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Sub-Contractors' Readiness on the Malaysian Security of Payment Legislation in Construction Industry

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Abstract—In Malaysia, subcontractors are definitely benefited from payment provisions in the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act). However, the particularly small sized sub-contractors need to enhance knowledge of the so-called the 'Security of Payment' Regime to improve their awareness of the benefits of the Act. Due to this, this on-going research attempts to introduce balance and proper guidelines to the sub-contractors, in giving the knowledge, to claim for payment and the main contractors able to make prompt payments. Before that, the research may first identify the payment provisions in the standard forms of contracts as well as in domestic sub-contracts especially on Contingent Payment, and exploring the problems and legal issues relating to payment default. Then, by determining the level of knowledge that the sub-contractors have to the proposed CIPA Act, and analysing 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 CIPA Act, the aim may be achieved. The purpose of this paper, though, is to disclose the finding of the first objective of the on-going research. 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.

Keywords- *legal readiness; Malaysia; sub-contractors; security of payment; construction industry*

I. INTRODUCTION

The construction industry plays an important role in any country's development process; it is both growth-initiating and growth-dependent [1]. The industry establishes buildings and infrastructure works required for social economic development which contribute to the overall economic

growth. The success of economic development will further lead to an increase in disposal incomes, generating demand for additional construction activities [19].

Construction in Malaysia spans a wide spectrum of activities stretching from simple renovation works for private homes to massive construction projects. Every such building activity may create its own unique set of requirements and circumstances. The different sectors including employer groups, contractors, suppliers, manufacturers, professionals have their own interests which are very often divergent and competing in nature. This division is best represented by the different and even opposing commercial objectives of the employer and contractor [16].

In a typical engineering and construction contract, it is apparent that the contractor's consideration vis-à-vis the contract entered into by the parties is the carrying out of the works under the contract, e.g. construction, installation, material supply, etc. This represents his part of the bargain or the promise made. In reciprocation, the employer must keep his side of the bargain by furnishing the necessary consideration which in most cases comes in a monetary form [20].

Payment of the monetary consideration for the contractor's performance is the employer's principal obligation (apart from that of provision of the site), failure in which regarded as a potentially fundamental breach [17].

Payment has been said to be the life-blood of the construction industry. Yet the industry knows payment default, specially delayed and non-payment, remain a major problem [4]. The success of a construction project requires the timely flow of money from the owner to the contractor down to the subcontractors, sub-subcontractors, suppliers, and vendors [13].

Contractors often attempt to shift the risk of the owner's non-payment to subcontractors by including contingent payment provisions – such as pay-when-paid or pay-if-paid clauses – in the subcontract [13].

The aim for the on-going research is to introduce balance frameworks (i.e. neither the main contractor nor the sub-contractor is at loss) on ways for the sub-contractor manages to claim the necessary payment and for the main contractor able to make the prompt payment. In order to meet the aim, therefore, the objectives of this research are:

- To identify the current legal aspect of payment provisions in the standard forms of contract as well as in the domestic sub-contract, especially on Contingent Payment.
- To explore the real problems and legal issues disputed by the sub-contractor and the main contractor relating to payment by analyzing judgment made in law cases.
- To determine the level of knowledge that the sub-contractors have to the proposed *Construction Industry Payment and Adjudication Act (CIPA Act)*.
- To investigate the various avenues available for the main contractor and the sub-contractor, those have been incorporated in the construction contract or statutes in the other developed countries, which improve the payment problem, with the Malaysian construction contract and legal issues as well as the proposed *Construction Industry Payment and Adjudication Act (CIPA Act)* that has yet to be introduced in the industry.

The purpose of this paper, though, is to disclose the finding of the first objective of the on-going research. Therefore, it is beyond the scope of this paper to discuss any findings from any of the rest of the on-going research objectives to date.

II. LITERATURE REVIEW

A. Nature of Construction Disputes

Figure 1 below shows that eight (8) areas/nature of construction disputes had been identified which are payment (51%), delay (19%), termination (18%), variation (13%), damages (11%), performance bond (8%), default (8%), and defect (1%) [2].

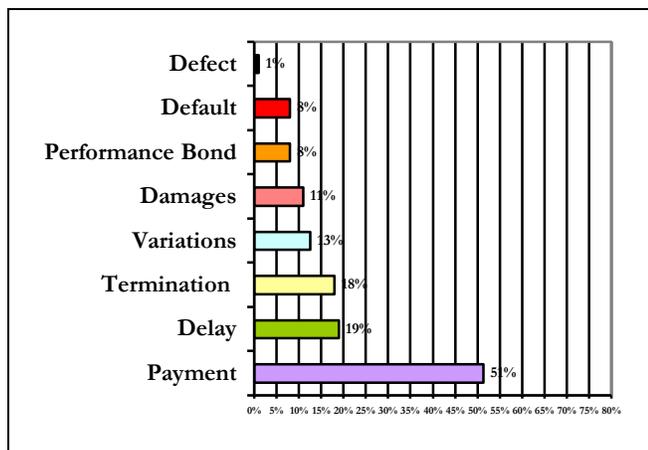


Figure 1. Nature of Construction Disputes [2].

