'PAY WHEN PAID' CLAUSES IN SUB-CONTRACTS*

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1.0 INTRODUCTION

1.1 It will not be incorrect to state that, for most non-standard building and engineering sub-contracts, there will inevitably be comprised therein a provision to the effect that the sub-contractor will only be paid after the main contractor himself has received payment from the employer (as the owner or promoter of the project or building is often but inaccurately referred to). Such a provision is often loosely termed in the industry as a 'pay when paid' clause.

1.2 On a wider context, there will also very often be a provision to the effect that the liabilities of the main contractor under the main contract will be assumed by the sub-contractor if such liabilities shall arise between the employer and the main

contractor *inter-se* which relate to the works comprised within the sub-contract. Such a provision is often loosely termed in the industry as a 'back-to-back' clause.

1.3 It may be stated at the outset that the terms 'back-to-back' and 'pay when paid' are broad and loose terms of industry usage and they have no defined legal meanings. Their intended effects may depend on a construction of the relevant provision actually incorporated and expressed in the sub-contract. In England itself a 'pay when paid' clause was first recognised in the well-known case of *Modern Engineering (Bristol) Ltd* v. *Gilbert-Ash (Northern) Limited*.[1]

1.4 It is the experience of this writer in Malaysia that often a 'pay when paid' clause is loosely drafted with many practical aspects of its enforceability, and the issues which can arise, not adequately covered nor carefully considered. There are even sub-contracts, which purport to convey the intended effect of 'pay when paid' provisions, that merely provide, "This contract shall be back-to-back with the main contract."! It must be appreciated that in the absence of privity between the employer and the sub-contractor, the terms of the main contract cannot bind the sub-contractor if such terms are not expressly incorporated into the sub-contract.

1.5 As perceptively pointed out by Lord Denning M.R., "There must be 'cashflow' in the building trade. It is the very lifeblood of the enterprise."[2] The main contractor will no doubt have the health of his cashflow in mind when he incorporates a 'pay when paid' provision in a sub-contract. The effect of this is that the risk of an unhealthy cashflow is as a consequence shifted to the sub-contractor. That brings into focus the subject matter of this paper *viz.* an analysis of 'pay when paid' clauses in sub-contracts and their enforceability, effects on related subjects such as insolvency of the employer, summary judgment

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1 [1974] A.C. 689 (HL); [1973] 3 All ER 195 (HL).

2 *Modern Engineering (Bristol)* v. *Gilbert-Ash (Northern) Ltd* (1973) 71 LGR 162 (CA) at p. 167. The decision of Lord Denning M.R. was overturned on appeal to the House of Lords (see Note 1 above) but the Law Lords (except for Viscount Dilhorne who quoted the relevant passage) did not in their opinion touch on this *dictum* of the Master of the Rolls.

application by the sub-contractor and others. It will also make a foray into the issue if this aspect of sub-contractor payment should be legislated as is the case in some jurisdictions to avoid the 'harshness' of these 'pay when paid' clauses.

1.6 It goes without saying that the sub-contractor, if he further sub-contracts out the works comprised within the sub-contract to another sub-sub-contractor, the position of the sub-contractor *vis-à-vis* the sub-sub-contractor will be identical to that between the main contractor and the sub-contractor. The chain relationship can go on with a contractor passing the risks to another lower-tiered contractor. The contractual and legal issues will nevertheless remain the same. The sub-contractor can be either a domestic sub-contractor or a nominated sub-contractor.

1.7 This paper will focus only on 'pay when paid' clauses and would not delve into the larger issue of 'back-to-back' provisions in sub-contracts.

2.0 JUDICIAL APPROACH: LITERAL CONSTRUCTION

2.1 A review of the cases decided in this region suggests that the courts appear to have adopted a literal construction in their approach to 'pay when paid' clauses. In the Hong Kong Court of Appeal's case of *Schindler Lifts (Hong Kong) Ltd* v. *Shui On Construction Co Ltd,*[3] the sub-contractor (Schindler) was claiming judgment for sums of money which were alleged to be owing upon two certificates issued under a building contract. The main contractor (Shui On) relied on a clause which provided that payment was to be made by the main contractor to the sub-contractor upon Shui On having received the payment from the developer of the project. The developer had earlier exercised its right of set-off for liquidated damages under the main contract between the developer and Shui On. In setting aside the High Court's decision[4] allowing an application by Schindler for summary judgment, the Court of Appeal effectively recognised the

[3] [1985] HKLR 118 (CA).
[4] [1984] HKLR 340 (HC).

validity of the 'pay when paid' provision in the sub-contract and another Hong Kong High Court's case of *Hong Kong Teakwood Works Ltd* v. *Shui On Construction Co Ltd*[5] was expressly approved.

2.2 The payment provision in *Hong Kong Teakwood* reads as follows:

> "Within 14 days of the receipt by the main contractor of payment from the employer against any certificate from the architect, the main contractor shall notify and pay to the sub-contractor ..."

The High Court in *Hong Kong Teakwood* held that the word "receipt" here must be construed as *actual* receipt by the main contractor of the sum certified in the certificate and Hunter J stated that "the prima facie meaning of receipt of payment is receipt of money".[6]

2.3 On the strength of the Hong Kong authorities, it seems that the court will tend to a literal construction of a 'pay when paid' clause. In fact, it would not be wrong to say that the court inclines to a construction of the clause as a pay *if* paid clause!

2.4 On very much the same material facts, the Singapore High Court in *Brightside Mechanical and Electrical Services Group* v. *Hyundai Engineering and Construction Co Ltd*[7] inclines to follow *Hong Kong Teakwood* even though *Hong Kong Teakwood* is not strictly a binding authority in Singapore. The relevant payment provision in *Brightside* reads as follows:

> "Within five days of the receipt by the contractor of the sum included in any certificate of the architect the contractor shall notify and pay to the sub-contractor …"

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5 [1984] HKLR 235 (HC). This decision was heard about three months before the decision in *Schindler* was handed down in the Hong Kong High Court.

6 *Ibid*., at p. 237.

7 [1988] SLR 186 (HC), [1988] 1 MLJ 500 (HC), (1988) 41 BLR 110 (HC).

