MALAYSIAN CONSTRUCTION INDUSTRY PAYMENT STRATEGIES FOR REFORM

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MALAYSIAN CONSTRUCTION INDUSTRY PAYMENT STRATEGIES FOR REFORM

LIM CHONG FONG

DISSERTATION SUBMITTED IN FULFILMENT
OF THE REQUIREMENTS
FOR THE DEGREE OF MASTER OF LAWS

FACULTY OF LAW
UNIVERSITY OF MALAYA
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ABSTRACT

The construction industry in Malaysia is a mature and significant contributor to the economy of the nation. There is ironically much exasperation and complaints on construction payment for work done, materials or goods supplied and services rendered.

This dissertation is therefore devoted to the examination into the causes of the payment problems and to the suggestion of reform proposal to alleviate them. The examination of the causes initially inquires into the operating norms of the construction industry. Against this background, the examination focuses on the adequacy and effectiveness of construction contract terms in use, the common law and statutory framework and dispute resolution procedure prevailing in the construction industry. The examination is undertaken in this manner systematically commencing with the Malaysian position and followed by the positions in the United Kingdom, Australia, New Zealand, Singapore, United States of America and Canada. It is seen that the causes of the Malaysian construction industry payment problems are five-folds, to wit, project finance, unfair contract terms, certification of payment, withholding of payment and dispute resolution and security of payment. These causes of the payment problems also occur but to varying degree in the other countries examined.

The experiences and solutions deployed by the construction industry of the other countries provide the strategies that can be adapted for use in Malaysia. Based on the

findings, the solution is a statutory one. The recommended strategy of reform proposal is to combine the solutions used in the United Kingdom, New Zealand and Singapore. This is done with necessary modification made to suit the Malaysian construction industry environment coupled with the introduction of new ideas such as the payment bond as security of payment. The strategy and solution for Malaysia is ultimately reduced into the proposed Construction Industry Adjudication and Security of Payment Act.

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The pursuit of this Master of Laws degree by dissertation has been very challenging and demanding beyond my expectation. It took me 11 semesters instead of 6 semesters as I originally envisaged.

After having practised construction law for more than a decade, I knew that there are serious construction industry payment problems that prevail and need to be addressed in Malaysia. They recur much too often and they kept me busy at work dealing with them as counsel and as arbitrator. I am therefore certain that there is the need for law reform.

In my quest to contribute to this reform, I was chosen to participate as a Fulbright scholar in 2003-2004 to examine into the problems and solution in the United States of America. In this respect, I wish to thank the Council for International Exchange of Scholars of the United States of America and Professor Hazel Glenn Beh of the William S. Richardson School of Law, University of Hawaii.

Upon my return, my close friend Sr Noushad Naseem, a past president of the Institution of Surveyors Malaysia convinced me that I should expand on my research done in Hawaii and formally submit a dissertation at postgraduate level. Thus, thank you Naseem though I am still unsure if I have made the right move embarking on this dissertation part time which has proven painstaking over the years.

In the course of researching and writing this dissertation, I met and had numerous dialogues with many people both from the legal profession and construction industry. There are too many to be all singled out. I nevertheless wish to particularly thank Steven Shee of Sunway Construction Sdn Bhd, Khoo Cheong formerly of Kemas Construction Sdn Bhd and Michael Chia, partner in Tan Kok Quan Partnership Singapore and of course Naseem whom I had repeated discourses and gained invaluable insights.

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CHAPTER 1

INTRODUCTION

1.1 Background of Study

The construction industry is an important cog in the wheel propelling the national economy. It enables the growth of other industries through its role as a fundamental building block of the nation's social economic development.[1] The industry provides work for many ranging from professional consultants such as architects, engineers, and quantity surveyors to main contractors, sub contractors, suppliers, and ultimately labourers who are employed by these contractors.

The industry works on the premise that these people are paid for work and services properly rendered. There is however much exasperation prevailing in respect of construction payment claims for work done and services rendered.[2] The unpaid main contractor or sub contractor has difficulty enforcing its claim as it is often faced with set offs and counter claims from the owner or the main contractor for unsatisfactory work or delayed completion or both. The professional consultant faces the same dilemma too except that the cross claims are usually for professional negligence.

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[1] Lembaga Pembangunan Industri Pembinaan, Construction Industry Master Plan Malaysia 2006-2015 (CIDB, 2006) at 19.

[2] *Id.* at 60-61. Also author's own experience and interviews with Steven Shee of Sunway Construction Sdn Bhd, S. Ramar of Road Builder (M) Sdn Bhd, Khoo Cheong of Kemas Construction Sdn Bhd and Ng Sin Kooi of IJM Construction Sdn Bhd, members of the Master Builders Association Malaysia (MBAM) on 4th January 2005 at MBAM premises after Contract and Practices Committee Meeting.

The criticality of timeous payment is acknowledged in the landmark construction law case of *Pembenaan Leow Tuck Chui & Sons Sdn Bhd v Dr Leela's Medical Centre Sdn Bhd*[3] which is one of the few construction law cases that has reached the apex Malaysian Supreme Court. In that case, Edgar Joseph Jr. FCJ stated:[4]

> "It is well known to lawyers engaged in the field of construction contract law that the question whether a building owner or main contractor is entitled to refuse payment of money to a contractor or sub contractor, as the case may be, allegedly due and payable under an interim certificate issued by an architect or engineer ... on the ground that he has a cross claim alleging defective work or over-valuation or damages for delay is a question of ever-recurring importance."

The unpaid main contractor or sub contractor or even professional consultant is thus constrained to litigate or more commonly arbitrate the claims and cross claims. They are always wishful of a swift resolution and thereafter successful collection of the unpaid dues ultimately.

1.2 Hypotheses and Objective of Study

In the premises, this dissertation examines in detail and tests the following hypotheses:

i) that the contract terms commonly employed in the Malaysian construction industry do not sufficiently and fairly allocate the risks between the parties

[3] [1995] 2 MLJ 57.
[4] *Id.* at 63.

and do not provide adequate remedy for late or non payment for work done and services rendered;

ii) that the statutory provisions and common law of Malaysia are not adequate to safeguard and balance the risks between the parties and provide for relief for late or non-payment for work done or services rendered; and

iii) that the dispute resolution procedures presently available in the Malaysian legal system are not adequate and effective in protecting and enforcing the claim for non or late payment for work done or services rendered in the construction industry.

In addition, if the hypotheses are tested in the affirmative, this dissertation also discusses the strategies including formulating the appropriate legal reform solution to improve the Malaysian construction industry payment.

1.3 Methodology of Study

This dissertation relied on a number of resources such as the standard forms of contract and published materials relating to the construction industry including construction law reports, textbooks, journals and periodicals. These materials are primarily obtained from the University of Malaya Law Library and from the internet. More importantly, the study dissertation includes the author's own experience and views of relevant construction industry players especially from member firms of the Master Builders Association of Malaysia so as to be abreast with the practical realities. The Master Builders Association of

Malaysia represents the major contracting organizations undertaking construction work in Malaysia.

The dissertation is only meaningful if it is done comparative with the position and experiences of other countries. In this respect, the position in the developed Commonwealth nations such as the United Kingdom, Canada, Australia, New Zealand and Singapore are examined. The commonality in legal systems as well as in construction norms and practices between Malaysia, on the one hand, and particularly the United Kingdom and Singapore, on the other hand, renders it suitable that comparisons be made with those countries. Apart from that, a comparative study with the position in the United States of America is useful as it is the world's foremost developed and leading nation.

The comparative study with the American position is based on research undertaken at the William S. Richardson School of Law of the University of Hawaii at Manoa and interviews with academics and legal practitioners in Hawaii.[5] As to the Commonwealth position, the published materials available in the aforementioned law libraries served as sources for discussion, analysis and evaluation. A number of interviews were also conducted with certain legal and construction practitioners from the United Kingdom, Singapore and New Zealand.

[5] Lim, Chong Fong, *Securing Payment and the Expeditious Recovery of the Unpaid Builder's Claim- An American Perspective* (MBAM, 2004 1st quarter Master Builders Journal) at 66, research undertaken under the Malaysian Fulbright scholarship in 2003-04.

1.4 Structure of the Dissertation

This dissertation is divided into five (5) chapters, to wit;

i) Chapter 1 - Introduction;

ii) Chapter 2 - The Malaysian Construction Industry Payment – Norms, Problems and Present Remedies;

iii) Chapter 3 - The United Kingdom and Commonwealth Construction Industry Payment – Experience and Solutions;

iv) Chapter 4 - The North American Construction Industry Payment - Experience and Solutions;

v) Chapter 5 - Recommendations and Conclusion.

Chapter 1 sets out the hypotheses, objective and methodology of the study and provides an outline of the chapters.

In Chapter 2, the legal aspects of the norms of the Malaysian construction industry, the payment terms in construction contracts and related contractual remedies are examined. In addition, payment problems that have arisen, the current statutory and common law remedies available and dispute resolution procedures as well as their effectiveness are also examined.

Chapter 3 similarly examines the legal aspects of the norms, contract terms and remedies in respect of the English and other Commonwealth construction industry payment. The examination further focuses on the problems identified and the reform solutions that were implemented.

A corresponding examination, similar to that in Chapter 3, is undertaken in respect of the American and Canadian construction industry payment in Chapter 4.

Chapter 5 analyses, in a comparative way, the norms and problems examined in Chapters 2, 3 and 4 and the strategies in attempt to search for a legal reform solution for the Malaysian construction industry payment. A statutory proposal is recommended for adoption in Malaysia including setting out a draft Act with the rationale explained. Finally, the hypotheses postulated in this Chapter are verified and followed with the conclusion.

CHAPTER 2

THE MALAYSIAN CONSTRUCTION INDUSTRY PAYMENT – NORMS, PROBLEMS AND PRESENT REMEDIES

2.1 Introduction

This chapter examines the Malaysian position in respect of construction industry payment with particular focus on the allocation of risks and remedies for late or non-payment for work done and services rendered. The chapter is divided into four parts. The first part deals with the norms of the construction industry whereby the players, funding and contracting arrangements are discussed. This sets out the background for an understanding of the remaining parts of the chapter. The second part identifies the normative inter-relationship and associated causes and problems encountered. In the third part, the present common law position in relation to identified problems is examined. The second and third parts collectively form the basis to test the veracity of the first and second hypotheses set out in Chapter 1. The fourth which is the final part discusses both the contractual and common law remedies currently available and their effectiveness in resolving the identified problems. The part forms the basis to test the veracity of third hypothesis set out in Chapter 1.

2.2 Norms of the Construction Industry

The construction industry in Malaysia represents about 3% of the gross domestic product (GDP) of the nation and is worth about RM7 billion in value[1] annually.

Just like any other economic activity, the construction industry faces challenges. The challenges in the Malaysian construction industry are best noted by the then Minister of Works in his message in the Construction Industry Master Plan that:[2]

> "The construction industry of today is unlike the construction industry of the past. The challenges faced by the industry in the demanding world of today are manifold and the constraints are ever increasing. It is no longer sufficient to deliver what the client wants as cost-effectively as it used to be in the past. We, in the construction industry must deliver our product not only as cost-effectively as possible but in the shortest time possible with the highest quality attainable."

Thus, the construction industry operates smoothly and effectively if these challenges as outlined by the Minister are met in each and every construction project. The aforesaid challenges essentially outline the expectations of the owner who commissions the project. There would of course be the reciprocal expectation of the other contracting party that payment in undertaking the project would be met by the owner.

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[1] Lembaga Pembangunan Industri Pembinaan, *Construction Industry Master Plan Malaysia 2006-2015* (CIDB, 2006) at 13.
[2] *Id.* at viii.

This part of the chapter on the norms thus examines the structure of the Malaysian construction industry and its players, the funding aspects in a construction project and the main types of construction contracts typically in use.