Furthermore, from Figure 2, we can identified the most payment problems are related to non-payment for certified sums and mislead or misunderstanding in payment procedure due to different type of different form between main contractor and sub contractor or between subcontractor and sub-subcontractor which represent (13.5%). This is followed by argument of the amount to be paid (10.8%), delay in progress payment, and unpaid for further payment due to debt settlement (8.1%), over deduction of the sum payment and claim for payment of work done (5.4%) while the others payment problem only represents 1%.

Since payment had been identified as the common nature of construction disputes, further analysis on payment disputes should be done for examples, analysis the causes of payment disputes in detail and find out the method to improve contract management in order to reduce payment disputes [2].

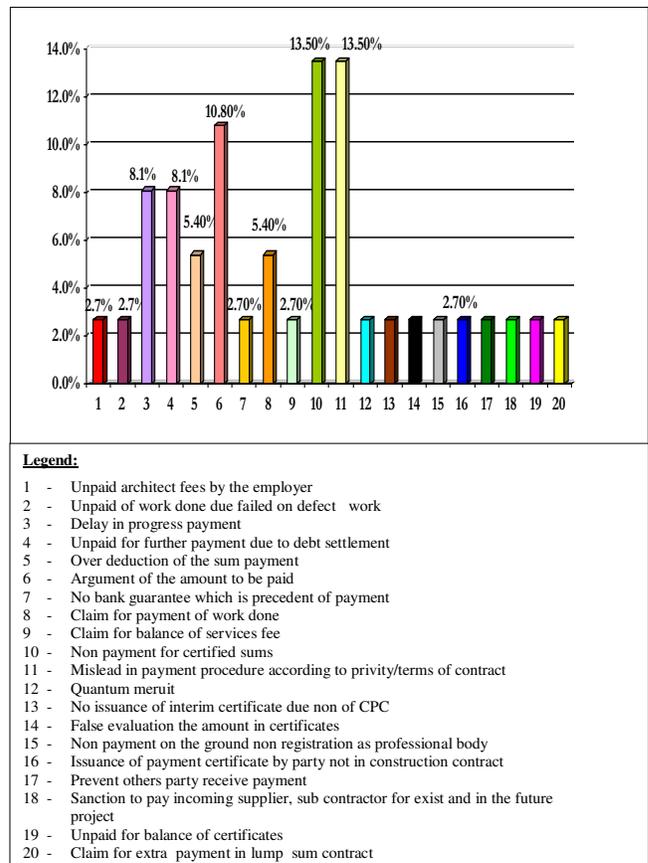


Figure 2. Types of Payment Disputes [2].

B. Principles Methods of Paying Sub-contractor

The principle methods of paying the sub-contractor the consideration for the work executed are namely, 'payment upon certification', 'direct payment', and 'contingent payment'. Although the first and third methods adumbrated hereabove involve the main contractor disbursing the necessary payment to the sub-contractor, the second formula is purely an employer and sub-contractor transaction as far as

the payment of the amount due is concerned; the main contractor being a mere interested third party or 'bystander' [21].

1) *Payment upon Certification:* The conditions precedent for the sub-contractor's entitlement to payment is the receipt of the interim payment certificate by the main contractor and the lapse of the defined 'window-period' for payment thereafter. It is immaterial that the main contractor not having received the said amount from the employer or his honouring period being longer than the grace period being given to him to reimburse the sub-contractor. Once he receives the relevant certificate, the clock starts ticking against him in regard to his obligation to pay [21].

2) *Direct Payment from the Employer:* Under this payment regime, although the payments due to the sub-contractor are included in the Interim and/or Final Certificates to the main contractor, such payments are not paid, as in the traditional method, through the latter but directly to the sub-contractor concerned by the employer. Only the relevant profit and attendance for the said sub-contractor is disbursed to the main contractor [21].

3) *Contingent Payment or Conditional Payment:* A third common scheme for paying sub-contractors is the method going under the umbrella description of 'contingent payment'. In actual fact, this regime encompasses a number of labels including, inter alia, the following, i.e. 'pay if paid' clauses, 'pay when paid' clauses, and 'back-to-back' clauses [21].