In construing the wordings of this provision which Thean J (as His Lordship then was) said were "clear and unambiguous and effect must be given to them", His Lordship concluded that the words "contemplate *actual* receipt by the main contractor of the sum included in the certificate. So construed, the effect of [the clause] is that until the defendants receive the sum claimed by the plaintiffs, the defendants are not obliged to pay it to the plaintiffs."[8] It did not seem to matter that the main contractor in this case did not receive actual payment because the employer was exercising its right of set-off against the main contractor for its delay as liquidated damages.

2.5 A decade after *Brightside*, Choo Han Teck JC (as His Lordship then was) in the Singapore High Court after having referred *inter-alia* to *Schindler*, *Hong Kong Teakwood* and *Brightside* upheld the validity of the 'pay when paid' clause in the case of *Interpro Engineering Pte Ltd* v. *Sin Heng Construction Co Pte Ltd*.[9] His Lordship explained:

> "The most difficult situation concerns instances in which the owner or employer seeks to set-off payments due to the main contractor against some alleged debt owing by the latter to him. In such cases, the sub-contractor is clearly an innocent party who would have done the work and is not being paid even though the employer is solvent. *It is up to the parties to provide expressly in the contract, if they so wished, that the main contractor shall assume responsibility for payment to the sub-contractor in this sort of event. In the absence of such express provisions the sub-contractor runs the risk that a plain reading of the 'pay when paid' clause in their contract leaves him with no remedy*."[10]

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8 *Ibid*., at p. 192 (emphasis supplied).
9 [1998] 1 SLR 694 (HC).
10 *Ibid*., para 19 at p. 701 (emphasis supplied).

2.6 In Malaysia, Azmel Maamor J upheld in the case of *BBR Construction Systems (M) Sdn Bhd* v. *Maxdouble Construction (M) Sdn Bhd*[11] a 'pay when paid' clause and he expressly approved *Brightside*. It seems therefore in Malaysia that a literal construction may also be placed on 'pay when paid' clauses. The relevant 'pay when paid' clause in *Maxdouble* reads as follows:

> "Progress payment, payment of authorised variations and claims after taking into account the … quantities duly checked and certified by the Main Contractor's Representative, shall be made to the Nominated Sub-Contractor at monthly intervals and within 7 days upon receipt of payment by the Sub-Contractor from the Main Contractor."

The High Court had quoted the headnotes in *Brightside* with approval but had regrettably missed an opportunity to examine and analyse the rationale and even the policy for a 'pay when paid' clause.

2.7 In yet another unreported decision, the High Court in Malaya again came to the same conclusion when interpreting a 'pay when paid' clause. Ramly Ali J in *Pernas Otis Elevators Co Sdn Bhd* v. *Syarikat Pembinaan Yeoh Tiong Lay Sdn Bhd*[12] again after reviewing *Schindler*, *Hong Kong Teakwood*, *Brightside* and *Interpro Engineering*, came to the conclusion that "There is no reason why this Court should not follow the same interpretation as that of the Courts in Singapore and Hong Kong" over the 'pay when paid' clause.[13] His Lordship further observed that "the Court has to consider the interest of the Main Contractor as well as the interest of the out-of-pocket Subcontractor; the freedom of contract … and that [the 'pay when paid' clause] must be accepted by the parties with the knowledge of the attendant risks."[14]

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11 [2002] MLJU 104 (HC). It is understood that the case is at the time of writing on appeal to the Court of Appeal.
12 [2003] MLJU 394 (HC).
13 *Ibid*., at p. 20.
14 *Ibid*., at pp. 20 – 21.

3.0 JUDICIAL APPROACH: NON-LITERAL CONSTRUCTION

3.1 In a refreshing approach and one that rejects the strict literal construction approach of the Hong Kong, Singapore and Malaysian cases cited above, Master Towle in the New Zealand High Court's case of *Smith & Smith Glass Ltd* v. *Winstone Architectural Cladding Systems Ltd*[15], similarly after having referred *inter-alia* to *Schindler*, *Hong Kong Teakwood* and *Brightside* declined to follow the reasoning and conclusions therein arrived at.

3.2 It will be pertinent to briefly review the reasons advanced by Master Towle in arriving at the conclusion which he did in *Winstone*. His Honour stated in his judgment the following:

> "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 clauses 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 clauses relied upon contain no ambiguity*."[16]

His Honour continued:

> "For myself I believe that unless the condition precedent is spelled out in clear and precise terms and accepted by both parties, the clauses … *do no more than identify the time at which certain things are required to be*

[15] [1992] 2 NZLR 473 (HC).
[16] *Ibid*., at p. 481 (emphasis supplied).

> *done,* ***and should not be extended into the "if" category to prevent a subcontractor who has done the work from being paid by someone higher up the chain***."[17]

3.3 Master Towle thus in *Winstone* rejected the 'pay when paid' clause being interpreted to mean and take effect as 'pay *if* paid' clause. This is a departure from the approach taken in *Schindler*, *Hong Kong Teakwood*, *Brightside, Interpro Engineering, Maxdouble* and *Pernas Otis.* His Honour further stated that any such 'pay when paid' clause would have to make it clear beyond doubt that the arrangement was to be conditional and not to merely governing the time for payment! As will be elaborated at later stage, the concept of rendering the 'pay when paid' clause as a ***condition precedent*** carries with it other implications.

3.4 His Honour regarded it as "strange" that the point had not previously been argued in Australia (and thus did not cite any authority from that jurisdiction) but he cited several American authorities and expressed the conclusion that "I believe that the approach which has been identified from the American decisions referred to is the correct one."[18]

3.5 Australia responded with a decision touching on this 'pay when paid' clause more than two years later *via* the Supreme Court of Queensland in *Iezzi Construction Pty Ltd* v. *Watkins Pacific (Qld) Pty Ltd*.[19] The material part of the 'pay when paid' clause in *Iezzi Construction* reads as follows:

> "(10) (c) The Builder shall make progress payments to the Subcontractor within fourteen (14) days after the Builder has received payment from the Proprietor in respect of the Work, the subject of the Subcontractor's claim."

