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# SECURITY OF PAYMENT IN MALAYSIAN CONSTRUCTION INDUSTRY: ISSUES ON SUB-CONTRACT'S DIRECT PAYMENT

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## **ABSTRACT**

In Malaysia, 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, 'direct payment' provision is applied for in most of the nominated sub-contracts and not to the domestic sub-contractors; thus the *Construction Industry Payment and Adjudication (CIPA) Act* is proposed. This paper, though, is to disclose the findings on legal cases and sub-contractors' perspective on direct payment, by preliminary analyzing the quantitative questionnaire survey to the first 81 from the identified 1,500 sub-contractors throughout the country. Before that, from 186 cases, only 5 selected cases are analysed that thoroughly addressed the judgment of direct payment. It is found out that the particularly small sized subcontractors are definitely 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 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 [8].

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 [2]. 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 [5].

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 [5].

## **2. LITERATURE REVIEW**

**Principles Methods of Paying Sub-contractor:** Supardi, Adnan and Mohammad [10] 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.

**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 [7].

**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 [7].

**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 [7].

**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 [6]. In summary, these avenues include:

**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 [2][3][4] for non-payment.

**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 [4].

**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 [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 [4] or charging order scheme might not be in the best public interest and of many of the parties – particularly the purchasers [2].

**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 [4].

**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 [3]. Supardi, Yaakob & Adnan [12] states that after discussing on the interpretation on application of injunction relief in performance bond, as in payment bonds, it is noticed that very careful choice of words should be adopted by the constructor of a performance bond so that a clear understanding of its conditionality can be achieved and undisputable. Therefore, Supardi, Adnan, & Yaakob [11] further stated that to be an undisputed meaning of the words in the performance bond, as in payment bonds, the performance bond itself should be either purely conditional or purely unconditional 'on-demand' bond.

**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 [3].

**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 [2].

### 3. METHODOLOGY AND DATA ANALYSIS

**Law Case Analysis on 'Payment Upon Certification':** Supardi, Adnan and Mohammad [9] 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 Agreement on the terms of payment; Counter claim; Delay; Direct payment; Final payment and certification; Injunction; Insolvency or winding up; 'Pay-when-paid' clause; Performance bond; and Progressive payments and certification.

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 'direct payment' specifically. From 186 cases deals with payment to sub-contractor, only 5 selected cases are analysed that thoroughly addressed the issue of 'direct payment' in their judgment.

**Case 1 - Perwik Sdn Bhd v Lee Yen Kee (M) Sdn Bhd [1996] 1 MLJ 857:** "It was held in allowing the plaintiff's appeal and dismissing the defendant's appeal that it is not legitimate to use as an aid in the construction of a contract anything which the parties said or did after it was made. Thus, the defendant should not be allowed on subsequent meeting to vary the terms of the original

agreement and schedule conditions of the building contract. Under the terms of the contract, all payments were to be made to the plaintiff. Accordingly, by paying the sub-contractors direct, the defendant had done so at its own peril. Under the contract, the defendant was still liable to the plaintiff.”

**Case 2 - *Lightcraft (KL) Sdn Bhd v Fortune Valley Sdn Bhd [2007] 7 MLJ 574:*** “It was held in entering judgment for the plaintiff for RM314,805.50 with interest and costs that the court found that the letter dated 2 July 1997 is very clear in its terms ie after the termination of the contract with Seloga Jaya, the plaintiff requested the defendant as the employer to make direct payments to the plaintiff for the works that had been carried out but which had not been paid by Seloga Jaya and that the obligation to indemnify the defendant would arise when the monies paid by the defendant is ultimately shown to be not legitimately due to the plaintiff. Therefore the argument of the learned counsel for the defendant that the payment of the RM365,000 was an advance from the defendant and that the plaintiff should refund the defendant that amount is unmeritorious given the clear meaning of the letter.”

**Case 3 - *Syarikat Mohd Noor Yusof Sdn Bhd v Polibina Engineering Enterprise Sdn Bhd (in liquidation) [2006] 1 MLJ 446:*** “It was held in allowing the appeal with costs that this was not a proper case to grant an order of winding up. One of the issues which need to be determined was whether it was the respondent and not other sub-contractors which completed the works and consequently whether the appellant paid directly to the respondent or to the sub-contractors for work done. The respondent had not exhausted all remedies available to them as provided under the said contracts. The dispute should be referred to the superintending officer or to arbitration as the case may be as provided for under the said contracts. There was nothing to prevent the respondent from filing a writ against the appellant if everything else fails. A winding up petition is not a legitimate means of seeking to enforce payment of a debt which is disputed.”