2.2.1 The Structure and Players

The construction industry is unique in that it is both multi-player and multi-level in structure. It is multi-player because the industry comprises owners or developers, consultants, main contractors, sub contractors, labourers, bankers, insurers, construction material manufacturers and suppliers and operators of construction plant and equipment. These players interact with each other contractually in a web-like and multi-level pyramidal structure. In a typical construction project, the legal relationship is that the owner or developer contracts with the main contractor. The main contractor in turn contracts with sub contractors (who may also in turn contract with sub sub contractors) and suppliers. The owner or developer also contracts with other entities, such as professional consultants, bankers and insurers.

The types and characteristics of these players are firstly examined to appreciate the business background setting in which construction projects are implemented.

a) The Owner

The principal player is the owner or developer who provides the land and money for the development of the construction project. The owner comprises both the public sector, namely, the Federal and State Government as well as statutory and governmental related bodies and the private sector.

Public sector projects mostly consist of infrastructure civil engineering type projects though there are also building projects such as schools, hospitals, and so on. The implementation of public sector projects is governed by the Government Contracts Act 1949 (Act 120) and the detailed procedures (including budget allocation and fund flow) to be followed are contained in various documents, such as the Treasury Instructions and circulars issued from time to time by the Treasury and the Director-General of Public Works.[3]

On the other hand, projects implemented by the private sector ranges from commercial, industrial and to a large extent residential buildings. Private sector developers carrying out the business of housing development are governed by the Housing Developers (Control & Licensing) Act 1966[4] (which was amended in 2007 by Act A1289) and regulations made thereunder.[5] "Housing Development" is defined in the Act as to develop or construct or cause to be constructed in any manner more than four units of housing accommodation and includes the collection of moneys or the carrying on of any building operations for the purpose of erecting housing accommodation in, on, over or under any

[3] Ketua Pengarah Kerja Raya, *A Guide on the Administration of Public Works Contracts* (Ibu Pejabat JKR Malaysia, 1988) at 1.
[4] Act 118.
[5] Housing Developers (Control and Licensing) Regulations 1989 and Housing Developers (Housing Development Account) Regulations 1991.

land; or the sale of more than four lots of land or building lots units with the view of constructing more than four units of housing accommodation.[6] The statutory regulations governing the business of housing development, amongst others, require the developer to possess a license which is issued by the Controller of Housing. The applicant for a license must nevertheless have an issued or paid up capital of at least RM250,000.00 if the application is made by a company or a deposit of RM200,000.00 in cash or other form as the Minister of Housing and Local Government may determine if the application is made by a natural person or body of persons.[7] The capital or deposit licensing requirement is for purposes of development expenditure as a whole and not only confined to construction payment. The issue of the license is discretionary. In order to ensure compliance with the provisions of the Act and regulations made thereunder including financial adequacy, it is an offence for any housing developer to engage in or undertake housing development without being duly licensed. The offence attracts a fine of not less than RM250,000.00 but not exceeding RM500,000.00 or to imprisonment for a term not exceeding 5 years or both on conviction.[8]

The other types of private sector development other than "Housing Development" such as commercial and industrial property development are not statutorily regulated.

Private sector developers are plentiful and are of varying sizes particularly in terms of financial strength. There are presently less than a hundred developers

[6] Section 3 of the Housing Developers (Control and Licensing) Act 1966 (Act 118).
[7] *Id.* Sections 5 and 6 (a).
[8] *Id.* Section 18.

listed as "Property" companies in the main board of Bursa Malaysia. Nevertheless, most of them often undertake development projects through their subsidiary companies which are "single project" companies. Many developers which are private limited companies carry out speculative development in that projects are undertaken for sale without full equity financing through internal capital to complete them.[9]

Whilst public sector projects are undertaken on state land, private developments are either undertaken on purchased land or in joint venture with land owners. In the latter, the financing burden of the developer is reduced by not having to purchase the land but the developer still has to finance the building construction carried out by the main contractor.

The presently prevailing system of private project development is "sell-then-build". By this "sell-then-build" system, the developer sells the project to purchasers prior to construction or completion and collects sales proceeds progressively as the project is constructed. This is in contrast with the "build-then-sell" system prevalent abroad where the project is only sold to purchasers after completion. In the former, the project financing burden on the developer is again much reduced as the construction funds are provided by the purchasers particularly if the project sales are good. The construction of the project gets into trouble when the sales are poor and the developer does not have sufficient capital or loan financing to see the project through to completion. There have been public demands requesting the authorities to introduce the "build-then-

[9] Interviews with Steven Shee of Sunway Construction Sdn Bhd, S. Ramar of Road Builder (M) Sdn Bhd, Khoo Cheong of Kemas Construction Sdn Bhd and Ng Sin Kooi of IJM Construction Sdn Bhd, members of the Master Builders Association Malaysia (MBAM) on 4th January 2005 & 17th April 2007 at MBAM premises after Contract and Practices Committee Meetings.

sell" system of private sector property development which has been successfully implemented in Australia. This is because there have been many incidents of abandoned development private sector projects undertaken under the "sell-then-build" system whereby innocent purchasers end as victims. The "build-then – sell" system will practicably compel the developers to procure sufficient construction financing upfront for payment of contractors and consultants to ensure project completion. Otherwise, the project will not take off. However, the recent 2007 amendment to the Housing Development (Control & Licensing) Act 1966 (Act 118) did not outlaw the "sell-then-build" system. The authorities merely advise the developers to progressively shift to the "build-then-sell" system with no pre-determined time frame. The Housing Development (Control & Licensing) Regulations 1989 have been amended to introduce standard forms of sale and purchase agreements on "10:90" basis. By this "10:90" basis, the purchaser merely pays 10% of the price on purchase and the balance 90% upon handover of the property. As a result, the construction financing requirement and risks to pay contractors and consultants are now considerably borne by the developers. The response by the developer on the "10:90" basis has been lukewarm as reported by the National House Buyers Association.[10]

It can therefore be seen that:

i) Malaysian construction project owners are both from public and private sectors. In some cases, the project owners provide land and money to undertake the construction while in other cases, the land owners provide the land in joint venture with the project owners.

[10] see report in www.iproperty.com.my (last accessed in December 2009).

ii) Other than housing developers, project owners are not regulated by law. Most private sector projects are undertaken by single project private limited liability companies. There is no law requiring financial adequacy on the part of the owner to complete the project.

iii) Except for licensed housing development, other project developments are unregulated free market business. Speculative development is rampant.

b) The Main Contractor

The other principal player is the main contractor who commonly constructs and completes the project for the owner or developer under a building contract. The bigger public listed main contractors increasingly undertake design of the project as well.

The carrying out of construction business as a contractor is regulated. Under the Lembaga Pembangunan Industri Pembinaan Malaysia Act 1994[11] (hereinafter referred to as the "Construction Industry Development Board Act" or "CIDB Act"), no person shall undertake to carry out and complete any construction work unless he is registered with the CIDB. The registration of contractors is divided into categories (Grade G1 to G7) within which they are classified into specialization groups and grades. The registration is based on personnel resources, experience and performance of the execution of engineering and construction works in commensuration with those categories and specialization in which the contractor wishes to be registered with the CIDB. In addition, the contractor must fulfill sufficient financial resources to

[11] Act 520, Section 25(1).

meet the financial commitments which would normally arise within the category and grade to be registered.[12] The minimum financial requirements have been set in terms of net worth at 5% of the capacity of the registration grade. Thus, if the contractor is registered at Grade G6 (to wit undertaking work not exceeding RM10,000,000.00, then the net worth has to be at least RM500,000.00).

By comparison, it is seen that for project development undertaken in excess of RM10 million in value (which is not uncommon), there is mis-match in terms of statutory capital requirements between the registered building contractor and the licensed housing developer. It is only logical that the developer being the paying party has to be financially stronger than the contractor and not vice versa since the former has to pay the latter.

In order to ensure compliance including financial capital adequacy, section 29 of the CIDB Act makes it an offence for any contractor carrying out and completing any construction work without being registered with the CIDB. It attracts a fine not exceeding RM50,000.00 on conviction. Furthermore, the CIDB may issue a stop work notice to any unregistered contractor carrying out construction work and in the event of non-compliance with the notice, attracts a fine of not exceeding RM500.00 on conviction. In a continuing offence, it attracts a fine of RM500.00 for every day which the offence continues after conviction. There is no reported case law but the CIDB has issued several stop work notices todate.[13]

[12] Lembaga Pembangunan Industri Pembinaan, *Registration Requirements and Procedures* (CIDB, 1996).

[13] Sections 30 (1) & (2) of the CIDB Act (Act 520) and inquiring with legal department of CIDB.

However, just like project developers, there are many main contractors in Malaysia and they are also of varying sizes financially. They range from sole proprietorship to partnerships (including family ones) to public listed companies. There are also a fair number of foreign contractors operating in this country.[14] However, from a financial standing perspective, there are presently also less than a hundred "Construction" companies listed in the main and second boards of Bursa Malaysia respectively. Nevertheless it is reported[15] that there is a total of 42,313 contractors which gives a ratio of 1 contractor to every 614 persons in the country. Most of the contractors belong to the smallest scaled[16] (35,253) and they are small and very dependent on government contracts that range from RM5,000.00 "surau" extensions to building RM100,000 drain systems. Based on recent CIDB statistics,[17] the number of contractors in Malaysia has grown beyond 60,000. Many are however classified under the lower G1-G3 categories.

The main contractors usually obtain work from both the public and private sector owner or developer through competitive bidding. In the latter, negotiated contracts are also common. Competitive bidding is done by way of the owner or developer making an open invitation to CIDB registered contractors of the requisite grade to bid whereas negotiated contracting is done though direct commercial negotiations between the owner or developer and the designated

[14] The number of foreign contractors average around a hundred based on the CIDB Annual Reports 2004-2008.

[15] New Sunday Times, May 1, 2005.

[16] Class F of the Pusat Khidmat Kontraktor, a governmental unit of the Ministry of Entrepreneur and Cooperative Development.

[17] Lembaga Pembangunan Industri Pembinaan, *Construction Quarterly Statistical Bulletin* (CIDB, 3rd quarter 2007).

contractor. The profit margin is however nowadays low.[18] This is because of intense competition due to insufficiency of work. The business risk is high in that the main contractor often absorbs the price variation and project completion risks.[19] In addition, main contractors are often required to furnish to the owner or developer performance bond to secure the due performance of the building contract. The performance bond is always an "on demand" bond and usually modeled and worded following the specimen[20] issued by the Public Works Department for public sector construction. The value of the performance bond is often 5 to 10% of the project contract sum.

Consequently, it can be summarized that:

i) Main contracting is regulated by statutory law and main contractors are required to be registered with the CIDB. Registration generally endeavors to ensure financial soundness and thus the financial means to undertake project construction. There is however no financial adequacy requirement specific for each project undertaken.

ii) There are many main contractors of varying sizes. Main contracting is however very competitive and a financially risky business with low profit margins.

iii) The main contractor has to further provide performance bond to the project developer to guarantee performance of the building contract.

[18] *Supra* n. 9.
[19] *Ibid.*
[20] Form PWD Q7/81.

c) The Sub Contractors and Suppliers

Besides the main contractor, there are often many layers of sub contractors and suppliers. The reality in the Malaysian construction industry nowadays is that the role of the main contractor is relegated to construction management. The physical works are carried out by sub contractors to the main contractor or even sub-sub contractors to sub contractors.[21] Most of the construction labourers are employed by them. The involvement of sub contractors is pervasive and they do a wide range of work from the very rudimentary labour intensive carpentry and steel reinforcement work to the very specialized mechanical & electrical (M&E) works and curtain walling work. There are of course also suppliers who supply materials and goods either to the main contractor or the sub contractors.

Generally there are two types of sub contractors known in the Malaysian construction industry, to wit, domestic sub contractors and nominated sub contractors.