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17 *Ibid*., at p. 481 (emphasis supplied).
18 *Ibid*., at p. 481.
19 [1995] 2 Qd. R. 350 (SC).

> (10) (d) It is expressly agreed that the Subcontractor's right to receive payment is entirely dependent upon the Builder having already received from the Proprietor payment in respect of the work, subject of the Subcontractor's claim, and that the Subcontractor shall have no other right to payment."

In *Iezzi Construction*, the proprietor (or more commonly referred to as the employer in this region) went into liquidation leaving monies unpaid to the builder (more commonly referred to as the main contractor). The builder thus repudiated the sub-contract which repudiation the sub-contractor accepted and subsequently sued the builder on a *quantum meruit* or for damages for breach of contract for in respect of unpaid work. The builder understandably put up a defence by relying on clause 10(d) reproduced above but the sub-contractor's claim for *quantum meruit* was upheld. The builder's appeal to the Supreme Court was dismissed.

3.6 The first English authority to have analysed in detail a 'pay when paid' clause is the decision of HHJ Humphrey Lloyd QC in the Technology and Construction Court's case of *Durabella Ltd* v. *J Jarvis & Sons Ltd*[20]. It may be stressed that the learned judge did not rule against the enforceability of such a properly drafted clause, but he added a qualification:

> "A contractor cannot rely on a 'pay when paid' clause if the reason for non-payment is its own breach of contract or default. It is trite law that one cannot take advantage from one's breach of contract. So if the employment of a contractor under a JCT form had been lawfully terminated for default to which a sub-contractor had not contributed then the contractor could not take advantage of the provisions by which the normal contractual code for payment is replaced by the new code under which no payment may be made until completion. The contractor has

[20] 83 ConLR 145 (QBD, TCC).

either deprived the sub-contractor of the opportunity to complete the sub-contract works, or, if they have been completed, of the opportunity to be paid upon application, statement, or certificate."[21]

3.7 The learned judge went on to state that a 'pay when paid' clause:

> "… can only be effective so long as the machinery of payment is capable of being operated. *It is an implied condition for the operation of such a clause*. If the machinery breaks down, e.g. certificates are not or cannot be issued as they should be, then the contractor, although it may not in any way be responsible, is nevertheless best placed to remedy the situation. *If the clause is to be effective then the contractor impliedly undertakes that it will pursue all means available to obtain payment, or it will not be able to rely on the provision to defeat the sub-contractor's claim*."[22]

3.8 The implication of the judgment quoted above (as well as that in *Winstone*) will be discussed at a later stage but suffice it to say that a 'pay when paid' clause, if it is subject to penetrating analysis, may not stand up to scrutiny and a literal construction of a 'pay when paid' clause should not be taken to be the only approach to construing such a clause. If the wordings of the relevant clause are clear, precise and unambiguous to convey the intended meaning, then the court may give effect to it. But it will be a daunting task indeed for a draftsperson of such a clause to actually express that it shifts *all* the risks of the upper-tiered contractor to the lower-tiered contractor, including the risk of insolvency of the employer.

3.9 In *Durabella*, HHJ Humphrey Lloyd QC opined, "The policy adopted in some American jurisdictions need not necessarily apply here."[23] In *Winstone*, Master Towle would however go so far as to say that "… I believe that *the approach*

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21 *Ibid*., para 17 at p. 154.
22 *Ibid*., para 18 at p. 154 (emphasis supplied).
23 *Ibid*., para 2 at p. 148.

which has been identified from the American decisions referred to is the correct one."[24]

3.10 It will be useful to cite one oft-cited American authority by way of illustration. In *Thomas J Dyer Co* v. *Bishop International Engineering*[25] the Court of Appeal held that the relevant 'pay when paid' clause was designed to effect the postponement of payment for a reasonable period after work had been completed so as to allow the main contractor opportunity to procure the necessary funds to the sub-contractor, but this was not to effect a *indefinite* postponement until the main contractor had himself been paid.

3.11 *Thomas Dyer* has been consistently followed in most American jurisdictions[26] to the knowledge of the present writer.

4.0 COMMENTS IN CONSTRUCTION LAW TEXTS

4.1 It will be useful to briefly survey and examine the commentaries of various learned texts in construction law to see what can be learned and distilled from them. The selected texts are *Hudson*, *Keating*, and *Emden*.

4.2 *Hudson* expresses the view that a 'pay when paid' sub-contract "has many features of a joint venture between main and sub-contractor"[27] and the learned editor of *Hudson* goes on to state that the presence of such a clause "will

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24 *Winstone, op. cit.*, at p. 481 (emphasis supplied). See also para 3.4 above.

25 (1962) Co 303 F2d 655 (CA).

26 For example, in *Midland Engineering Co* v. *John A Hall Construction Co* 398 F Supp 981 (1975) and *Peacock Construction Company Inc* v. *Modern Air Conditioning* (1977) Fla App 353 So 2d 840. *Peacock Construction* is one of the American authorities cited and followed by Master Towle in *Winstone*. *Thomas Dyer* has however been criticised by I. N. Duncan-Wallace QC in his collection of papers, *Construction Contracts: Principles and Policies in Tort and Contract* (1986) at pp. 321 – 323. It is submitted that, with respect, the learned editor of *Hudson*, in coming to his conclusion that *Thomas Dyer* has ignored the intention of the parties to the contract, has erred in construing the contract from a subjective viewpoint rather than from an objective viewpoint as he should have. See para 5.1 below.

27 I. N. Duncan-Wallace QC, *Hudson's Building and Engineering Contracts* 11th Edition (1995) (herein as "*Hudson*") Volume 2, para 13.110 at p.1363.

obviously support a 'joint venture' interpretation where there is no separate provision in the sub-contract regulating the timing and payment of any final balance… The presence of such a provision specifically relating to final balance is naturally still more likely … to be in favour of a 'joint venture' interpretation."[28]

4.3 With respect to the learned editor of *Hudson*, this writer finds difficulty to concur with such a view. A contractor and a lower-tiered contractor cannot be construed as forging a "joint venture" just because of the presence of a 'pay when paid' clause; a joint venture cannot be said to have been forged and formed by the presence of one provision which *may* suggest this while ignoring the rest of the provisions of the sub-contract which do not point to and suggest an intended joint venture.[29]

4.4 *Keating*[30] has briefly touched on 'pay when paid' provisions in sub-contracts but it is suggested that it does not contain any new material which has not been discussed above.

