It is expected the Act is enacted before the Master Plan ceases in 2015.

Supardi, Adnan & Mohammad [4] conclude that in the standard forms of construction contracts, currently, the payment structure to the sub-contractors are divided into three: payment upon certification, direct payment from the employer, and contingent payment or conditional payment. As long as the Malaysian 'Security of Payment' Regime remains in proposal, the sub-contractors have to bear with the current structure of payment mechanisms.

3 Law Case Analysis on Contingent Payment

Supardi, Adnan & Mohammad [3] summarise that the analysis of law cases set up the issues and judgment on related matters on payment mechanism to sub-contract works. The issues are listed as follows:

- a) Agreement on the terms of payment
- b) Counter claim
- c) Delay
- d) Direct payment
- e) Final payment and certification
- f) Injunction
- g) Insolvency or winding up
- h) 'Pay-when-paid' clause
- i) Performance bond
- j) Progressive payments and certification

Thus, on the part of sub-contractors, they will need to enhance their knowledge, especially on the discussion on the issues of payment to them, in order to be successful in benefitting the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act).

The first methodology for this paper, though, is the content analysis on Malaysian law case held in Malaysian court to date published in the Malayan Law Journal. However, there are not many cases in the Malaysian Construction Industry deals with contingent payment. From 186 cases deals with payment to sub-contractor, only 3 selected cases are analysed that thoroughly addressed the issue of contingent payment as their main issue.

3.1 Case 1: *Asiapools (M) Sdn Bhd v IJM Construction Sdn Bhd* [2010] 3 MLJ 7

Low Hop Bing JCA in delivering judgment of the court states that in ordinary parlance, 'progress payment' portrays any payment according to 'progress' i.e. the forward movement of the works. 'Progress payment' clearly includes a payment at any stage, from the first stage, to the second stage, culminating in the final stage i.e. the final payment. Upon the true construction of clause 13.01, in particular the expression 'progress payment', he is of the view that it is sufficiently wide to include the final payment claimed by the sub-contractor, in which case, the sub-contractor is only entitled to payment after the main contractor has been paid by the employer.

Abdul Malik Ishak JCA, furthermore, is of the view that the effect of a 'pay-when-paid' clause will be entirely a matter of construction, requiring clear and unambiguous words, and requiring careful consideration of whether, on a true construction, the clause affects the right to payment or only the time for payment.

He further adds that it is a correct assertion to say that words generally are to be understood in their plain and literal meaning. This does not mean that one must refer to the dictionary in order to obtain the dictionary sense of the word. Rather the words must generally be understood to mean one thing and not another. This is, of course, always subject to admissible evidence being adduced to show that the words are to be understood in some technical or special sense. Here, there is no necessity to adduce any evidence to interpret clause 13.01. The words appearing in clause 13.01 that '*the payment in respect of any work,... shall be made to the sub-contractor within 14 days after receipt by the main contractor of payment certified as due in the interim certificate from the client*' are rather plain and they clearly preclude the main contractor from paying immediately to the sub-contractor unless the main contractor receives payment from the employer.

3.2 Case 2: *Seloga Sdn Bhd v UEM Gynisys Sdn Bhd* [2007] 7 MLJ 385

Mohd Ghazali JCA in delivering judgment of the court noted that the pay when paid clause require that payments to the sub-contractor by the main contractor is to be made 'within forty five [45] days from the date of receipt by the main contractor of any certificate or duplicate copy thereof from the Architect or until receipt of Main contract payment from the Employer, whichever is later'. The main contractor has admitted that it received 'payment' under the main contract from the employer, through the said scheme of arrangement.

The pay when paid clause (clause 10) reads: "*You have agreed that payments will be made to you within Forty Five [45] days from the date of the receipt by the contractor of any certificate of duplicate copy thereof from the Architect or until receipt of main contract payment from the Employer, whichever is later.*" From the reading, the words 'receipt of main contract payment' must be given its normal meaning. Therefore, in Mohd Ghazali JCA view, these words simply mean receipt of money and definitely not receipt in kind. The facts showed that the sub-contractor never made any overt or implied gesture to accept payment in kind. Their letters to the main contractor were neither acts of acceptance nor communication of acceptance but were express rejections of a proposed payment in kind.

Counsel for the main contractor referred to several authorities including *Interpro Engineering Pte Ltd v Sin Heng Construction Co Pte Ltd* [1998] 1 SLR 694 and *Brightside Mechanical & Electrical Services Group Ltd & Anor v Hyundai Engineering & Construction Co Ltd* [1988] 1 MLJ 500 and *Hudson's Building and Engineering Contracts* (11th Edition) Volume 2 by I.N. Duncan Wallace. Mohd Ghazali JCA has perused the authorities and found that the issues litigated or discussed therein were different, viz., it relates to entitlement to progress payments between the main contractor and the sub-contractor where no payments were received from the employer and did not deal with payment in kind. Hence, there was already receipt of payment by the main contractor from the employer. It should have been in the form of moneys but the main contractor agreed to accept in kind instead as satisfaction of the moneys due and owing to them by the employer. It was not a case where a main contractor has not been paid by an employer. The sub-contractor was clearly not a party to the said scheme of arrangement and hence was in turn under no obligation to receive the payment in kind in place of monies. The material words in the pay when paid clause are receipt of payment. They must give those words their normal meaning. The prima facie meaning of receipt of payment is receipt of money. Mohd Ghazali JCA agrees with the learned judge of the lower court that the main contractor in turn was obliged to make monetary payment to the sub-contractor for the debt owing.