**Case 4 - *JKP Sdn Bhd v PPH Development (M) Sdn Bhd and another appeal [2007] 6 MLJ 239:*** “It was held in dismissing the appeal and allowing the cross appeal in part that the other document which carried more weight was the supplementary agreement. Again this document should not be taken in isolation. Since the respondent was not a party in this agreement, the respondent was not privy to the terms and conditions therein. But this was not the issue. The focus on this document was that it contained provisions to pay the debts of the first defendant direct to the respondent. This was exactly what the respondent claimed that the appellant represented to them. When there existed such similar undertakings, especially made in a self declaratory statement in a formal document to a party who was very much involved in the matter, then it strongly implied that the representation was made.”

**Case 5 - *Tang Eng Iron Works Co Ltd v Ting Ling Kiew & Anor [1990] 2 MLJ 440:*** “It was held in dismissing the defendants’ appeal that the onus was on the plaintiffs to show that the defendants had been guilty of dishonest fraud. The plaintiffs had succeeded in showing that the defendants had intended to defraud the plaintiffs: (a) the use of the loan moneys for a purpose other than what they were meant for constituted dishonest fraud; (b) the loans to the directors were in breach of s 133 of the Companies Act 1965, and the defendants had tried to pull wool over the eyes of the plaintiffs by that fact in the accounts; and (c) the speed

of disposal and registration of the property and the direct payment to PFB in settlement of HLE's debt showed a scheme to defraud the plaintiffs.”

**Perspective Analysis of Sub-contractors on ‘Payment Upon Certification’:** 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 81 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 ‘direct payment’ and the use of ‘direct payment’ provisions as payment remedies for sub-contractors. The 5-level likert scale was used including prevailing the respondent’s lack of knowledge on the payment methods that is either they are not sure, do not understand or filling blanks.

Table 1 shows the level of agreement on the two questions that are thrown to the sub-contractors to benefit from, under ‘direct payment’ provision. Twenty-six percent (26%) respondents agreed that there are problems in regards to the existing ‘direct payment’ in sub-contract. Added to that, twenty-one percent (21%) respondents strongly agreed with the problems. However, sixteen percent (16%) and ten percent (10%) respondents respectively were not sure and did not fill the required questions whether the use of ‘direct payment’ provisions are adequate enough to add to the problems, whereas sixteen percent (16%) and eleven percent (11%) respondents were respectively disagreed and strongly disagreed.

Tab.1 perspective of sub-contractors on direct payment

Issues	Did Not Fill	Strongly Disagreed	Disagreed	Not Sure	Agreed	Strongly Agreed
Existing problems	10%	11%	16%	16%	26%	21%
Usage as remedies	10%	1%	0%	16%	43%	30%

In contrast with the provision of existing problems with ‘direct payment’ as stated above, forty-three percent (43%) and thirty percent (30%) respondents still respectively agreed and strongly agreed that the use of ‘direct payment’ provision will solve problems in sub-contractor’s payment. Sixteen percent (16%) and ten percent (10%) respondents were respectively not sure or did not fill the required questions, whereas only one percent (1%) respondents strongly disagreed with the use of ‘direct payment’ provision.

#### 4. CONCLUSION AND RECOMMENDATIONS

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 ‘direct 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 so-called ‘Security of Payment’ regime applied in other developed country could be the solution in Malaysia. The sub-contractor, though, have to have the knowledge of adjudication in order to benefit from it. However, at the current state, it is not legitimate to use as an aid in the construction of a contract anything which the parties said or did after it was made; it is to understand the clear meaning of the terms; a winding up petition is not a legitimate means of seeking to enforce payment of a debt; when there existed a self declaratory

statement in a formal document, it strongly implied that the representation was made; and the onus was on the plaintiffs to show that the defendants had been guilty of dishonest fraud.

There are contrasting agreement in the application of ‘direct payment’ provision. In one hand, most of the respondents agree on the current problems in regards to ‘direct payment’ for the sub-contractors, but on the other hand, most of the respondents agree on the usage of the ‘direct 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 quite an amount of 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.

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