4.5 *Emden* has criticised *Schindler*, *Hong Kong Teakwood* and *Brightside* on the following two grounds:

> "… firstly they give the notion of 'receipt' of money unduly narrow meaning, requiring an actual transfer of funds rather than including a settlement by way of set-off, which would normally be sufficient to establish payment. Secondly, it seems doubtful whether the contractor's

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28 *Ibid*., para13.144 at p. 1366.

29 Choo Han Teck JC (as His Lordship then was) in *Interpro Engineering* stated that "… it is not likely that these parties would normally intend to form a joint venture partnership as such. It is only so far as the reward of profit is concerned that they may agree that they will both share the risk of the employer not making payment." See *Interpro Engineering*, *op. cit.*, para 14 at p. 699.

30 Stephen Furst and Vivian Ramsey, *Keating on Building Contracts* 7th Edition (2001) (herein as "*Keating*") para 12-63 at pp. 370 – 371. It is to be noted that this edition of *Keating* predates *Durabella*. The paragraph reads, in part, "there is no reason, in principle, why the English courts should not give effect to a properly drafted clause according to its true construction." This statement has been described by HHJ Humphrey Lloyd QC as being "somewhat delphically" in *Durabella*, para 15 at p. 153.

right to withhold payment should be exercised when payment is in turn withheld by the employer on the basis of a matter which is not the fault of the sub-contractor. *This is almost equivalent to allowing a party to take advantage of his own wrong …*"[31]

4.6 The learned authors of various texts thus offer different positions on a common issue. The present writer will offer his own view below and to which we now turn. It however has to be said that the present writer will attempt to analyse the issue from first principles and from both policy and equity viewpoints.

5.0 LITERAL CONSTRUCTION: A CRITIQUE

5.1 Three points will first have to be made clear. Firstly, for a 'pay when paid' clause to be effective, it must be expressly stated in the sub-contract itself and not by merely referring to it in another document, e.g. the provisions in the main contract. This was so held in the Malaysian case of *Royden (M) Sdn Bhd* v. *Syarikat Pembenaan Yeoh Tiong Lay Sdn Bhd*.[32] Lim Beng Choon J in *Royden* distinguished *Brightside* on the ground that the main contract conditions did not bind the sub-contractor even though there was a provision in the sub-contract (as most sub-contracts invariably would) to the effect that the sub-contractor shall been deemed to have notice of all the provisions of the main contract. Secondly, in attempting to ascertain the presumed intention of the contracting parties to a contract, the court will generally adopt an *objective* approach: this means that the court will consider what would have been the intention of *reasonable persons* in the position of the actual parties to the contract and not the post-event declaration and conduct of the parties themselves.[33] Thirdly, even though the completion dates for construction contracts are not usually of the essence, the time of

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[31] A. J. Anderson *et al*, *Emden's Construction Law* 8th Edition (1992) (herein as "*Emden*"), para [816] at p. II 244 (emphasis supplied, footnotes omitted).

[32] [1992] 1 MLJ 33 (HC).

[33] See generally Kim Lewison QC, *The Interpretation of Contracts* 3rd Edition (2004), para 1.03 at pp. 4 – 7 and para 2.05 at pp. 26 – 31.

effecting payment in construction contracts, being commercial contracts, will be of the essence.

5.2 The position of the present writer is that a 'pay when paid' clause should not be literally constructed or interpreted: the reasoning and the conclusion in *Schindler*, *Hong Kong Teakwood*, *Brightside*, *Interpro Engineering*, *Maxdouble* and *Pernas Otis* should not be regarded as correct and final. It is further submitted that this literal approach can and will in many instances lead to injustice and, taken to their logical conclusion, even absurdity.

5.3 Let's picture the following likely scenario in the Malaysian construction scene. The developer of a project, possibly as a business strategy or may be (cynically) as a means of circumventing the cumbersome provisions of for example Housing Development Account, appoints its own fully-owned subsidiary to be the contractor to undertake the construction of the project. This main contractor will then appoint a sub-contractor (SC 1) to undertake the construction and SC 1 further sub-contracts the works to another sub-contractor (SC 2). In all the sub-contracts, a 'pay when paid' clause is incorporated. The developer, for the purpose of internal accounting or for other corporate or fiscal reasons, fails to pay the main contractor. Does this mean that SC 1 and SC 2, in particular SC 2, will need to suffer because of this? No doubt for SC 2 to assume greater risks (of not being paid), he can price for this and in principle should have priced the works at a higher price but if that were to be the case (Isn't it a truism that price reflects risks?), would it be meaningful for SC 1 to sub-let the works to SC 2? Or for that matter, if the argument goes, would it be meaningful for the main contractor to sub-let the works to SC 1? Seeing from this perspective, the 'pay when paid' clause/arrangement can be argued (theoretically) from first principles to lack justification for its continued use and adoption. Commercial world would of course operate differently.

5.4 It is pertinent to stress that *Schindler*, *Hong Kong Teakwood* and *Brightside* are all decisions on summary judgment (Order 14) applications and thus were not fully argued in full trials, the conclusions and decisions therein arrived at cannot thus be said to be final. In *Hong Kong Teakwood*, Hunter J expressly stated that his interpretation of the relevant 'pay when paid' clause in that case was what he himself would regard as "the prima facie meaning".[34] This view was echoed by Thean J (as His Lordship then was) in *Brightside* where His Lordship stated that his view of the 'pay when paid' clause in that case "can only be regarded as a *provisional one*, or in the words of Hunter J, a prima facie one."[35] Being *prima facie*, provisional and not being final, it is submitted that the interpretations of the respective 'pay when paid' clauses therein advanced can and should be subjected to scrutiny and critical comments.