C. Proposed Malaysian Construction Industry Payment and Adjudication Act (CIPA Act)

The Construction Industry Development Board Malaysia (CIDB) gathered together captains of the Malaysian construction industry in 2003 and 2004 at meetings chaired by the Malaysian Minister of Works. A Malaysian 'Latham Report equivalent' was considered and 10 areas of priority were identified and working groups formed. Among the areas of priority identified were technology, human resources, health and safety, industrialised building systems, productivity and quality, and payment [5][10].

The contents of a *Construction Industry Payment and Adjudication Act* (CIPA Act) [4] are as below:

- A scheme for regular payment where there is no provision for a payment mechanism in a construction contract.
- Outlawing 'pay-when-paid' and 'pay-if-paid' clauses in construction contracts.
- The rights for a party who has not been paid to suspend works.
- The provision of a speedy dispute resolution process called adjudication for disputes relating to a construction contract.
- The provision of remedies for the recovery and security of payment under a construction contract.

D. Avenues to Improve Payment Problem

There are various avenues that are available to improve the payment problem in the construction industry and some of these options have been incorporated in the construction contract or statutes in the other developed countries. We should choose and adopt the best solutions which best suits and serves the Malaysian construction industry [19]. In summary, these avenues include:

1) *Suspension of work or going slow:* Clause 30.7 of the Agreement and Conditions of PAM Contract 2006 (With Quantities) and Clause 42.10 of the CIDB Standard Form of Contract for Building Works 2000 Edition provide for suspension of work. There are no general common law right of suspension of work [4][6][11] for non-payment. In the *Kah Seng Construction Sdn Bhd v Selsin Development Sdn Bhd* [1997] 1 CLJ Supp 448 case (as cited in [11]), Low Hop Bing J succinctly held: "*In my judgment, it is trite law that a contractor can only terminate his contract with his employer (at common law, as opposed to the exercise of an express termination clause) if he shows, inter alia, a repudiatory breach by the employer has evinced an absolute refusal not to perform his side of contract. There is no intermediate right in a building contract to suspend works. By suspending works without valid legal cause, the plaintiff has in fact repudiated its contractual obligations.*"

2) *Eradication of "pay when paid":* The standard forms of construction contract do not provide for such a remedy other than the CIDB Standard Form of Contract for Building Works 2000 Edition under Option Module C Clause C3.(c). The right of suspension is quite useless if the sub contract is subjected to a "pay when paid" condition which is rather common unless of course the contractor has absconded with money paid by the employer [11].

3) *Adjudication:* Adjudication is provided in the Agreement and Conditions of PAM Contract 2006 (With Quantities) under Clause 34.0. The adjudication process in the United Kingdom does not also make the claimant a secured creditor after a decision is obtained. The successful claimant must still apply to the court for summary judgment and thereafter execute the judgment in the usual ways [11].

4) *Liens:* No construction contract elsewhere provide clause on lien, but the United States of America and Canada addressed it by way of mechanic lien statutes that is absent in Malaysia. Any attempt to provide security for payment to a contractor, subcontractor or supplier through a lien [11] or charging order scheme might not be in the best public interest and of many of the parties – particularly the purchasers [4].

5) *Trust:* The trust concept is not alien in Malaysia in respect of retention of monies. It is provided in Clause 30(6)(a) of the Agreement and Conditions of PAM Contract 2006 (With Quantities) and Clause 42.3(c)(i) of the CIDB Standard Form of Contract for Building Works 2000 Edition. The trust is however a conditional one in that it

permits the employer or the contractor to set off permissible deductions there from [11].

6) *Payment bonds*: Clause 42.1(e) of the CIDB Standard Form of Contract for Building Works 2000 Edition provide for payment bond. It is undisputable that the payment bond is one of the best remedies available to contractors. However, the contractors have to provide payment bonds to their subcontractors and suppliers in addition to the performance bond to the developer. This double bond provision will inevitably reduce the contractor's financial liquidity and result in the much needed cash flow for the project channeled to the bank for securing the bonds [6].

7) *Direct payment from principal*: Direct Payment is provided in the P.W.D. Form 203A (Rev. 2007) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract under Clause 60.1. All subcontractors and suppliers will have similar access to direct payments, which is discretionary and not statutory [6].

8) *Contractor's project account*: There have also been other 'creative' suggestions e.g. REHDA on the possibility of creating a 'contractor's project account'. But this has yet to be explored in detail [4].