3.3 Case 3: *Antah Schindler Sdn Bhd v Ssangyong Engrng & Const. Co Ltd* [2008] 3 MLJ 204

Suriyadi JCA, in delivering judgment of the court, states that by the very language alluded to in the relevant provisions of the current main contract and subcontract, read together with clause 27(a)(vii), he has construed the latter as a mere provision imposing a time limit for payment. He found no express provision mounted into it which imposed any restriction over the rights of the sub-contractor to pursue its claim against the main contractor. Master Towle in *Smith & Smith Glass Ltd v Winstone Architectural Cladding Systems Ltd* [1992] 2 NZLR 473 had occasion to state:

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 to be merely governing the time for payment. I believe that the contra proferentem 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.

It was his views that, since it was not unambiguously expressed in clause 27(a)(vii) that the sub-contractor was to be denied its rights from pursuing the claim in the current format, this action was procedurally correct.

From the above arguments and despite the production of a substantial amount of documents, Suriyadi JCA was of the view that the case was straightforward and simple. He was satisfied, not unlike the High Court judge

that the salient terms of the written contract had been agreed upon by both parties. The history of payments showed that parties had acceded to the mode of payment. On the other hand, he disagreed that this 'pay when paid' clause disallowed the sub-contractor from pursuing this claim, on account of there being no bar preventing it. He also found, as the High Court judge did that there was no dispute as to the quantum, and to that date the sum claimed still remained unpaid.

4 Perspective Analysis of Sub-contractors on Contingent Payment

The second methodology for this paper is the questionnaires survey that was sent to 1,500 sub-contractors throughout Malaysia. However, this preliminary survey analysis was done only the first 79 respondents due to the timeline of the survey is still on-going. Agreement to statements are asked whether there are problems in regard to the existing contingent payment, the relevancy of the prohibition of conditional payment provisions in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act), and the use of 'pay when paid' provisions as payment remedies for sub-contractors. The 5-level likert scale was used including prevailing the respondent's lack of knowledge on the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act), that is either they are not sure, do not understand or filling blanks.

Table 1: Perspective of Sub-contractors on Contingent Payment

Questions	Did Not Fill	Strongly Disagreed	Disagreed	Not Sure	Agreed	Strongly Agreed
Existing problems	11%	10%	10%	33%	27%	9%
Prohibition in CIPA Act	11%	6%	5%	25%	42%	10%
Usage as remedies	10%	10%	8%	28%	29%	15%

Table 1 shows the level of agreement on the three questions that are thrown to the sub-contractors to benefit from, if they were provided in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act). Thirty-three percent (33%) respondents were not sure whether there are problems in regards to the existing contingent payment in sub-contract. Added to that, eleven percent (11%) respondents did not fill the required questions whether the use of 'pay when paid' provisions are adequate enough to solve the problems. However, twenty-seven percent (27%) and nine percent (9%) respondents respectively agreed and strongly agreed with the problems, whereas ten percent (10%) respondents both were strongly disagreed and disagreed.

In regards to the prohibition of contingent payment provisions made in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act), a high forty-two percent (42%) together with ten percent (10%) respondents respectively agreed and strongly agreed with the provisions. Only six percent (6%) and five percent (5%) respondent respectively strongly disagreed and disagreed that the prohibition of contingent payment provisions included in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act) will solve the sub-contractor's payment problems. However, twenty-five (25%) and eleven percent (11%) respondents were respectively not sure or did not fill the required questions..

In contrast with the provision of eradicating contingent payment as stated above, twenty-nine percent (29%) and fifteen percent (15%) respondents still respectively agreed and strongly agreed that the use of 'pay when paid' provision will solve problems in sub-contractor's payment. Twenty-eight percent (28%) and ten percent (10%) respondents were respectively not sure or did not fill the required questions, whereas only eight percent (8%) and ten percent (10%) respondents respectively disagreed and strongly disagreed with the use of the contingent payment.

5 Conclusion

Based on the analysis on law cases and feedback of the survey, it is found that the small number of cases published in the Malaysian courts in the issue of contingent payment because of the total amount that the parties have to bear. Because most of the sub-contractors are small in capital, adjudication provision in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act) could be the solution. The sub-contractor, though, have to have the knowledge of adjudication in order to benefit from it. However, at the current state, the parties have to bear to whatever is stated in their sub-contract in whatever format of payment whether the deal is in real money, in particular form or historically done.

There are contrasting agreement in the application of 'pay when paid' provision. In one hand, most of the respondents agree on the prohibition of conditional payment stated in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act) that create payment problems for the sub-contractors, but on the other hand, most of the respondents agree on the usage of the contingent payment in the construction industry. That some respondents are said to be so used to the current state of payment mechanism that they are not willing to change the nature. Or the small-sized sub-contractors does not have the knowledge of other form of security of payment that resulted in such agreement.

Thus, by referring to the high percentages of respondents who are not sure or did not fill in Table 1 above, the adequacy of security of payment framework to the particularly small sized sub-contractors needs to be produced. The accepted security of payment framework, though, needs to be of easy to read and understand for its effectiveness in delivering the knowledge. Further to that, the analysis of the various avenues which improve the payment problem in the construction industry those have been incorporated in the construction contract or statutes in the other developed countries as well as the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act), also needs to be done for its effectiveness.

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