The specialist sub contractors often operate as nominated sub contractors. In other words they are selected by the owner but are required to enter into the contract with the main contractor. There is no privity of contract between the nominated sub contractor and the owner. These specialist subcontractors are generally stronger financially. They will nevertheless have to resort to the main contractor for contractual payment except in such situation where the owner is found to have warranted payment directly. The other sub contractors who are

[21] *Supra* n. 9.

directly selected and engaged by the main contractor are domestic sub contractors.

Except for the specialist sub contractors, most of the other sub contractors are small with limited financial strength. They often follow and operate together with a particular main contractor or sub contractor. Sub contractors depend on payment by the main contractor for cash flow. The profit margin is often low to maintain overall competitiveness.

Sub contractors are within the definition of a contractor under the CIDB Act and must therefore also be registered. This is however often not the case especially at the lower layers of sub contracting because[22] many are unable to satisfy or comply with the registration requirements.

In gist, it is thus summarized that:

i) Physical construction work is extensively carried out by sub contractors. Though there are also many sub contractors, most are tied with and follow the main contractor. They employ the labourers and pay their wages.
ii) Except for specialist sub contractors, most sub contractors have limited financial means and depend on payment from the main contractor for cash flow.

[22] *Supra* n. 9.

d) The Professional Consultants

Besides the project owner and contractors, there are the professional consultants who are also the players involved in the construction industry. They are the architects, engineers and the quantity surveyors who normally provide the design, cost planning and control and supervision of the work. The practice of professional consultancy is regulated by statute.[23] Thus the consultant must be registered, failing which an offence is attracted under the respective statute. Besides, the unregistered consultant is prohibited from recovering any fee for services rendered.[24] These professional consultants commonly enter into consultancy agreements with the owner under the traditional system of procurement where design of the project is given by the project owner to the main contractor. If, however, a design and build or turnkey[25] system of procurement wherein the main contractor also undertakes design is adopted, then these consultants will be engaged by the main contractor.

The size of the professional consultants in Malaysia is mostly small comprising of sole proprietorships and partnerships. Accordingly, their financial capacity is also limited and they often work on stage payments provided by the owner.

e) Others

Besides the main players which comprise of the owner, contractors and professional consultants, there are secondary players such as the banker who

[23] Architects Act 1967 (Revised 2002) (Act 117), Registration of Engineers Act 1967 (Revised 2002) (Act 1158) and Quantity Surveyors Act 1967 (Revised 2002) (Act 487).
[24] *Sami Mousawi Sdn Bhd v State Government of Sarawak* [2004] 2 CLJ 186.
[25] *High Mark Sdn Bhd v Patco (M) Sdn Bhd* [1985] 1 CLJ 100 – This is an example of a case where the contractor undertook the project on a turnkey basis and the turnkey obligations are discussed therein.

provides funds to the owner or acts as surety for the main contractor by furnishing performance bond to the owner. This function is sometimes undertaken by an insurance company. There is also involvement on the part of the insurers who normally provides the "Contractor All Risk" and "Workmen Compensation" insurances for protecting the work.

2.2.2 Project Funding

Project development and construction requires money. The players in the construction industry work or provide services in return for money.

Since the owner or developer is generally the beneficiary of the construction project, the money or funding must be provided by the owner. The funding for a construction project must therefore flow "top down".

a) Sources of Funds

Public sector project funding is normally sourced from the budget allocated under the national economic plans. There is generally no risk of inadequate funds to complete the project. The private sector owner or developer's funds are however either generated internally through capital funds or externally through financial institutional borrowings or a combination of both. For licensed housing development in particular, the construction is predominantly funded by the purchasers under the present "sell-then-build" system through

external bank end financing[26] obtained by the purchasers. The drawdown of the end financing is governed by the Housing Developers (Housing Development Account) Regulations 1991 and Amendment Regulations 2002. In gist, the Regulations mandatorily require the developer to open and maintain a housing development account wherein the purchasers' funds must be paid therein. Monies in the account can only be withdrawn by the developer for certain specified purposes in connection with the project.[27] These purposes include construction payment to contractors and professional consultants.

There is frequently also external syndicated bank financing[28] which may be in the form of the combination of term loan, bridging finance and revolving credit obtained by the owner to fund the construction project. This is crucial if the owner's own internal capital or purchaser's external end financing are inadequate. However, there is difficulty securing timely and adequate financing from financial institutions especially amongst small and medium size players. These financial institutions have restrained lending to certain players because of poor credit ratings, incomplete loan applications, project non-viability, etc.

The laws regulating project construction are contained in the Street Drainage and Building Act 1974[29] and the Uniform Building Bye Laws 1984 made thereto. However the aforesaid statute and bye-laws do not deal with project funding. There is no requirement that the owner has to satisfy the relevant

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[26] For instance, see *Lim Chee Holdings Sdn Bhd v RHB Bank Bhd* [2002] 1 LNS 203 and [2005] 4 CLJ 305 (CA), where the end financing for the purchasers was arranged by the developer together with bridging loan by way of overdraft facilities secured against a charge on the land titles of the development and a master guarantee .

[27] Regulation 7 of the Housing Developers (Housing Development Account) Regulations 1991.

[28] For instance, see *Silver Concept Sdn Bhd v Brisdale Rasa Development Sdn Bhd* [2005] 3 CLJ 259 where the developer borrowed from the bank by way of a syndicated loan which resulted in litigation; see also *Supra* n. 1.at 60-61.

[29] Act 133.

governmental authorities that it is financially able to undertake the construction project.

b) Fund Flow

The principal funding of the main contractor's construction project work is through progress payments of the owner. There is, to a limited extent, internal capital funding and sub contractors' and suppliers' credit.[30] Frequently, main contractors also resort to external borrowing from banks or insurance companies by way of factoring facility.[31] As for sub contractors and suppliers, they principally rely only on progress payments from the main contractor. This is especially so for the sub contractors to pay the wages of the labourers.

Professional consultants fund their operations mostly through fee payments from the owner often supplemented by external bank overdraft facilities to finance their professional firms.[32]

It can therefore be discerned that "top down" fund adequacy and flow from the owner to the main contractor and then to the sub contractors and suppliers down the pyramidal structure is crucial and imperative for the successful completion of the construction project. Dislocation in the fund flow invariably results in the suspension or abandonment of the project.

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[30] *Supra* n. 9.

[31] For instance, see *Intelek Timur Sdn Bhd v Future Heritage Sdn Bhd* [2004] 1 CLJ 743 and *Bina Jati Sdn Bhd v Sum-Project (Brothers) Sdn Bhd* [2002] 1 CLJ 433 where it is seen that the contractors took factoring facilities to finance their construction operations .

[32] Interviews with Sr Noushad Naseem and Sr Eddie Wong, Fellows of the Institution of Surveyors Malaysia on 22nd June 2005 at Bangunan Juruukur after ISM Council Meeting.

2.2.3 Construction Contracts

a) Generally

Having examined and discussed the players and funding in the construction industry that form the background business setting, the types of construction contracts and their payment related terms are next examined. This is necessary to appreciate the legal relationship and assumed risks between the players.

In Malaysia, it is common that construction contracts especially main contracts are based on standard forms of contract. In the public sector, there is a family of PWD forms of contract produced to govern the relationship between the Government as employer and the main contractor (the PWD Sections 203A and 203 (Rev. 10/83 Edition) forms) as well as the PWD 203A and 203 (Rev. 2007 Edition) forms, the relationship between the main contractor and the nominated sub contractor (the PWD 203N (1983 Edition) form as well as PWD 203 N (Rev. 2007 Edition) form) and the relationship between the main contractor and the nominated supplier (the PWD 203P (1983 Edition) form). The forms are meant to complement each other and operate under the traditional system of procurement. There is a separate PWD form of contract (the PWD DB/T form as well as PWD form DB (Rev. 2007 Edition)) which was produced to operate under the design and build or turnkey system of procurement.[33] The difference between the traditional system and the design and build or turnkey system of procurement is that the design task and responsibility for the project are borne by the owner in the former and by the contractor in the latter. The PWD forms

[33] Lim Chong Fong, *The Malaysian PWD Form of Construction Contract* (Sweet & Maxwell Asia, 2004) at 1.

are drawn up by the Government. They are widely used in all public sector construction for both building and engineering projects.

In the private sector, the predominant form used for building works is the PAM form of main contract (1998 Edition)[34] drawn up by the Malaysian Institute of Architects. Recently, the PAM form of main contract (2006 Edition) was launched though its use is presently still not widespread. There is also the PAM form of nominated sub contract (1998 Edition and 2006 Edition) to supplement the PAM form of main contract. For civil engineering works, it is common for the parties to adopt the PWD 203A form of contract with the necessary modifications.

Both the PWD and PAM forms of contract have their origins in their English counterparts. The PWD form can be traced to the English 1931 RIBA standard form of contract jointly produced by the Royal Institute of British Architects, National Federation of Building Trade Employers and the Institute of Building.[35] It has been amended and revised several times, the latest being in 2007. As to the PAM form of contract, it is modeled on the English 1963 RIBA/JCT standard form of contract produced by the Royal Institute of British Architects and sanctioned by many related organizations including the County Council Associations, the Royal Institution of Chartered Surveyors and National Federation of Building Trade Employers.[36] The PAM form of contract was launched in 1969 jointly sanctioned by the Pertubuhan Akitek Malaysia and the Institution of Surveyors Malaysia. There was a revision done in 1998 and again

[34] Sundra Rajoo, *The Malaysian Standard Form of Building Contract* (Malayan Law Journal Sdn Bhd, 2nd ed., 1999) at 2.
[35] Nigel Robinson (et al.), *Construction Law in Malaysia and Singapore* (Butterworths Asia, 2nd ed., 1996) at 19.
[36] I.N. Duncan Wallace, *Building and Civil Engineering Standard Forms* (Sweet & Maxwell, 1969) at 3.

in 2006. The PAM form of nominated sub contract is based on the English Federation of Association of Specialists and Sub-Contractors form of contract.

Besides the PWD and PAM forms of contract, there is also the CIDB standard form of building contract which is locally drafted and launched in 2000. There is a CIDB form of nominated sub contract to supplement it. The object of launching the CIDB forms of contract is to provide an alternative form of the contract for the private sector, in addition to the PAM forms of contract. However, the CIDB form of contract has not been very much used todate. The PWD form is perceived to be more favorable to the employer whilst the CIDB form is perceived instead to be more favorable to the contractor. The PAM form is considered to be balanced.[37]

Other than the aforementioned standard forms of contract, there are many "tailor made" or bespoke contracts in use largely at the sub contract level of construction contracting. Most main contractors have their own "in house" sub contracts in use. More often than not, they contain a "pay when paid" payment provision. Pursuant to the "pay when paid" provision, the main contractor is not bound to pay the sub contractor unless and until the main contractor has correspondingly been paid by the owner or developer. In other words, the object is that the main contractor is in effect shifting its payment risks to the sub contractor. It is also common that the payment provisions in standard forms of nominated sub contract are accordingly amended.[38] At the lower layers of sub contracting in the pyramidal structure, the contracts tend to be simple and

[37] *Supra* n. 9.

[38] For instance, see *Pernas Otis Elevator Co Sdn Bhd v Syarikat Pembenaan Yeoh Tiong Lay Sdn Bhd & Anor* [2004] 5 CLJ 34 where the payment on certificate under the nominated sub contract has been amended to payment on a "pay when paid" basis.

rudimentary ones. These contracts are usually in the form of letters, often containing the basic terms of valuation of work and payment. As to supply contracts, they usually comprise simple purchase orders.[39]

b) Main Contracts

1) Progress Payment

If there is no provision for progress payment, building contracts may be construed as entire contracts under the Malaysian common law.[40] The common law rule is that if the contract is construed as an entire contract, entire performance is a condition precedent to payment. The rigour of this common law rule has been modified by the doctrine of substantial performance that a promisor who has substantially performed his side of the bargain may sue on the contract for the agreed sum but he remains liable in damages for his partial failure to fulfill his contractual obligations. [41] It is a question of construction of the contract in each case and the parties are at liberty by express words make entire performance as a condition precedent to payment. Hence, when the contract provides for progress payments to be made as the works proceed but for retention money to be held till completion, then the entire performance is a condition precedent only to the retention money but not to the progress payments. The contractor is not entitled to the retention money unless the work is entirely completed without defect and omission.