5.5 The implications of a 'pay when paid' clause being a condition precedent expounded by Master Towle in *Winstone* can be developed further. This condition precedent must be distinguished from that which renders a contract a *conditional contract*, one which will only come into existence and be a binding contract upon the fulfilment of the condition. In our discussion, the condition precedent refers to one which suspends the performance of an obligation comprised within the binding contract until the fulfilment of that condition.[36]

5.6 The implications of a 'pay when paid' clause being a condition precedent can be the following:

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34 *Hong Kong Teakwood*, *op. cit.*, p. 240.

35 *Brightside*, *op. cit*., p. 192 (Italics supplied).

36 See for example, *National Land Finance Co-operative Society Ltd* v. *Sharidal Sdn Bhd* [1983] 2 MLJ 211 (FC) and *Aberfoyle Plantations Ltd* v. *Khaw Bian Cheng* (1960) 26 MLJ 47 (PC). Further, note however section 33(a) of Contracts Act 1950 which provides that "Contingent contracts to do or *not to do anything* if an uncertain event happens cannot be enforced by law unless and until that event has happened." (Italics supplied)

(a) the parties are under an implied obligation not to prevent the fulfilment of the condition and reasonable opportunity must be given to the party who is under a duty to effect the fulfilment of the condition;[37]

(b) the party who relies on the 'pay when paid' clause may be under an implied obligation to take steps to procure the fulfilment of the condition;[38]

(c) if no time is fixed in the contract itself for the fulfilment of the condition, then the condition must be fulfilled within a reasonable time.[39]

5.7 Following from the above, it can be seen that if a 'pay when paid' clause is a condition precedent, it cannot be construed as a 'pay *if* paid' clause because of the requirement for the fulfilment the condition precedent within reasonable time. In this regard, it is respectfully submitted that the reasoning and conclusion in *Schindler*, *Hong Kong Teakwood* and *Brightside*, as well as *Interpro Engineering*, *Maxdouble* and *Pernas Otis*, cannot be supported. There cannot be an *indefinite time* for which a main contractor suspends his payment obligation to the sub-contractor: the payment must still be made within a reasonable time even if the main contractor has still not received payment from the developer. What constitutes reasonable time is of course a question of fact, not law.

5.8 The conclusion above also spells the logical conclusion that if the developer becomes insolvent and is subsequently wound-up, the sub-contractor will still have a cause of action to recover any outstanding payment from the main contractor notwithstanding the presence of a 'pay when paid' clause in the sub-contract. As submitted above, a 'pay when paid' clause cannot take effect to indefinitely suspend payment; were it to be so the 'pay when paid' clause is essentially construed as one which is a 'pay if paid' clause. This narrow

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37 *Bournemouth & Boscombe Athletic FC* v. *Manchester United F.C.* The Times, May 22, 1980 (HC).
38 This is another way of stating point (a) by putting it in a more active sense.
39 *Aberfoyle*, *op cit*., at p. 49. See also section 47 Contracts Act 1950.

construction, it is submitted, cannot be supported on an analysis of the law from first principles.

5.9 *Schindler*, *Hong Kong Teakwood* and *Brightside* also seem to establish the principle that even if the non-payment by the employer is due to the default of the main contractor, the 'pay when paid' clause would nevertheless still be upheld. As *Emden* has correctly criticised, "*This is almost equivalent to allowing a party to take advantage of his own wrong …*"[40] It is trite law that a party cannot benefit from his own breach.[41] If this principle is accepted, and there is no reason why it should not be, then the principle expounded in *Schindler*, *Hong Kong Teakwood Brightside, Interpro Engineering, Maxdouble* and *Pernas Otis* clearly cannot be supported.

5.10 Can a 'pay when paid' clause in a sub-contract be argued to be unreasonable and ineffective thus would not be given effect? Can it be argued that it is void as being contrary to public policy? Such a possibility had not been approved by HHJ Humphrey Lloyd QC in *Durabella*. To the first of these two questions, it thus seems that the answer is likely to be negative: it can also be said that it depends on the circumstances of the case. The second question is more controversial and it is submitted that it is unlikely that a judge will descend to the arena of the two warring parties and decide this point one way or another on policy ground. It may also be argued that such a task lies within the province of the legislature of the government, not judiciary.

5.11 It may however be mentioned in passing here that in the case of *Bailes* v. *Modern Amusements Pty Ltd*[42] it was held that an agreement between a company and a shareholder that a loan by the shareholder would only be repaid by the company when the company considered it is in a position to repay it was void for

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40 See para 4.5 above and footnote 31.

41 See, for example, *Alghussein Establishment* v. *Eton College* [1988] 1 WLR 587 (HL). This was also recognised by HHJ Humphrey Lloyd QC in *Durabella, op. cit*., para 17 at p. 154.

42 [1964] V.R. 436 (SC, Vic).

uncertainty. If this principle and reasoning in *Bailes* can be imported and applied to 'pay when paid' clauses, the clauses may be argued to be void for uncertainty. Whether the court will take this course however remains to be seen.

5.12 In *Ward* v. *Eltherington*,[43] McPherson J held, with reference to *Bailes*,

> "The plaintiff firm had completed their work … the plaintiffs should be paid for their work. This means that they were to be paid a reasonable sum for their services … The time for payment for the work, as distinct from the right to charge for it all, having been *postponed to an event which has not happened*, and a *reasonable time having elapsed*, the plaintiffs are entitled now to recover the agreed sum for their services. The condition precedent to performance by payment … having been *discharged by impossibility of performance, that condition is discharged, leaving the plaintiffs' right to a fee unconditional and unimpaired*."[44]

It is submitted that the principles established in *Ward* v. *Eltherington* quoted above lend credence to the arguments advanced above *viz.* the literal construction approach in *Schindler*, *Hong Kong Teakwood* and *Brightside* cannot be supported in law even though none of these three cases appears to have been cited in *Ward*.

5.13 The following paragraphs will attempt a criticism of the literal approach of construing 'pay when paid' clauses from a more practical perspective, i.e. that a strict literal construction approach will leave glaring gaps in some of the issues commonly encountered in building and engineering contracts.