E. Review of Previous Studies

In the Malaysian context [3], there has been no extensive local research in the area of security of payment regime. Instead, the research undertaken has focused on the possible introduction of a Malaysian Construction Industry Payment and Adjudication Act ([4] as cited in [8]) and the choices for security of payment regime provisions that are of interest to the Malaysian Government ([9] as cited in [8]). Given the lack of research concerning this subject, this research has the potential to provide a better theoretical and practical understanding of the likely efficacy of the security of payment regime in the context of the Malaysian construction industry [8].

The followings are some of research activities have been undertaken that seems related with the undergoing research on the security of payment regime and the sub-contractors..

Abidin [2] recognized payment as the ordinary nature of construction disputes and misled in payment method according to conditions of standard form of contract and non-payment of certified sums are connected to the dispute. Che-Munaaaim [7] concluded that in the Malaysian construction industry. Delayed and non-payment trouble have been experienced by numerous local contractors and when it comes to government clients, the state of affairs is extreme inferior. In fact, huge amounts of money are involved in this difficulty and the image and performance of the construction industry could have affected by other problems from this.

Mohd-Nazir [14] specifies the clients-related type key factors of delayed payments problems that are appeared. Rosli [18] revealed that because of the non-standard form,

the domestic subcontractor faced problems with payment phrase, termination part, variation and also arbitration. However, the most often problem is connected with payment phrase. Sin [19] shows the main worry in the construction industry has been the subject of payment.

Yin [24] proposes that in the main conditions, the employer is not the repudiator or breach of contract because of non-payment.

Uher & Brand [22][23] concludes that from subcontractors' perspective, the impact of the Act has been largely a positive one. Subcontractors (as claimants) have been highly successful at adjudication under the Act, particularly those making smaller payment claims. However, despite the positive impact, subcontractors generally have been shown to have a low level of working knowledge and understanding of the adjudication process. More effort is however needed to enhance knowledge of the Act among particularly small sized subcontractors to improve their awareness of the benefits of the Act.

III. METHODOLOGY AND DATA ANALYSIS

The literature part of this on-going study gives a thorough understanding on the current legal aspect of the payment provisions in the standard forms of contract as well as the domestic sub-contract, especially on Contingent Payment. This is done by exploring the current and past research on the subject-matter locally and internationally through books, articles, internet, standard forms of contract, acts, etc.

The other objectives will be by quantitative survey questionnaires, qualitative in-depth interviews and focus group [15] validation on the framework produced.

It seems that the above avenues that and the concentrations are on ways the delayed and non-payment contractor or sub-contractor manages to claim the necessary payment due to default by the paymaster. This is true when the *Construction Industry Payment and Adjudication Act* (CIPA Act) that has yet to be introduced in Malaysia, is being proposed. Since most of the problems are the payment relationship between the sub-contractor, whether domestic or nominated, with the main contractor, the effectiveness of Contingent Payment is in question. This has yet to be studied in detail.

One of the more controversial types of clauses in today's construction contracts deals with "contingent payment", which in general contractors use to allocate the risk of an owner's non-payment among subcontractors. Depending on the wording, contingent payment clauses are interpreted as either (1) creating a condition precedent to payment ("pay if paid") or (2) delaying payment for a contractually prescribed time or for some reasonable time if none is prescribed ("pay when paid") [12].

A generically drafted contingent-payment provision may not effectively shift the risk to the extent intended by the contractor. Courts across the country vary greatly on their willingness to enforce contingent payment provisions, and such enforcement depends on the precise wording of the clause [13].

The construction afforded to the said category of contingent payment clauses under different jurisdictions does not show any consistency and at the moment the situation is so murky that no general principles can be distilled. In view of the current nebulous position of the entire interpretation process, it is perhaps useful to look at the relevant case law and/or authoritative pronouncements to shed some light on this matter and provide some guidance to practitioners [21].

IV. CONCLUSION AND RECOMMENDATIONS

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.

A. Significant Contributions to New Knowledge

This research may provide good base for future discussion about payment in construction contract and the balance and proper avenues available for the sub-contractor to claim and the main contractor to make the payment in questions. Given the most disputed issues in Malaysian construction contract, this on-going research may also reduce the present problems on payment in construction contract, and may provide the ways to improve construction contract practice and management.

It is believe that, this on-going research contents may be very useful to practitioner of both legal and construction contract community as well as the academic students especially to those involves in construction contract management.

B. Benefits to the Country/Society/Organisations

Recently studies on the payment issues in the construction industry become popular because of the proposed *Construction Industry Payment and Adjudication Act* (CIPA Act). Since Malaysia produce a lot of legal cases on payment in the construction contract, this on-going research may introduce the balance and proper ways for the sub-contractor to claim and the main contractor to make the necessary payment. The research may also reduce the present problems on payment in construction contract.

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