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[39] *Supra* n. 9.

[40] Section 38 Contracts Act 1950 (Act 136) and *Ming & Co v Leong Ping Ching* [1964] 30 MLJ 312 which referred to *Sumpter v Hedges* [1898] 1 QB 673.

[41] *Kunchi Raman, KP v Goh Brothers Sdn Bhd* [1978] 1 MLJ 89 following *Hoenig v Issacs* [1952] 2 All ER 176.

It is financially onerous on the main contractor to construct and complete the project without progress payment. Without progress payment, the main contractor has to be sizeable and financially strong to undertake the project. This will often result in higher construction price to the owner due to the main contractor having to assume this financial risk. It is therefore uncommon of Malaysian projects to be undertaken without progress payment unless pursuant to a special arrangement. This was seen in the Marinara tower project in Kuala Lumpur where the main contractor undertook the project on a "bullet payment" on completion. By "bullet payment" it means that the owner only pays the main contractor the contract price in one lump sum on completion of the work. It was an entire contract. The owner has however to procure a bank guarantee for payment to comfort the main contractor. That notwithstanding, there was a major dispute which eventually arose as to whether the project was completed for the release of the bullet payment.[42] Other such projects without progress payment are those done under "Private Finance Initiative" whereby the main contractor teams up with bankers to finance the project. The projects include the Pahang-Selangor inter state water supply scheme but these type of projects are rare.

Thus, all the standard forms of main contract provide for progress or stage payment to the main contractor as the execution of the work progresses.

In this regard, the PWD form of main contract (Rev. 10/83 Edition)[43] and (Rev. 2007 Edition),[44] the PAM form of main contract (1998 Edition)[45] and (2006

[42] *Pekeliling Triangle Sdn Bhd v Chase Perdana Bhd & Anor* [2003] 1 CLJ 153.
[43] Clause 28.
[44] Clauses 47(a) and 28.

Edition)[46] and the CIDB form of main contract[47] have the following common features:

i) At defined intervals, usually monthly or sometimes where a defined stage of work is achieved, the work done is certified by the contract administrator named in the contract.

ii) The certificate is known as the interim certificate.

iii) The contract administrator must certify work (including work of nominated sub contractors) that is properly done and materials, goods and equipment delivered (but not pre-maturely brought) to site for incorporation into the work.

iv) The contract administrator is also authorized to certify for additions and deductions involving the adjustment of contract sum as permitted under the contract.

v) The owner must pay the amount stated in the interim certificate within the time defined in the contract (usually 30 days from the date of the certificate).

In addition all the forms except the PWD form of main contract require the main contractor to submit interim payment application or claim with supporting particulars whereupon the contract administrator then carries out his valuation and certification as aforesaid. The requirement is even stricter in the PAM form of main contract (2006 Edition) wherein it is provided that failure on the part of

[45] Clauses 30(2) and (3).
[46] Clauses 30(1) and (2).
[47] Clause 42.1.

the main contractor to submit the interim claim is deemed as a waiver of the main contractor's entitlement to that interim certificate.

The PWD and CIDB forms of main contract further require the main contractor to have attained a specified minimum value of work done and materials and goods before an interim certificate would be issued. This is provided to motivate the contractor to expedite the execution of the work beyond the minimum value at each interval of interim certification. Otherwise, the main contractor would have to finance the work done below the minimum value for a longer period of time till the next interim certification if and when the minimum value is surpassed.

The PAM forms of main contract (1998 Edition)[48] and (2006 Edition)[49] as well as the CIDB form of main contract[50] also require the contract administrator to certify variation work done as part of work properly done in the interim certificate. This provision is not found in the PWD form of main contract but should be so by implication.[51]

Likewise, the PAM form of main contract (1998 Edition)[52] and (2006 Edition)[53] as well as the CIDB form of main contract[54] require the contract administrator to certify loss and expense properly ascertained in accordance with the contract in the interim certificate. This is not the case under the PWD form of main contract.

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[48] Clause 11.5(v).
[49] Clause 11.9.
[50] Clause 29.3.
[51] *Supra* n. 33. at 111.
[52] Clauses 11.6 and 24.4.
[53] Clauses 11.9 and 24.4.
[54] Clause 32.5(a).

It is therefore seen that the main contractor under all the major forms of construction contract at the main contract level is entitled to progress payments from the employer for work (including variation work, which can be substantial if the changes are major additions) properly done as the execution of the work progresses. Further, the main contractor is also entitled to be paid for materials and goods brought to site. These "top down" progress payments go a long way to finance the construction work and the main contractor must carry out his cash flow planning accordingly. The condition precedent to progress payment is the issuance of an interim certificate by a third party contract administrator, to wit, the architect under the PAM form of main contract or usually a construction professional under the CIDB and PWD forms of main contract (though the latter is usually a government servant). The certifier is required to act honestly and fairly without interference of the employer.[55] If the certifier fails to certify accordingly, the main contractor is entitled to claim for payment without a certificate but this will necessarily involve legal proceedings.[56]

2) Retention

Whilst the main contractor is progressively paid on the execution of the work, it is common for the owner to want to retain a certain percentage from the payment as security for non performance of the construction contract. This is particularly to safeguard against the main contractor's failure to remedy defects which manifest during the defects liability or maintenance period after

[55] *Hickman & Co. v Roberts* [1913] AC 229 and *Perini Corporation v Commonwealth of Australia* [1969] 2 NWSLR 530.

[56] Vincent Powell-Smith, *The Malaysian Standard Form of Building Contract* (Malayan Law Journal Sdn Bhd, 1990) at 10.

completion of the works. The percentage retained is often ten percent of each payment up to a maximum of five percent of the whole contract sum. Thereafter no further retention is then withheld from the payment.[57] As a matter of cash flow in financing construction operation, the main contractor must therefore allow for this expected shortfall in payment accordingly.

The PAM form of main contract (1998 Edition)[58] and (2006 Edition)[59] as well as the CIDB form of main contract[60] thus allow the contract administrator to deduct retention money from the value of work done and materials, goods and equipment delivered to site in the interim certificate. Half of the retention will be released upon completion whilst the balance will only be released upon the issuance of the certificate of making good defects (to wit when all the defects that manifest during the defects liability period are satisfactorily rectified). There is no retention to be deducted under the PWD form of main contract.

Moreover, the owner must hold the retention money on trust as fiduciary for the main contractor as beneficiary without the obligation on the part of the owner to invest the money. That notwithstanding, the owner has a right of recourse to the retention money for such deduction sum as certified by the contract administrator under the contract.

In the CIDB form of main contract, it is mandatory for the owner to open and place the retention money in a trust account in a bank. However in relation to

[57] *Supra* n. 9.
[58] Clauses 30.4 and 30.5.
[59] Clauses 30.5 and 30.6.
[60] Clause 42.3.

the PAM form of main contract, the owner is obliged to do so only if requested or compelled[61] by the main contractor.

It can hence be discerned that the main contractor must provide for retention deduction from the progress payment in the main contractor's cash flow planning in financing the construction work. In other words, the main contractor must allow for this expected short-fall in progress payment until the maximum retention deduction is reached. Besides, the main contractor must also be vigilant to monitor the status of the retention money that is being deducted from the progress payments and held under trust. In particular, it is critical to ensure the opening and maintenance of the trust account in a bank so that the money is and remains secured until release. The final release of the retention money will take a considerable time which is usually after at least 1 year from completion of the work, when all defects that have manifested during the defects liability period have been rectified.

3) Final Payment

Although, the different forms of construction contracts have slightly different provisions on final payment they are nevertheless similar in that final payment is usually payable after all final accounting of the works including that for variations have been finalized. They are commonly certified in the final certificate and paid after the expiry of the defects liability or maintenance period.

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[61] *Rayack Construction Ltd v Lampeter Meat Co Ltd* (1979) 12 BLR 30 and applied in *Lee Kam Chun v Syarikat Kukuh Maju Sdn Bhd (Syarikat Perumahan Pegawai Kerajaan Sdn Bhd, Garnishee)* [1988] 1 MLJ 444 – In these cases, the main contractor successfully applied for a mandatory injunction against the employer to have the retention monies placed into a trust account.

The common features as seen in the provisions on final payment under the PWD form of main contract (Rev. 10/83 Edition)[62] and (Rev. 2007 Edition),[63] PAM form of main contract (1998 Edition)[64] and (2006 Edition)[65] and the CIDB form of main contract[66] are as follows:

i) Upon achieving completion of the work, the main contractor is required within a prescribed time to submit the claim or supporting documents or both relating to final adjustment of the contract sum (including that of nominated sub contractors) under the main contract.

ii) The contract administrator must make the final valuation of the work done including variations and other adjustments of the contract sum and issue the final certificate within the prescribed time.

iii) The owner must pay the main contractor the amount stated in the final certificate within the time prescribed in the contract.

Nevertheless, there are differences noted amongst the standard forms of contract too.

The primary difference relates to the prescribed time to make the final valuation and issuance of the final certificate. In the PWD form of main contract, the final certificate must be issued within 3 months from the issuance of the certificate of making good defects irrespective of whether the main contractor has fully submitted the claim or supporting documents. The prescribed time for

[62] Clause 48.
[63] Clause 31.
[64] Clauses 30.6 and 30.7.
[65] Clauses 30.10 to 30.15.
[66] Clauses 42.5 to 42.8.

the issuance of the final certificate under the PAM form of main contract and CIDB form of main contract is however dependent on the main contractor's submission of the claim or supporting documents.

Except for the PAM form of main contract (2006 Edition), another notable difference is that there is no obligation on the parties to attempt to agree on the final valuation by the contract administrator. The parties can however dispute the final certificate later. In the PAM form of main contract (2006 Edition), the contract provides for and requires the parties to specifically agree on the final valuation prior to the issuance of the final certificate, failing which the dissatisfied party must refer the dispute to arbitration within 3 months from receipt of the final valuation. Otherwise the final valuation is deemed conclusive and accepted by the parties.

The time that elapses between completion of the work and the issuance of the final certificate can be considerable, often in excess of 15 months if not more.[67] Thus the main contractor has to wait some time for the final payment and must provide for such in the cash flow planning accordingly. This financial burden on the main contractor is addressed only in the CIDB form of main contract where the final accounting is divided into 2 stages. The first stage allows the contract administrator to estimate the final value of the work and issue a penultimate payment certificate within 6 months from the submission of the main contractor's claim. The second stage then involves the detail final valuation and issuance of final certificate.

[67] *Supra* n. 9.

It can therefore be discerned that the final accounting will be a meticulous and long process and the main contractor must have the financial stamina to await and collect the final payment.

4) Contractual Remedies for Non Certification or Non Payment

All the standard forms of main contract provide for payment against interim and final certificates. Thus, as far as payment to the main contractor is concerned, the issuance of the certificate is paramount as it is the condition precedent thereto.[68]

In the event of non certification the recourse available to the contractor under the PAM form of main contract (1998 Edition)[69] and (2006 Edition)[70] respectively is to proceed for arbitration to obtain an award accordingly. The award is then registrable as a judgment in the High Court.[71] There is a similar provision[72] in the PWD form of main contract (Rev. 10/83 Edition) akin to that in the PAM form of main contract. The provision in the CIDB form of main contract is not as specific as the PAM form of main contract but the clause is wide enough to be construed likewise.[73] This provision is however deleted in the PWD form of main contract (Rev. 2007 Edition). With the exception of the PWD form of main contract, the PAM and CIDB forms of main contract permit disputes over the withholding of the certificate to be arbitrated before the

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[68] *Ling Heng Toh v Borneo Development Corporation Sdn Bhd* [1973] 1 MLJ 23.
[69] Clause 34.1(iii).
[70] Clause 34.5(c).
[71] Section 27 of the Arbitration Act 1952 (Act 93) or Section 38 of the Arbitration Act 2005 (Act 646).
[72] Clause 54(a)(iii).
[73] Clauses 47.1, 47.3(a) and (b)(ii) read together.

completion of the work.[74] This is sensible as the main contractor may not otherwise have the financial stamina to proceed to complete the work. In addition the CIDB form of main contract allows the main contractor to claim for interest.[75]

With regard to non payment, there is no prescribed remedy whatsoever expressly provided in the PWD form of main contract. In the PAM form of main contract (1998 Edition), there is a sole provision[76] for the main contractor to determine its employment under the contract.

