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Insights

PAYMENT DOWN THE CHAIN

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SUMMARY

Cash-flow management remains one of the main problem areas in construction and engineering projects. Issues in getting paid, serious enough on their own, are often an early warning sign for a project heading into wider difficulties. There can of course be a number of culprits for cash-flow difficulties.

I'm going to take a look at conditional payment clauses and consider the guises they can take, how different jurisdictions have chosen to deal with them, what problems they can cause and finally, in jurisdictions where they are permitted, approaches which have evolved to mitigate their misuse.

Some background

The construction and engineering sector is not alone in needing to ensure that the cascade of cash for goods and services runs smoothly through a procurement chain. But for a myriad of reasons it has struggled to establish harmonised and globally accepted practices.

In international projects the long journey that a component or material might take from initial order to some of its value being included in a payment application, let alone in a payment, passes through some of the less mainstream provisions of standardised contracts that are seldom negotiated. A supplier or subcontractor can lose its leverage to withhold performance long before it is entitled to payment. As payment filters down from the employer, usually through a main contractor, and then to subcontractors and suppliers, the efficiency of such payments and each tier's recourse against non-payment become highly significant.

Different guises

A pay-when-paid provision, being a catch all term for a range of slightly different models, transfers the risk of delayed payment down the supply chain; the paying party (for example the main contractor) makes payment once it has received the corresponding amount from higher in the chain.

Such provisions typically sit within the overall payment mechanism such that the main contractor is essentially a go-between: collecting and collating applications for payment and passing them up with its mark-up and its own application, and distributing the money downwards (assuming it all goes smoothly).

Variants of “pay when paid” clauses include “certify when certify” or “pay when certified” and others. There are also more onerous provisions which do not focus on the timing of the payment (the **when**) but use condition precedent language to avoid the right to payment arising (the **if**).

Different approaches

Sir Michael Latham’s hugely influential report, Constructing the Team (published in the UK a generation ago), diagnosed a wide range of issues facing the industry and among his many conclusions that:

any attempt… to introduce ‘pay-when-paid’ conditions should be explicitly declared unfair; and invalid.

Legislation was passed in England and Wales in swift response to Sir Michael's report, and is now deeply entrenched in the legal regime for construction projects in the UK. The prohibition of pay-when-paid clauses was one of a number of seismic changes implemented.

Similar prohibitions have been imposed for projects within the borders of numerous jurisdictions including European countries, Australia, Singapore, New Zealand along with several states in Canada and the US. It is also under discussion for contemplated legislation in Hong Kong SAR but this has been stalled for some time. Some special rules often apply in the event of insolvency, but typically where such prohibitions exist all the above variants are barred. Separately, in some jurisdictions "pay-if-paid" provisions have been voided on public policy grounds.

But there are still many jurisdictions without such legislation and, in those, pay when paid arrangements are commonly agreed and/or imposed. Certain standard forms of contract/subcontract also persist in including pay-when-paid clauses or their variants and, to an

extent, this legitimises their continued use where permitted. The Consensus Docs 750 Subcontract Agreement, widely used in the US and further afield, contains a pay-when-paid clause. Similarly, the **FIDIC forms of Subcontract** (which are designed with the 1999 main contract suite in mind) have a mechanism for delaying payment down the chain if the relevant work is not certified or paid to the main contractor. A drafting note and template "particular condition" state that the published terms will need amending or will be invalidated in some countries. By implication, therefore, the concept of such clauses is presented as acceptable market practice where not prohibited.

A problem?

Such an arrangement can place much of the risk of non-payment from the employer on the shoulders of companies or traders that are unable to bear it. It can also put a subcontractor in a helpless position to advance its own claims for payment.

While large subcontractors might be well placed to work with the main contractor to exert a certain amount of pressure on the employer if money is not flowing, that does not always work out in practice; such cooperation relies on a measure of transparency that might not be available or appropriate.

There are also conceptual difficulties: while there are some procurement methods where a main (or management) contractor's role is almost limited to being a go-between, the contractor in traditional procurement structures could be said to have a role that assumes more proactivity.

Mitigation

Generally, though, if such a clause exists in a contract and passes the usual thresholds of enforceability, the issue of whether it's a fair or appropriate arrangement is, on the face of it, moot.

That might not, however, be the end of the story. Larger subcontractors sometimes have the leverage to negotiate provisions that obligate the contractor to take steps, or reasonable steps, to secure payment. Or might provide for a long-stop payment period (or whatever is reasonable) in the event that the employer does not pay or certify.

Occasionally it is argued that an implied obligation on the contractor to the same effect would be appropriate as a way of making commercial sense of the arrangement (for example, the parties could be deemed not to have needed to spell it out that the contractor should not sit back and do nothing where it might hold the key to everyone getting paid). In the Gulf Civil code jurisdictions some argue that the overriding obligation to perform one's contractual obligations in good faith gets to the same point.

Yet difficulties remain: the loss in the event of a breach of such a term (express or implied) or good faith duty would be the cost and loss flowing from failure to secure more timely payment, not the principal sum; although under good faith-type principles one could see an argument leading to

forfeiture of the right to rely on the clause if, in bad faith, the contractor does not attempt to secure payment. However the outcome of these types of argument in adjudication and arbitration can be difficult to predict. Liquidated interest or finance charges for late payment will usually be the more convenient remedy but depending on the language used a payment might not actually be “late” for that purpose even if delayed under the main contract. The question of interest can become circular, not to mention somewhat academic, if the core problem is that money is not flowing from the employer at all.

Leaving those issues aside, how far should a contractor reasonably be expected to push it to comply with such an obligation if an employer is simply not paying? A subcontractor’s perspective might be that its counterparty should do all manner of things (suspension, claims and disputes escalation, termination) but in some circumstances (depending on the nature of the employer) that might make matters worse and, crucially, might not actually lead to faster payment. From their vantage point, how can an adjudicator or arbitrator determine as between the contractor and the subcontractor, on objective factual evidence, what type of judgment call the contractor should have made?

Final thoughts

The legal prohibition of these types of clause as inherently unfair is impossible to reconcile with the apparent belief that they are suitable, where not specifically prohibited, in internationally-standardised forms of subcontract. As the potential mitigations might not be as helpful in practice as they appear, the only reliable solution is to try and iron them out one subcontract at a time.

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MEET THE TEAM

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