5.14 Picture the following scenario in a tripartite employer – main contractor – sub-contractor relationship. As between the main contractor and the sub-contractor *inter-se*, there may be claims pursuant to the sub-contract for what is commonly

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43 [1982] Qd. R. 561 (SC, Qld).
44 *Ibid*., at p. 563 (emphasis supplied).

called "loss and expense" or "Costs" in building and engineering contracts, these claims can be independent of the main contract. In such a situation, can the sub-contractor's claim for payment be resisted on the strength of the 'pay when paid' provision in the sub-contract? Further, claims for "loss and expense" or "Costs" are by their nature out-of-pocket claims which do not entitle the claimant to any profits or mark-ups, would it then be equitable for the main contractor to subject these claims to the mercy of the 'pay when paid' clause? In similar vein, what about *quantum meruit* claims and claims for refund of retention monies? It is submitted these *quantum meruit* claims and claims for release of retention monies fall within the same category as that for "loss and expense" or "Costs" claims which do not contain any profit element.[45] What then is the situation with variation works? It is suggested that if the validity of a 'pay when paid' clause can be upheld, it may be that the clause can be used to postpone payment of these works for a reasonable period.

5.15 If the main contract is terminated, the contract comes to an end and ceases to exist, there will not be any contractual machinery of payment capable of being operated and thus the 'pay when paid' clause in the sub-contract cannot be effective and be used by the main contractor against the claims of the sub-contractor.[46] What if the situation is one when it is the employment of the main contractor which has been determined as is more commonly the case?[47] In this case, the main contract survives and it is only the main contractor's *employment* under the main contract which has been determined. In such a situation, can the main contractor resist the sub-contractor's claims for payment by resorting to the 'pay when paid' clause? On the strength of *Durabella*, it is submitted that the main contractor's attempt in this regard is not likely to succeed.[48]

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45 In *Iezzi Construction*, the Court of Appeal in Queensland held that the 'pay when paid' clause therein excluded *quantum meruit* claims.

46 See the judgment of HHJ Humphrey Lloyd QC in *Durabella*, *op. cit.*, para 18 at p. 154.

47 See, for example, clause 25.2 of PAM 1998 Standard Form of Building Contract and clause 44.1(c) of CIDB Standard Form of Contract for Building Works 2000 Edition.

48 See the judgment of HHJ Humphrey Lloyd QC in *Durabella*, *op. cit.*, para 17 at p. 154.

5.16 The question of set-off is a tricky one. In *Schindler*, *Hong Kong Teakwood* and *Brightside* the payment which should otherwise have been made by the employer has not been "actually and physically" made because the amount involved has been set-off by the amount which was owed, or claimed to have been owed, by the main contractor. What if the main contractor has actually issued a certificate to the sub-contractor on the sum certified? Would this entitle the sub-contractor to payment despite the presence of the 'pay when paid' clause? Would the situation be the same if the Engineer/S.O./Architect has actually issued a certificate to the sub-contractor directly?[49]

5.17 It must be stressed that a properly issued payment certificate establishes an entitlement or a right to payment of the sum so certified subject to permissible contractual set-offs[50] but it does not address the issue of the actual payment itself. At any rate, the question of actual payment is beyond the jurisdiction of the certifier in most building and engineering contracts, be they of standard or non-standard varieties and it is not one which can be "certified" and be indicated on a certificate. It is therefore submitted that the entitlement of a sub-contractor who has been issued a certificate may still be subject to the constraints of the 'pay when paid' clause if the validity of the clause can be upheld. The presence and implications of the 'pay when paid' clause and the issuance of a payment certificate (and hence the implications on payment of *Pembenaan Leow Tuck Chui*) are separate matters.

5.18 There is one more practical difficulty on the operation of a 'pay when paid' clause. It may not be a problem in a tripartite situation of employer – main contractor – sub-contractor if the main contractor fully sub-lets the works comprised within the main contract to a single sub-contractor. However, what if

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[49] For example as in the case of nominated sub-contractor/supplier under clause C3.(b) in Option Module C of CIDB Standard Form of Contract for Building Works 2000 Edition; note however that CIDB Standard Form of Contract for Building Works 2000 Edition does not contain any 'pay when paid' provision for nominated sub-contractor/supplier sub-contract.

[50] See the illuminating analysis in the judgment of Edgar Joseph Jr FCJ in *Pembenaan Leow Tuck Chui & Sons Sdn Bhd* v. *Dr Leela's Medical Centre Sdn Bhd* [1995] 2 MLJ 57(SC).

there are a few or many sub-contractors whose works collectively form the works comprised within the main contract and whose claims to the main contractor collectively form the main contractor's claim to the developer/employer? Picture the following scenario. The developer/employer releases less than the certified sum to the main contractor and sets-off the remainder because of the default of the main contractor, for example deduction for liquidated damages. If all the sub-contracts contain therein 'pay when paid' clauses, how is the main contractor to apportion and ascertain which sub-contractors to pay, and what amounts?

5.19 The discussion can be taken a step further. If the main contractor's claim to the developer/employer is the summation of all the sub-contractor's claims and if the sum certified by Engineer/S.O./Architect is less than this amount and no breakdown is given on the face of the certificate, the main contractor will still face the same problem.

5.20 In such situations and if the 'pay when paid' clauses do not contain specific provisions to cater for these, it is submitted that the 'pay when paid' clauses can be argued to lack certainty and are ambiguous and in such situations, the relevant 'pay when paid' clauses can be construed strictly *contra proferentem*.

5.21 Aggregating the discussions above, it is respectfully submitted that the ratios of *Schindler*, *Hong Kong Teakwood* and *Brightside*, if at all they do propound any coherent and defined principles, and all cases which purport of follow these three cases[51], may need to be re-examined. The principles laid down in *Winstone*, *Durabella* and *Ward* are logical, well reasoned and equitable and should rightly be considered by the judiciary and even arbitrators. The approach of the American authorities, as exemplified by *Thomas Dyer*, should also be considered.

[51] Such as *Interpro Engineering* and *Maxdouble, op. cit*.