There are several recourse available to the contractor for non payment under the PAM form of main contract (2006 Edition) and the CIDB form of main contract. The main contractor has the option to suspend[77] or slow down[78] the work. The main contractor may also determine its employment under the contract.[79] Besides that, the main contractor also has the rights to claim for interest.[80] In the PAM form of main contract (2006 Edition) the interest is further specified to be on a simple basis at 1% above the Maybank Base Lending Rate.

It is therefore seen that the common standard forms of main contract do provide for contractual remedies for non certification as well as non payment. The remedy for non certification requires submission to arbitration wherein the

[74] Clauses 34.5(iii) and 47.3 (b) respectively.
[75] Clause 42.13.
[76] Clause 26 (i).
[77] Clause 30.7 of the PAM form of main contract and Clause 42.10 of the CIDB form of main contract respectively.
[78] Clause 42.10 of the CIDB form of main contract only.
[79] Clause 26.1(a) of the PAM form of main contract and Clauses 45.1(a)(i) and (b)(i) of the CIDB form of main contract respectively.
[80] Clause 30.17 of the PAM form of main contract and Clause 42.13 of the CIDB form of main contract.

arbitration award overrides the requirement for a certificate and takes the place in lieu of the certificate. The remedies for non payment vary with the forms of main contract in use but the correct exercise of the remedies necessarily assumes undisputed entitlement to payment under the certificate.

5) Deductions by the Owner

The standard forms of main contract also expressly provide for deductions by the owner or developer against payment to the main contractor for non performance by the contractor, the most typical being for late completion and non rectification of defective work.

In all the standard forms of main contract, there is provision[81] for the imposition and deduction of liquidated and ascertained damages for late completion of the work. The deduction is nevertheless conditioned upon the contract administrator issuing a certificate of non completion. In *Lion Engineering Sdn Bhd v Pauchuan Development Sdn Bhd*,[82] it was held that the issuance of the certificate of non completion is a condition precedent to the right of the owner to impose and deduct liquidated and ascertained damages for late completion.

In addition, the imposition and deduction of liquidated and ascertained damages for late completion is subject to Section 75 of the Contracts Act 1950 which reads:

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[81] Clause 40 and Clause 33 of the PWD form of main contract (Rev. 10/83 Edition) and (Rev. 2007 Edition) respectively, Clause 22.1 of the PAM form of main contract (both 1998 and 2006 Editions) and Clauses 26.1(a) and 26.2(a) of the CIDB form of main contract.

[82] [1997] 4 AMR 3315.

> 75. When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of a penalty, the party complaining of the breach, is entitled, whether or not actual loss or damage is proved to have been caused thereby, to receive from the other party who has broken the contract, reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.

The Federal Court in *Selvakumar a/l Murugiah v Thiagarajah a/l Retnasamy*[83] held that Section 75 requires the party seeking to rely and enforce the liquidated damages provision in the contract to prove his actual loss suffered in the usual way of proving damages except in situations where it is difficult to do so because there is no known measure of damages. However, the Federal Court subsequently in *Metramac Corporation Sdn Bhd v Fawziah Holdings Sdn Bhd & Ors*[84] (without overruling the *Selvakumar* case) held that Section 75 is to be interpreted based on English legal principles in that the party may enforce liquidated damages simpliciter unless the other party establishes that it is a penalty. The Federal Court again in *Johor Coastal Development Sdn Bhd v Constrajaya Sdn Bhd*[85] reviewed the cases on Section 75 and held that the *Selvakumar* case is still good law but without referring to and overruling the *Metramac Corporation* case. By reason of the conflicting Federal Court cases, the position is thus unclear. It is submitted that the *Metramac Corporation* case is to be preferred since it better reflects the presumed intention of the parties. Thus, it is also seen that the PAM form of main contract (both 1998 and 2006 Editions)[86] provide that the liquidated damages are deemed agreed damages

[83] [1995] 2 MLJ 817.
[84] [2007] 4 CLJ 725.
[85] [2009] 4 CLJ 569.
[86] Clause 22.2.

without requiring the owner to prove his loss. This provision is in effect an attempt to contract out of Section 75 but there is no reported case on it particularly on its validity todate. It is submitted that it is valid in principle.[87] Nevertheless, it appears settled that the liquidated damages may be interlocutorily deducted pending trial of the dispute on the entitlement as held in *Arab Malaysian Corp Builders Sdn Bhd v ASM Development Sdn Bhd.*[88]

In all the standard forms of main contract, there are provisions[89] for the owner to engage a third party to carry out defect rectification if the main contractor fails to comply with the contract administrator's instruction to do so. The owner may then set off the costs incurred from the certified payment due to the main contractor. In the PAM form of main contract (2006 Edition),[90] the owner cannot effect the deduction unless the contract administrator has assessed the costs and 28 days prior written notification of the amount and grounds of deduction is made to the main contractor of the owner's intention to do so.

Thus, it is seen that the main contractor's right to progress and final payments and the availability of contractual remedies provided in the contract can be subject to cross claims. These cross claims are in the form of deductions by the owner in diminution or extinction of the main contractor's payment. Some of the deductions such as the imposition of liquidated and ascertained damages, require certification by the contractor administrator whilst others do not. The certification or assessment by the contract administrator is a safeguard against

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[87] see *infra* n. 122.

[88] [1998] 2 CLJ 169.

[89] Clause 5(b) of the PWD form of main contract (Rev. 10/83 Edition), Clause 5.3 of the PWD form of main contract (Rev. 2007 Edition), Clauses 6.4, 6.5 and 2.2 of the PAM form of main contract (1998 Edition), Clauses 6.5 and 2.4 of the PAM form of main contract (2006 Edition) and Clause 15.7(a) and (b) of the CIDB form of main contract.

[90] Clause 30.4 of the PAM form of main contract.

abuse by the owner provided the contract administrator acts honestly and independently.

c) Nominated Sub Contracts

1) Progress Payment

As with the main contract, the nominated sub contractor is also entitled to be paid progressively in tandem with the execution of the sub contract works. Therefore, in all the standard forms of nominated sub contract, the common feature[91] is that the nominated sub contractor will submit its payment claim at defined intervals corresponding to the main contract payment provision. The nominated sub contractor's progress payment claim is then included in the main contractor's claim for progress payment from the owner. The nominated sub contractor payment by the main contractor is also based on the certification of the contract administrator under the main contract. This certification gives comfort to the nominated sub contractor that the work done would be fairly valued instead of falling within the prerogative of the main contractor. The certification mechanism under the nominated sub contracts is hence often described as "back to back" with the certification under the main contract. The interim certificate under the main contract will separately set out the amount of work properly done by the nominated sub contractor as well as material, goods and equipment delivered. The payment to the nominated sub contractor must be made by the main contractor within a defined date from the issuance of the

[91] Clause 30 of the PWD form of nominated sub contract (1983 Edition), Clause 34 of the PWD form of nominated sub contract (Rev. 2007 Edition), Clauses 11.1 to 11.4 of the PAM form of nominated sub contract (1998 Edition), Clauses 26.1 to 26.2 of the PAM form of nominated sub contract (2006 Edition) and Clauses 28.1 to 28.3 of the CIDB form of nominated sub contract.

interim certificate by the contract administrator. The main contractor must pay the nominated sub contractor irrespective of whether the main contractor has been paid by the owner or developer. In other words, payment is not on a "pay when paid" basis.[92] In the PWD form of nominated sub contract (Rev. 2007 Edition), the payment is made directly from the Government to the nominated sub contractor upon certification.

It can hence be seen that progress payments to the nominated sub contractor are also "top down". The amount to be paid is however certified by the contract administrator of the owner or developer instead of the main contractor even though privity of contract is between the nominated sub contractor and the main contractor. The cash flow planning of the nominated sub contractor to finance the construction work has to be made accordingly.

2) Retention

In tandem with the main contract, the nominated sub contract under the PAM and CIDB forms of sub contract also provide for retention.[93]

As with the situation under the main contract, the retention money of the nominated sub-contractor is held under trust. The trustee in the PAM (1998 Edition) and CIDB forms of nominated sub contract is stated as the main contractor. On the other hand, the PAM (2006 Edition) form of nominated sub

[92] *Supra* n. 36.

[93] Clause 11.11 of the PAM nominated sub contract (1998 Edition), Clause 26.4 of the PAM form of nominated sub contract (2006 Edition) and Clause 28.4 of the CIDB form of the nominated sub contract.

contract suggests[94] that the trustee is the owner or developer presumably following the English decision of *Re Arthur Sanders Ltd* .[95] In that case, it was held that the retention money was held by the owner or developer and there was an equitable assignment of the main contractor's equitable interest in the retention in favour of the nominated sub contractor. It was also not to be subject to recourse or deduction by the employer.

As far as the release of the retention money is concerned, the PAM (2006 Edition) and CIDB forms of nominated sub contract provide that the first half is to be released to the nominated sub contractor upon practical completion of the nominated sub contract work. The release under the PAM (1998 Edition) form of nominated sub contract is however effected only upon completion of the main contract work. With regard to the remaining half, all the forms provide that the balance is released in tandem with the release under the main contract.

The nominated sub contractor must therefore allow in its cash flow planning of the construction work for deduction in progress payment due to retention. It is clear under the PAM (1998 Edition) and the CIDB forms of nominated sub contract that the main contractor can be compelled by the nominated sub contractor to open and secure the money in a trust account.

[94] Clause 26.4.
[95] (1981) 17 BLR 125.

3) Final Payment

In the PWD and PAM (1998 Edition) forms[96] of nominated sub contract, the final accounting and payment are on a "back to back" basis with the main contract. However, in the PAM (2006 Edition) and the CIDB forms[97] of nominated sub contract, the final accounting is done in advance of the main contract if the nominated sub contract work is completed ahead of the main contract work.

The final payment under all the forms is "back to back" with the main contract. Nevertheless, pursuant to the PAM and CIDB forms of nominated sub contract,[98] the contract administrator under the main contract has the discretion to certify that early final payment be made by the main contractor to the nominated sub contractor. The nominated sub contractor is however required to provide acceptable indemnity to the main contractor in respect of the nominated sub contract work.

It can therefore be discerned that the settlement of the final payment to the nominated sub contract will generally be as lengthy as in the main contract unless the contract administrator is willing to consider certifying early final payment to the nominated sub contractor. The cash flow planning of the nominated sub contractor must cater for the same accordingly. In the PWD

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[96] Clauses 32(a) and (b) of the PWD form of nominated sub contract (1983 Edition), Clause 36 of the PWD form of nominated sub contract (Rev. 2007 Edition) and Clauses 11.1 to 11.3 of the PAM form of nominated sub contract (1998 Edition).

[97] Clauses 26.7 to 26.9 of the PAM form of nominated sub contract (2006 Edition) and Clause 28.6 of the CIDB form of nominated sub contract.

[98] Clauses 11.9 and 11.10 of the PAM form of nominated sub contract (1998 Edition), Clause 26.9 of the PAM form of nominated sub contract (2006 Edition) and Clauses 28.7 and 28.8 of the CIDB form of nominated sub contract.

form of nominated sub contract (Rev. 2007 Edition), the Government again as in respect of progress payment pays directly to the nominated sub contractor.

4) Contractual Remedies for Non Certification or Non Payment

Since payment for work done and material, goods or equipment delivered by the nominated sub contractor is subject to certification by the contract administrator under the main contract, all the forms[99] of nominated sub contract (with exception of the CIDB form) provide for the nominated sub contractor to "name borrow" the main contractor's name in recourse. This "name borrowing procedure" enables the main contractor to pursue on behalf of the nominated sub contractor the remedy for under or non certification of payment by way of arbitration with the owner or developer. In so doing, the nominated sub contractor is required to give acceptable indemnity to the main contractor. In addition, there is provision in the PAM form of nominated sub contract (2006 Edition)[100] or alternative recourse for the nominated sub contractor to submit to arbitration directly against the main contractor.

As to non payment of progress and final payment to the nominated sub contractor by the main contractor, there are several contractual remedies available to the nominated sub contractor under the various forms of nominated sub contract:

[99] Clause 30(a) of the PWD form of nominated sub contract (1983 Edition), Clause 35 of the PWD form of nominated sub contract (Rev. 2007 Edition), Clause 11.6 of the PAM form of nominated sub contract (1998 Edition), Clause 4.1 of the PAM form of nominated sub contract (2006 Edition).

[100] Clause 29.2(c).

i) The nominated sub contractor may be paid the unpaid certified payment directly[101] by the owner or developer. The payment is solely discretionary on the part of the owner or developer who may then recover or deduct the same from the main contractor.

ii) The nominated sub contractor may suspend the execution of the work.[102]

iii) The nominated sub contractor may slow down the rate of execution of the work under the CIDB form of nominated contract.[103]

iv) The nominated sub contractor is entitled to claim for interest on the unpaid amount at 1% simple interest above the Maybank base lending rate under the PAM (2006 Edition) form of nominated sub contract.[104]

v) The nominated sub contractor may invoke arbitration against the main contractor.[105]

As with the main contract, the exercise of the aforesaid remedies is critically dependent upon whether the non payment is subject to any cross claim by the main contractor.

5) Deductions by the Main Contractor

As in the main contract forms, there are express provisions in all the standard forms of nominated sub contract for deduction by the main contractor from

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[101] Clause 31(b) of the PWD form of main contract (Rev. 10/83 Edition), Clause 27(c) of the PAM form of main contract (1998 Edition), Clause 27.6 of the PAM form of main contract (2006 Edition) and Clause 29.1(a) of the CIDB form of nominated sub contract.

[102] Clause 11.7 of the PAM form of nominated sub contract (1998 Edition), Clause 26.15 of the PAM form of nominated sub contract (2006 Edition), Clause 29.2(a) of the CIDB form of nominated sub contract.

[103] Clause 29.2(a).

[104] Clause 26.17.

[105] Clauses 35(a) (iii) & (c) of the PWD form of nominated sub contract (1983 Edition), Clause 39 of the PWD form of nominated sub contract (Rev. 2007 Edition), Clause 22.1 (iii) & (iv) of the PAM form of nominated sub contract (1998 Edition), Clauses 29.1 and 29.2 (e) of the PAM form of contract (2006 Edition) and Clause 34.1(a) (ii) & 34.3(a) of the CIDB form of nominated sub contract.

payment due to the nominated subcontractor for late completion, defective work done and so on. All the forms have specific provision[106] dealing with late completion. Similarly there are provisions[107] that deal with defective work done by the nominated sub contractor.

Furthermore, there is a general set off clause provided[108] in some of the forms of nominated sub contract which permits the main contractor to make deductions from payment that are due or have become due to the sub contractor. In the PAM (2006 Edition) form of nominated sub contract, the permitted deductions or set off are enumerated and the exercise thereof must be accompanied with complete details of the assessment of the deduction. The main contractor must give to the nominated sub contractor 28 days prior written notice of intention to set off.

It can again be discerned that the nominated sub contractor's right to progress or final payment is subject to possible cross claim by way of deduction from the main contractor.

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[106] Clause 27 of the PWD form of nominated sub contract (1983 Edition), Clause 30 of the PWD form of nominated sub contract (Rev. 2007 Edition), Clauses 22.1(iii) & 37(iv) of the PAM form of nominated sub contract (1998 Edition), Clause 16.1 of the PAM form of nominated sub contract (2006 Edition) and Clause 20 of the CIDB form of nominated sub contract.

[107] Clauses 18(a) & (b) of the PWD form of nominated sub contract (1983 Edition), Clause 21.2 of the PWD form of nominated sub contract (Rev. 2007 Edition), Clauses 10.2, 10.4 & 10.5 of the PAM form of nominated sub contract (1998 Edition), Clause 17.7 of the PAM form of nominated sub contract (2006 Edition) and Clause 21 of the CIDB form of nominated sub contract.

[108] Clause 33 of the PWD form of nominated sub contract (1983 Edition), Clause 37 of the PWD form of nominated sub contract (Rev. 2007 Edition) and Clause 26.13 of the PAM form of nominated sub contract (2006 Edition).

d) Domestic Sub Contracts

There is no standard form of domestic sub contract in Malaysia. Thus, each main contractor has its own form of contract. There are also rampant oral contracts in use. The domestic sub contracts usually contain terms which are often more favourable to the main contractor.[109]

As to payment terms, both progress and final payment, there is no requirement of certification or assessment by an independent third party such as the contract administrator of the project. The payment terms are usually based on the domestic sub contractor's claims which would then be assessed by the main contractor. That notwithstanding, payment of the assessed sum would commonly be on a "pay when paid" basis, to wit, conditioned upon the main contractor having received the corresponding payment from the owner or developer. A typical "pay when paid" clause reads:- "Payment in respect of any work, materials or goods comprised in the sub contract shall be made within seven days after receipt by the main contractor from the employer."[110]

Furthermore, there is often a general set off clause provided in the sub contract allowing the main contractor to make various deductions from payment that are due or to become due to the sub contractor.

Occasionally, there might be an arbitration clause in the sub contract, but more often there is none.

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[109] *Supra* n. 9..

[110] Extracted from *Pernas Otis Elevator Co Sdn Bhd v Syarikat Pembenaan Yeoh Tiong Lay Sdn Bhd & Anor* [2004] 5 CLJ 34.

It can be discerned that the payment terms of domestic sub contracts are less favorable than those found in nominated sub contracts. In this regard, the domestic sub contractors thus assume more payment risks. The unequal position is primarily because most domestic sub contractors tend to be closely associated with and follow the main contractor over time from project to project. There is often an element of trust between them. On the other hand, nominated sub contractors are often a "one off" relationship with the main contractor because they are nominated by the owner or its contract administrator.

e) Supply Contracts

There is no standard form of supply contract for material, goods or equipment in the Malaysian construction industry other than the PWD nominated supply contract (PWD 203P form) pursuant to the PWD203 form of main contract. Thus, most supply contracts are based on negotiated terms between the main contractor or sub contractor and the supplier. More frequently the supply contracts are based on simple purchase orders only.[111] Most supply contracts are on 30 to 60 day credit payment terms.[112] Some suppliers also require guarantees from the purchasing sub contractors or financially weaker main contractors.[113]

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[111] *Supra* n. 9.

[112] See for instance, *Buildcon Concrete Sdn Bhd v Syarikat Pelaras Utara Sdn Bhd & Others* [2007] 1 LNS 291.

[113] See for instance, *Pengkalen Concrete Sdn Bhd v Chow Mooi & Anor* [2003] 6 CLJ 326.

f) Professional Consultancy Agreements

The professional consultants commonly involved are registered architects, engineers and quantity surveyors. The professional registration bodies established under the respective statutes, to wit, the Board of Architects and Board of Engineers Malaysia have drawn up scales of professional fees and conditions of engagement. However, the owner commonly contracts directly with the consultants based on negotiated fees below the scale as well as on other commercial terms.[114] Only the architect's profession requires the architect to mandatorily contract with the employer based on the Conditions of Engagement of an Architect made pursuant to Rule 29 of the Architects Rules 1996 but yet there is rampant contracting out thereto.[115]

It is not uncommon that the consultant is paid in stages as the project progresses with part end payment comprising of taking up portions of the built development.

Having examined the norms of the Malaysian construction industry, the pertinent features seen are as follows:

i) The construction industry is a complex multi-tier and multi-player industry.

ii) The owner or developer must have sufficient funds to construct and complete the project. However, there are no laws to ensure funding

[114] In *Mott MacDonald (Malaysia) Sdn Bhd v Hock Der Realty Sdn Bhd* [1997] 1 CLJ Supp 182, it was held that the scale of engineers' fee was in effect a scale of maximum fees.

[115] For instance, see *AC Ho Sdn Bhd v Ng Kee Seng* [1998] 2 CLJ 645 where the parties attempted to contract by way of letter only.

sufficiency. The Government or other public sector agencies are presumed to have the funds. This is not necessarily the case in the private sector, even if the developer was a licensed housing developer.

iii) The funds must be sourced internally through budget allocation or capital, otherwise externally through loan financing.

iv) The construction payment process requires the flow of fund "top down" from the owner or developer to the main contractor to the sub contractors and suppliers and so on.

v) Based on the standard forms of construction contract in use, the construction work is financed by progress payment. Although registered contractors have certain financial capability, regular and prompt progress payment is critical to cash flow to ensure continuity and completion of work. Final payment is essential to settle all outstanding construction debts incurred and earn the profit, otherwise reduce the loss.

vi) The construction contract particularly the standard forms of contract have detailed provisions relating to performance of the contract, both on payments and deductions. At the main contract and nominated sub contract levels, the payment and deduction provisions are further required to be independently and fairly administered by the professional consultants.

vii) Different standard forms of contract allocate risks and remedies relating to performance of the contract differently, some more extensive than others especially in regard to the remedy for non payment. The main contracts often require the main contractor to furnish a performance bond to the owner. This is usually in addition to the retention money withheld during the course of construction.

viii) At the sub contract level "pay when paid" payment provision is widespread. This conditional payment mode is fine if the payment is made regularly by the owner or developer to the main contractor.

The abovementioned norms represent the typical operating environment wherein the construction industry players can reasonably expect to encounter, and hence to cope with the arising challenges when undertaking construction of a project.

2.3 The Problems in the Malaysian Construction Industry

2.3.1 Feedback from the Construction Industry

Arising from the norms in the construction industry, the major problems[116] faced in relation to construction payment are five–fold and may be summarized as follows:

i) The competition for contracts for construction work and services is very intense. For continuity of work or survival, many contractors and professional consultants bid and enter into contracts at lean if not zero profit margin. There is therefore little if not no capacity to absorb shortages in payment. In addition, main contractors and consultants are commercially constrained to enter into contracts with owners or developers who are not proven to be financially adequate to undertake the project. This is especially so in private sector speculative development

[116] *Supra* n. 9. and the author's own experience .

projects where specially created single project purpose private limited company is set up as the named owner or developer to undertake the project. In other words, these speculative developers use a different private limited company to contract with main contractors in each project or phase thereof. It is therefore very risky contracting with such a company as most owners or developers will simply let the insolvent company be wound up in financial trouble. Consequently, the judgment creditor ends up receiving nothing. This problem is hereinafter referred to as the "Project Finance problem".

ii) The construction contracts are tailored in favour of the party that pays the money. This is the application of the famous phrase "He who pays the piper calls the tune".

Thus very often, standard forms of main contract are modified. This includes requiring the furnishing of an acceptable on-demand performance bond (often 5%-10% of the contract sum in value) as a condition precedent to progress payment, retention money to be held free from trust, part payment in kind such as taking units in the completed development and deletion of contractual remedies against non payment. In addition, terms that are favorable to the contractor are deleted such as contractual determination. By such deletion, the common law right to termination for fundamental or repudiatory breach of contract is arguably also extinguished. This follows from the House of Lords case of *Mottram Consultants Ltd v Bernard Sunley and Sons Ltd*[117] where it was held that in construing a printed contract, the court is entitled to look at the words

[117] (1974) 2 BLR 28.

that have been deleted as part of the surrounding circumstance in the light of which one must construe what the parties have chosen to leave in. In that case, the provision for deduction by way of set off has been deleted, thus the court construed that no deduction against payment would be allowed.