6.0 OTHER CONSIDERATIONS

6.1 If the sub-contractor commences a writ action against the main contractor and the main contractor's only defence is the provision of a 'pay when paid' clause in the sub-contract, can the sub-contractor's summary judgment application[52] succeed? The decisions of *Schindler*, *Hong Kong Teakwood* and *Brightside* are all Order 14 applications and in all three cases, the plaintiffs failed.

6.2 It needs to be appreciated that "[T]he effect of Order 14 is to shut the defendant from having his day in the witness box. It is a very special jurisdiction and is only to be invoked in cases where there is no triable issue."[53] In *Fadzil bin Mohamed Noor* v. *Universiti Teknologi Malaysia*[54], Raja Azlan Shah CJ (Malaya) (as His Royal Highness then was) said,

> "An Order 14 order in the view we have always taken of it is a very stringent procedure because it shuts the door of the court to the defendant. The jurisdiction ought only to be exercised in proper cases."[55]

Further, it is also provided that summary judgment ought to be refused where the court is satisfied that "there is an issue or question in dispute which ought to be tried or that there ought for some other reason to be a trial of that claim."[56]

It is therefore pertinent to ask if the 'pay when paid' defence is a reason where "there ought … to be a trial"? As stated above, the judges in *Schindler*, *Hong Kong Teakwood* and *Brightside* had all answered the question in the affirmative.

6.3 In *Schindler*, McMullin VP opined,

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52 Order 14 Rules of High Court 1980 and Order 26A Subordinate Courts Rules 1980.
53 *Ng Hee Thong* v. *Public Bank Bhd* [1995] 1 MLJ 281 (CA) *per* Sri Ram JCA at p. 287.
54 [1981] 2 MLJ 196 (FC).
55 *Ibid*., at p. 199.
56 Order 14 r 3(1) Rules of the High Court 1980.

> "Given the complexity of the chain of contract (*sic*) binding the employers, the sub-contractor and the main contractor, these were not questions fit for determination upon O. 14 proceedings, even though the resolution of them depended upon the legal interpretation of the contractual documents."[57]

6.4 A contrary approach was however adopted by Master Towle in *Winstone* where he granted an application for summary judgment the relevant contract under consideration of which also contained a 'pay when paid' clause. His Lordship said in his judgment in *Winstone* that the arguments focused on the 'pay when paid' clause were not "seriously arguable":

> "I am satisfied that the documentation adduced is sufficiently clear to show that those defences are not seriously arguable and in a summary judgment context the plaintiff discharges the burden of showing that there is no reasonably arguable defence."[58]

6.5 It is submitted that it is a general rule in hearing Order 14 application that where there is a difficult question of law to be tried, leave to defend should be granted, that is, the application for summary judgment will not succeed. This however should not be taken as the fixed and unchanging rule. In *SL Sethia Liners Ltd* v. *State Trading Corp of India Ltd*[59] Kerr LJ explained:

> "… If a point of law is raised on behalf of the defendants, which the court feels able to consider without reference to contested facts simply on submission of the parties, then it is now settled that in applications for summary judgment under O 14 the court will do so in order to see whether there is any substance in the proposed defence. If it concludes that, although arguable, that point is bad, then it will give judgment for the

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57 *Schindler, op. cit.*, at p. 124.
58 *Winstone, op. cit.*, at p. 482.
59 [1985] 1 WLR 1398 (CA).

plaintiffs … If the contract between the parties contains an arbitration clause to which s 1 of the Act of 1975 applies, then the court is not thereby precluded from considering whether there is any arguable defence to the plaintiffs' claim. If the court concludes that the plaintiffs are clearly right in law then it will still give judgment for the plaintiffs. In the same breath, as it were, it will then have decided that in reality there was not in fact any dispute between the parties. If the court is satisfied that the plaintiffs are clearly right in law, and that the defendants have no arguable defence, then it will not avail the defendants to have raised a point of law which the court can see is in fact bad. In those circumstances the defendants cannot be heard to say that there was a dispute to be referred to arbitration. But if the court concludes that the plaintiffs are not clearly entitled to judgment because the case raises problems which should be argued and considered fully, then it will give leave to defence, and it is therefore bound to refer the matter to arbitration under s 1 of the Act of 1975."[60]

6.6 Aggregating the discussion in the preceding few paragraphs, it is submitted that the plaintiff in a summary judgment application will have an uphill task if 'pay when paid' defence is raised.[61] It will thus be left to the higher judiciary to authoritatively state and conclude the law with respect to 'pay when paid' clauses and until then, as already stated, the plaintiff's application pursuant to Order 14 Rules of High Court 1980 will not be an easy one.[62] Summary judgment can however be given for the sum which is "indisputably due" and the Court can refer the rest to arbitration.[63]

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60 *Ibid*., at pp. 1401 – 1402.

61 This defence must however be pleaded: *Janagi* v. *Ong Boon Kiat* [1971] 2 MLJ 196 (HC). It may be pertinent to point out that the point was fully argued in a full trial with witnesses called from both the plaintiff and the defendant in *Maxdouble* i.e. *Maxdouble* is not a case on Order 14 application.

62 See however the decision of the (former) Supreme Court in *Malayan Insurance (M) Sdn Bhd* v. *Asia Hotel Sdn Bhd* [1987] CLJ (Rep) 182 (SC) where it was held that if the issue raised is solely a question of law and simple undisputed facts the Court should exercise its duty under Order 14 RHC 1980 and decide on the question of law.

63 *Ellis Mechanical Services Ltd* v. *Wates Construction Ltd* [1978] 1 Lloyd's Rep 33 (CA) *per* Lord Denning MR at p. 35.

6.7 It will be pertinent to ask another question: what would be the legal position if the same sub-contract contains both a 'pay when paid' clause and an arbitration clause? Can a defendant in this case defeat a summary judgment application by resorting to an application for a stay of legal proceedings?[64] It is submitted that Kerr LJ in *SL Sethia* has convincingly laid down the law in this situation[65] and the application for a stay of legal proceedings with a singular view of defeating a summary judgment application will not succeed.[66]

7.0 LEGISLATIVE INTERVENTION?

7.1 As stated earlier, and is obviously understood, 'pay when paid' clauses can work injustice to no fault of the sub-contractor. In present economic climate, jobs are scarce and lower-tiered contractors strictly do not enjoy equal bargaining power *vis-à-vis* the higher tiered contractor. Further, if the situation gets rough, too many bankruptcies involving contractors will certain not lend a healthy outlook of the economy. One can be thus forgiven to ask if legislative protective measures should be enacted to shield these commercially weak, and weakened, contractors from the hardships of 'pay when paid' clauses which are labelled by certain quarters as "unhealthy commercial practices" of the construction industry.