At the sub contract level, the main contractors always stipulate payment on the "pay when paid" basis either in modification of the standard forms of nominated sub contract or pursuant to their in-house standard term in domestic sub contracts. The cash flow risk in the event of non or late payment by the owner or developer to the main contractor is shifted to the sub contractor.

In respect of professional consultants, the fee payment provision from the owner or developer is often "back-loaded". In other words, stage fee payment is not in direct proportion with the value of services rendered at that stage but is skewed to be paid later to facilitate the owner or developer's cash flow. There is often payment in kind as well.

The aforesaid problem is hereinafter referred to as the "Unfair Contract Terms problem".

iii) The professional contract administrator at times does not administer main contracts independently and fairly in accordance with the intent of the contract. The contract administrator is beholden to the owner or developer who pays his fees. The contract administrator's independence is compromised to please the owner or developer to ensure that the contract

administrator's own fee payment, cash flow and future business relationship stay unaffected. The problem is pervasive especially in speculative development projects where the owner or developer surreptitiously interferes with the certification by inducing or threatening the contract administrator to certify in accordance with the owner or developer's cash flow ability. There are thus frequent complaints of under certification of progress payment as well as late certification of both progress and final payment. This problem is hereinafter referred to as the "Certification of Payment problem".

iv) The execution of construction work is dispute prone. There would often be disputes pertaining to work not properly done or achieving the desired quality in accordance with the contract, delayed completion of the work or both. The determination of the culpability is often a complex question. As a result of disputes, progress or final payment would be withheld until the dispute is satisfactorily resolved. The disputed payment sum is often huge and may extend from hundreds of thousand to millions of Ringgit. This problem is hereinafter referred to as the "Withholding of Payment problem".

v) The current modes of construction dispute resolution by way of arbitration or court litigation take months and quite typically years to complete. Many parties cannot financially sustain such delayed justice. Moreover, there is no security for payment. In other words, the successful party is not assured of payment after the conclusion of the dispute resolution process. This problem is hereinafter referred to as the "Dispute Resolution & Security of Payment problem".

The above five problems which have been identified will hereinafter throughout this dissertation be collectively known as the "Malaysian Construction Payment Problems".

2.3.2 Construction Industry Development Board Survey

The status of the Malaysian construction industry payment is seen in a recent survey commissioned by the CIDB in 2006.[118] The survey encompassed payment problems faced by both contractors and professional consultants. The survey revealed that payment problems are in fact serious if not also chronic. The estimated number of contractors experiencing late and non payment in public and private sector construction projects both exceed 10,000. Further, the projected total amount of payment still overdue in public and private sector projects exceed RM13.9 billion and RM23.7 billion respectively. The position of the professional consultants is similarly serious in that the projected total amount of payment still overdue exceed RM0.5 billion and RM1.1 billion for public and private sector projects respectively. Many are suffering in silence.

2.4 The Law Relating to Construction Contract Payment

2.4.1 Generally

The Contracts Act 1950 sets out the Malaysian law of contract generally and is applicable to all kinds of commercial contracts including construction contracts. There is no specific statute that deals with or regulates construction contracting,

[118] Lembaga Pembangunan Industri Pembinaan, *A Report of a Questionnaire Survey on Late and Non Payment Issues in the Malaysian Construction Industry* (CIDB, 2006).

unlike for example the Housing Developers (Control and Licensing) Act 1966[119] that regulates housing development. The contract between the licensed housing developer and purchaser is thus based on the statutory standard form prescribed by the Housing Developers (Control and Licensing Regulations) 1989. In *SEA Housing Corporation Sdn Bhd v Lee Poh Choo*[120] it was held that the attempt to contract out by modifying the statutory housing development rules by way of contract failed. The primary object of the statute is to protect the weak against the strong and any attempt to do otherwise is void. This principle of prohibiting contracting out of the statute in protection of the weaker party is affirmed by the Federal Court in *Kimlin Housing Development Sdn Bhd v Bank Bumiputra Malaysia Bhd & Ors.*[121] Contracting out of a statutory provision is only permitted if it is expressly provided in the statute itself.

Freedom of contracting therefore prevails in the construction industry since there is no specific statute setting out the rules pertaining to contractual terms. In consequence, the allocation of risks and responsibilities between the parties need not be balanced or fair in construction contracts. The only limitation to this freedom is if there is any attempt to contract out of those sections in the Contracts Act 1950 that avoid the agreement.[122] There is therefore no prohibition for parties to contract out of or modify the provisions in the standard forms of construction contracts, often in favour of the party awarding the contract who is also the paying party thereunder. This also explains why the more fair and balanced CIDB standard form of main contract (where the main

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[119] *Supra* n. 4.

[120] [1982] 2 MLJ 31, FC; see also *MK Retnam Holdings Sdn Bhd v Bhagat Singh* [1985] 2 MLJ 212.

[121] [1997] 3 CLJ 274.

[122] *Ooi Boon Leong & Ors v Citibank NA* [1984] 1 MLJ 222 where it was held that if freedom of contract is to be curtailed, the prohibition would be expressed in the statute as seen in those sections that avoid the agreement such as in Sections 25 to 31 of the Contracts Act 1950.

contractor, inter alia, is clothed with more favourable payment terms as well as contractual remedies for breaches of contract) is rarely used at all. The PAM forms of contracts are often modified in favour of the paying parties.

2.4.2 Statutory and Common Law Remedies

As far as remedies for breaches of contract are concerned, there are limited statutory remedies available, such as in the Contracts Act 1950[123] and Specific Relief Act 1950.[124] The relevant provision under the Contracts Act is Section 74 which states:

> "74 (1) When a contract has been broken, the party who suffers by the breach is entitled to receive from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from the breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.
>
> (2) Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach."

In the illustrations to Section 74, the relevant building contract examples provided are as follows:

> "(f) A contracts to repair B's house in a certain manner and receives payment in advance. A repairs the house, but not in according to contract. B is entitled to recover from A the cost of making the repairs conform to the contract.

[123] Act 136.
[124] Act 137.

(l) A, a builder contracts to erect and finish the house by the 1st of January, in order that B may give possession of it at that time to C, to whom B has contracted to let it. A is informed of the contract between B and C. A builds the house so badly that, before the 1st of January, it falls down and has to be rebuilt by B, who in consequence, loses the rent which he was to have received from C, and is obliged to make compensation to C for the breach of his contract. A must make compensation to C for breach of his contract. A must make compensation to B for the cost of rebuilding the house, for the rent lost and for the compensation made to C.

(n) A contracts to pay a sum of money to B on a day specified. A does not pay the money on that day. B, in consequence of not receiving the money on that day is unable to pay his debts and is totally ruined. A is not liable to make good to B anything except the principal sum he contracted to pay, together with interest up to the day of payment."

If the breach is fundamental, Section 40 of the Contracts Act provides:

"40. When a party to a contract has refused to perform, or disabled himself from performing, his promise in its entirety, the promisee may put an end to the contract, unless he has signified, by words or conduct, his acquiescence in its continuance."

If the promisee ends the contract, then Sections 65 and 76 of the Contracts Act apply:[125]

"65. When a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is promisor. The party rescinding a voidable contract shall, if he has received any benefit thereunder from another party to such contract, restore the benefit, so far as may be, to the person from whom it was received.

[125] *Yong Mok Hin v United Malay States Sugar Industries Ltd* [1967] 2 MLJ 9 (FC) following *Muralidhar Chartterjee v International Film Company Ltd* [1943] AIR 30 PC 34.

76. A person who rightly rescinds a contract is entitled to compensation for any damage which he has sustained through the non–fulfillment of the contract."

The Specific Relief Act 1950 deals, inter alia with remedies of specific performance of contracts[126] and injunctions.[127] These remedies are seldom applicable to construction contracts because compensation in damages would usually be an adequate relief.[128] Also, specific performance are not granted in respect of construction contracts as it would involve work which the court cannot superintend.[129]

It must also be appreciated that the aforesaid remedies are substantive remedies in law that would be granted after final determination of the dispute on its merits either in court litigation or arbitration. It would only be in clear cut cases that the dispute can be summarily determined and the remedies ordered, although such cases are rare.

2.4.3 The Remedies for the Unpaid Main or Sub Contractor

The unpaid main contractor or sub contractor has to sue to recover payment with interest, often by way of summary judgment or winding up proceedings to expedite the recovery of payment.

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[126] Sections 11 to 29 of the Specific Relief Act 1950.
[127] *Id*, Sections 50 to 55.
[128] Section 54(f) read with Section 20(1)(a).
[129] Section 54(f) read with Section 20(1)(b).

If the non payment is for a sufficiently large sum of money and persistently repeated, it may tantamount to a fundamental breach which entitles the unpaid main contractor or sub contractor to terminate the contract.[130]

It is however unclear whether the obligation to build and the obligation to pay under a building contract are independent promises or reciprocal promises under the contract. The former is one which can be enforced without showing performance of the plaintiff's own promise, or readiness and willingness to perform it[131] whereas the latter is as set out in Sections 52 and 53 of the Contracts Act 1950, to wit:

> 52. When a contract consists of reciprocal promises to be simultaneously performed, no promisor need perform his promise unless the promisee is ready and willing to perform his reciprocal promise.
>
> 53. Where the order in which reciprocal promises are to be performed is expressly fixed by the contract, they shall be performed in that order; and where the order is not expressly fixed by the contract, they shall be performed in that order which the nature of the transaction requires.

It has been held that the issue of whether an obligation is a reciprocal or an independent promise is a question of construction depending on the intention of the parties, the good sense of the case and order in which several things are to be done.[132] In all the Malaysian standard forms of construction contracts, there is certainly no express linkage between progress payment and continuing

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[130] *Citex (M) Sdn Bhd v Ingebeck (M) Sdn Bhd* [1995] 1 LNS 52 following *Ban Hong Joo Mines Sdn Bhd v Chen & Yap Ltd* [1969] 2 MLJ 83; see also Sections 40 and 76 of the Contracts Act 1950.

[131] J.L. Kapur, *Pollock & Mulla Indian Contract and Specific Relief Acts* (Tripathi 13th ed., 1986) at 432.

[132] *Morton v Lamb* (1797) 7 TR 125.

execution of the work. This suggests that the obligations are independent obligations.

In *Kah Seng Construction Sdn Bhd v Selsin Development Sdn Bhd*,[133] it was held (though not discussed in the context of reciprocal versus independent promises) that the unpaid main contractor or sub contractor cannot suspend work. Low Hop Bing J (as he then was) succinctly held that:

> "In my opinion, in the absence of a specific provision in the contract, a contractor has no automatic right to suspend works simply because one or two of his certificates have not been paid (see Keating on Building Contracts (5th Edition) (1991) at page 157). In *Lubenham v South Pembrokeshire District Council* [33 BLR 39] at pp. 69-70, it was argued on behalf of the plaintiff builder that, "there was a general rule whereby a contractor was entitled to suspend his operations on (the employer's failure to pay), quite apart from the terms of the contract." May LJ said in answer to this submission that "In our view it is quite plain that in this passage Lord Salmon was merely drawing attention to provisions in the contract forms and was not suggesting that outside the terms of the contract altogether a contractor had the right to suspend work or not to give further credit." I am quite satisfied that there was no legal basis on which the suspension of the work can be justified in this case."