7.2 However, it may also be argued that in a free enterprise economy, why should the legislature be involved in matters which are best left to businessmen to conclude their deals on negotiating table? Further, laws should not be enacted just because of the present economic climate alone: what if in years to come the table is turned? In addition, it is also claimed, not without validity, that some sub-contractors are giants themselves. Indeed, HHJ Humphrey Lloyd QC in

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64 Application made pursuant to section 6 Arbitration Act 1952.
65 Quoted *in extenso* in para 6.5 above.
66 Section 1 Arbitration Act 1975 in Kerr LJ's judgment in *SL Sethia* refers to application for stay of legal proceedings and so that the matter (dispute or difference) can be referred to arbitration.

Durabella regarded both parties to be of equal bargaining power[67] and the learned judge went on to say:

> "Certain sectors of the construction industry were found to be already so well organised that no regulation of any of their contracts or sub-contracts (at whatever level or tier) was needed."[68]

7.3 Further, Choo Han Teck JC said in *Interpro Engineering*:

> "While the courts will readily wrap a caring arm around the weak and the meek, they cannot do so in every instance. Everyone negotiates his own contract. He is at liberty to give and take as much as he can mutually agree with the other side. *The sub-contractor per se is not a special species which requires special principles of law to give him a generous dose of legal protection*."[69]

7.4 Central to the whole controversy will of course be the crucial question of the lower-tiered contractor's cash flow. Lord Denning MR's oft-cited *dictum* that "There must be 'cash flow' in the building trade. It is the very lifeblood of the enterprise."[70] invited the following direct and somewhat blunt responses from Lord Diplock in the House of Lords, "… so it is of all commercial enterprises engaged in the business of selling goods or undertaking work or labour …"[71] and "Cash flow is the lifeblood of village grocer too …"[72]

7.5 That famous though perhaps overworked *dictum* of the Master of the Rolls had been described by Lord Diplock as "so elementary an economic proposition".[73] It

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67 *Durabella, op. cit.*, para 16 at p. 154.
68 *Durabella, op. cit*., para 20 at p. 155.
69 *Interpro Engineering, op. cit.*, para 10 at p. 698 (emphasis supplied). Ramly Ali J in *Pernas Otis, op. cit.* at p. 21, also used a similar phrase as that emphasized.
70 *Modern Engineering (Bristol)* v. *Gilbert-Ash (Northern) Ltd* (1973) 71 LGR 162 (CA) at p. 167.
71 *Gilbert-Ash (Northern) Ltd* v. *Modern Engineering (Bristol)* [1973] 3 All ER 195 (HL) at p. 215.
72 *Ibid*., at p. 216.
73 *Ibid*., at p. 216.

has also been graphically referred to as "the fatigued mantra" by V. K. Rajah JC in the Singapore High Court in *Jia Min Building Construction Pte Ltd* v. *Ann Lee Pte Ltd*.[74] These however should not be used to detract from the importance of cash flow in building industry, indeed in all commercial enterprises.[75]

7.6 In *J. M. Hill & Sons Ltd* v. *London Borough of Camden*[76], Lawton LJ said, at p. 45 of the judgment:

> "As I have said, ***the very essence of the provisions of contract about payment on the architect's certificate was to maintain cash flow of the contractors*** …" (emphasis added)

7.7 The question of whether there should be any legislative protection of the sub-contractors against the adverse effects of the 'pay when paid' clauses is thus one which, like most political issues, there may not be a right or wrong answer. It must however be stated that some jurisdictions have enacted acts precisely to this effect. For example, Building and Construction Industry Security of Payment Act 1999 (amended 2002) in New South Wales, Australia; Construction Contracts Act 2004 in Western Australia; Construction Contracts Act 2002 (New Zealand); Builders' Lien Act (Alberta, Canada) and Housing Grants, Construction and Regeneration Act 1996 in England are all parliamentary initiatives to contain the harshness of the 'pay when paid' clauses and others besides.

7.8 It may be briefly mentioned here that 'pay when paid' clauses have been made ineffective in England if the employer is still solvent;[77] this effectively removes from the risks of the sub-contractor one of the worst effects of 'pay when paid' clauses.

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74 [2004] 3 SLR 288 (HC, S'pore) at p. 298, para 31.
75 Lord Diplock himself accepted this: see *Gilbert-Ash, op. cit.*, at p. 215.
76 (1980) BLR 31 (CA).
77 Section 113 (1) Housing Grants, Construction and Regeneration Act 1996 (England).

7.9 Across the causeway, Singapore has in 1April 2005 put into effect The Building and Construction Industry Security of Payment Act 2004. Under this Act, 'pay when paid' clauses are rendered unenforceable "by whatever name called".[78]

8.0 CONCLUSIONS

8.1 This paper has attempted to first analyse the literal construction of 'pay when paid' clauses and gone on to detail the alternative approaches of construing such clauses in sub-contracts. A critique of the literal approach followed which analysed 'pay when paid' clauses from first principles and using the fact that these clauses are essentially conditions precedents to be fulfilled before payment can be effected. It is submitted that construing 'pay when paid' clauses as 'pay if paid' clauses cannot be legally supported and 'pay when paid' clauses can only take effect, if they can be upheld, to postpone payment for a reasonable period of time.

8.2 It cannot be said that the law in this area is well settled. The final words on these 'pay when paid' clauses await inputs from the higher judiciary, or from the legislature. With the judicial attitude so far exhibited, it seems that any meaningful change would likely have to come from the legislature.

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[78] Sections 9(1) and (2) The Building and Construction Industry Security of Payment Act 2004. See also Chow Kok Fong, *Cash Flow in the Construction Industry – Case for Statutory Intervention* The Singapore Law Gazette, February and March 2005.