As a corollary, the main contractor or sub contractor cannot therefore also slow down the execution of the work.[134]

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[133] [1997] 1 CLJ Supp 448 at 457 but contrast *Woon Hoe Kan & Sons Sdn Bhd v Bandar Raya Development Bhd* [1974] 1 MLJ 24 where the then Federal Court held (but without detailed reasoning) that the contractor is under no obligation to finance the employer's property development and is entitled to stop all further work when progress payment remained unpaid by the employer in breach of contract.

[134] *Supamarl Ltd v Federated Homes Ltd* (1987) 9 ConLR 26.

The unpaid main contractor or sub contractor is constrained to carry on the execution of the work with due diligence to completion either wholly with its own financing or whilst so working sue for payment on the interim certificate. Unless the contract has an express provision to terminate the contract for non payment, it would certainly be precarious for the unpaid main contractor or sub contractor to attempt to terminate the contract as it could otherwise be construed as a wrongful abandonment of the works. The proper exercise of the decision to terminate is situational and very much dependent on the facts of each case. In *Yong Mok Hin v United Malay States Sugar Industries Ltd*,[135] it is held that it was wrongful to terminate the contract for the other party's failure to pay a single installment of progress payment because the breach is not seen to be fundamental or repudiatory on the facts of the case.

2.4.4 Remedies for the Unpaid Suppliers

The unpaid supplier of construction materials or goods has several recourse under the Sale of Goods Act 1957.[136]

Whilst the goods or materials are still on transit, the unpaid supplier has a lien over the materials or goods. The unpaid seller also has the right to retain the goods or materials until the whole of the price has been paid or tendered.[137]

After delivery, the unpaid seller loses the lien unless there has been a reservation of right of disposal. If the right of disposal has been reserved, the

[135] [1966] 2 MLJ 286.
[136] Act 382.
[137] Section 47.

title to the materials or goods does not pass and the unpaid seller may obtain a court order of delivery up and obtain re-possession of the goods or materials.[138] In any event, the goods or materials become the property of the owner or developer once they are affixed or incorporated into the works. The right of the unpaid supplier is then only to sue the buyer,[139] usually the main contractor or sub contractor for the price of the goods or materials.

2.4.5 Remedies for the Unpaid Professional Consultants

The unpaid professional consultants such as the architect, engineer and quantity surveyor have limited remedies because their legal position is akin to the contractor vis a vis the owner or developer. They are not entitled to suspend work for non payment of fees. They will have to sue for their fee payment with interest.[140]

Based on the above discussion it is submitted that the Contracts Act 1950 and common law provide limited remedies to the unpaid parties. Their recourse is to sue for the debt or damages for breach of contract. It is only in a fundamental or repudiatory breach situation that the unpaid party can terminate the contract and sue for damages.

Be that as it may, it must also be appreciated that the remedy of "self help" is unavailable in construction contracts. In other words, the unpaid main contractor or supplier would not be able to remove any part of the work,

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[138] *Antah Schindler Sdn Bhd v Bayan Bay Development Sdn Bhd* (1998) (Penang HC) unreported.

[139] Section 55 of the Sales of Goods Act 1957 (Act 382).

[140] *Daya Bina Akitek Sdn Bhd v Dato Syed Hamzah bin Syed Abu Bakar* [2002] 1 LNS 170, *Hasbullah Chan & Associates Architects v Rahika Holdings Sdn Bhd* [2000] 7 CLJ 109 and *Hamzah, TR and Yeang Sdn Bhd v Lazar Sdn Bhd* [1985] 2 MLJ 45.

equipment etc. once it is built and attached to the land, otherwise they would be liable for trespass. This is because by Section 5 of the National Land Code 1965 (Act 56), land includes all things attached to the earth or permanently fastened to any thing attached whether on or below the surface. Thus, all work done or material supplied which is incorporated into the building become fixture[141] and form part and parcel of the land.

The proper and sole remedy is confined to commencing legal action for debt or damages.

2.5 The Malaysian Construction Payment Problems and Presently Available Recourse

2.5.1 The Project Finance Problem

It is clear that there are no laws in Malaysia prescribing or ensuring adequacy of funds to undertake the development or construction of a project. There is thus no legal recourse to address this problem.

The current reality involves many construction players taking huge commercial risks in expectation of getting paid when carrying out a project. If they are not prepared to assume the risks, then the only commercial recourse is not to bid or undertake the project.

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[141] *Goh Chong Hin & Anor v The Consolidated Malay Rubber Estates Ltd* (1924) 5 FMSLR 86 and *The Shell Company of the Federation of Malaya Ltd v Commissioner of the Federal Capital of Kuala Lumpur* [1964] MLJ 302.

2.5.2 The Unfair Contract Terms Problem

Save only where the sections in the Contracts Act 1950 expressly stipulate that the agreement as agreed between the parties is rendered void (such as through coercion, undue influence or misrepresentation), the Act allows freedom of contracting. In other words, parties are otherwise free to agree on terms of contract as they see fit.

The agreement on terms of contract is a commercial exercise depending on the relative bargaining powers of the parties. If both parties are of equal bargaining position, then it can realistically be expected that there will be extensive negotiations and the resultant terms are fairly balanced. Otherwise, the paying party would often dictate the terms including departure from the standard forms of contract.

There is no legal recourse unless the agreement can be said to be procured through coercion by way of economic duress. In that event, the contract is voidable.[142] It is generally very difficult to make a sufficient case in economic duress. In the non construction contract case of *Chin Nam Bee Development Sdn Bhd v Tai Kim Choo and Others*,[143] the court examined the facts in the light of Sections 14 and 15 of the Contracts Act and rejected that there was operative economic duress. The court came to the same conclusion in the subsequent cases of *Teck Guan Trading Sdn Bhd v Hydrotek Engineering (S) Sdn Bhd*[144]

[142] Sections 14, 15 and 19(1) of the Contracts Act 1950.
[143] [1988] 2 MLJ 117.
[144] [1996] 4 MLJ 331.

and *Mohd Fariq Subramaniam v Naza Motor Trading Sdn Bhd.*[145] The English construction contract cases where economic duress were successful were *D. & C. Builders Ltd. v Rees*[146] and *Williams v Roffey Bros & Nicholls (Contractors) Ltd.*[147] However both the cases involve variations in the course of the performance of the contract where there were threats to break the contract if it was not accordingly varied. It must be noted that these cases involved duress inflicted mid stream during the performance of the contract but not on entry into the contract. This can thus be contrasted against unequal commercial bargaining position and power during the formation of the contract *ab-initio*. Thus it is said in Chitty on Contracts[148] that there is Commonwealth authority which holds that a person who is under no duty to enter into a contract with another is entitled to set his own terms, even though this may seem extortionate and the other party may have little choice but to comply.

In consequence, the reality is that construction industry players are left again with only the commercial recourse by pricing the risk relating to these unfavourable terms in the bid.

2.5.3 The Certification of Payment Problem

In most construction contracts, the certificate is the condition precedent to payment for both interim progress and final payments.[149] The certificate creates a debt due.

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[145] [1997] 3 CLJ Supp 249.
[146] [1966] 2 QB 716.
[147] [1991] 1 QB 1.
[148] H.G. Beale (et. al.) *Chitty on Contracts Vol. 1* (Sweet & Maxwell, 28th ed., 1999) at 7-032, applying *Morton Construction v City of Hamilton* (1961) 31 DLR (2d) 323.
[149] *Ling Heng Toh Co v Borneo Development Corporation Sdn Bhd* [1973] 1 MLJ 23.

The proper certification of work properly done and materials or goods supplied is significantly dependent on the integrity of the certifier. In all the standard forms of contract, the certifier is thus relegated to the contract administrator who is an independent professional consultant. The certifier is expected to certify independently, fairly and of course correctly. In the non standard form contract, the certifier is invariably a personnel of the paying party.

The problems encountered are often attributed either to the incompetency (or negligence) of the certifier or to the interference of the certifier by the paying party.

In *Lubenham Fidelities & Investment Co Ltd v South Pembrokeshire District Council,*[150] the English Court of Appeal held that the contractor is only entitled to payment of the sum actually shown on the certificate to be due from the owner even if the certificate contains a latent or patent error. In that case, the certifier architect was negligent by making invalid deductions on the face of the interim certificate and the owner refused to pay the sums in excess of the amount actually certified as due. This was held not to be a breach of contract and the legal recourse was to submit for arbitration to have the certification re-determined.

In addition, there may also be legal recourse against the certifier in negligence although English case law[151] suggests that there might not be a duty of care

[150] (1986) 33 BLR 39.

[151] *Pacific Associates v Baxter* (1988) 44 BLR 33 and followed in the Hong Kong case of *Leon Engineering & Construction Co Ltd v Ka Duk Investment Co Ltd* (1989) 47 BLR 139.

owed by the professional consultant to the contractor if there is an alternative mechanism for the contractor to seek recourse under the building contract against the employer. The reasoning is that in considering whether a duty of care existed, it was relevant to look at all the circumstances and this included the building contract. There would have been no voluntary assumption of responsibility by the professional consultant relied upon by the contractor to give rise to liability for economic loss in circumstances which there was an arbitration clause in the building contract permitting the arbitrator to review the professional consultant's decision. There is no reported Malaysian case on an action by the contractor for negligence against the consultant certifier due to under-certification of work done.

As to interference by the owner or developer on the independence of the certifier, the act of interference constitutes a breach of contract. In addition, several of the standard forms[152] of main contract provide the contractual recourse of allowing the main contractor to determine its employment under the contract. The practical difficulty is however for the contractor to prove interference. In the English case of *RB Burden Ltd v Swansea Corporation,*[153] it was held that there must be actual intermeddling by the owner with the certification process. In that case, the owner employed a quantity surveyor to make valuations under a building contract. The quantity surveyor made an erroneous valuation which he declined to change and the architect certified the amount valued by the quantity surveyor. The contractor purported to determine the employment on the ground that the quantity surveyor's action constituted

[152] Clause 26.1(ii) of the PAM form of main contract (1998 Edition), Clause 26.1(b) of the PAM form of main contract (2006 Edition) and Clause 45.1(a)(ii) of the CIDB form of main contract.

[153] [1957] 3 All ER 243.

interference or obstruction by the owner with the issue of the certificate. The House of Lords found that the conduct of the quantity surveyor merely resulted in the issue of a certificate for a smaller amount and that was a matter for arbitration. Likewise, in *Ling Heng Toh Co v Borneo Development Sdn Bhd*[154] the contractor was unsuccessful where it was alleged that the owner had obstructed or intermeddled with the issuance of the interim certificate. In that case, the contractor was dissatisfied with the interim certification of the engineer due to the shortfall in the value certified. The owner paid as certified but wrote to the contractor that as far as the owner could see, the engineer had certified in accordance to the agreement. The owner also suggested to the contractor to make a further progress claim. The contractor however construed that the owner had obstructed or intermeddled with the certifier and accordingly sued the owner for the alleged under-certified sum. The Federal Court held that the owner's conduct did not constitute obstruction or intermeddling with the certification process.

If no certificate of payment is issued, the position of the unpaid main contractor or sub contractor is even more precarious. The only legal recourse is either to commence arbitration proceedings for withholding of certificate provided there is an arbitration agreement or to file an action in court on the basis that the owner or main contractor has waived the requirement or prevented the issuance of the certificate.[155] Such a situation is usually not straight-forward. Notwithstanding that the work has been completed and the sub contractor has

[154] *Supra* n. 119.
[155] *Croudace v London Borough of Lambeth* (1986) 33 BLR 20.

submitted its final claim[156] or the architect has issued a statement of final account,[157] the application for summary judgment by the unpaid sub contractors would fail in the absence of certification by the relevant certifier under the contract. There is an exception seen in the case of *Jetera Sdn Bhd v Maju Holdings Sdn Bhd* where the sub contractor in the absence of the final certificate sued on his final claim and applied for summary judgment. The sub contractor failed at first instance but the Court of Appeal robustly reversed it[158] based on the special facts of the case, particularly the unreasonable conduct of the main contractor. The High Court was able to subsequently distinguish it in another similar case of *Pintaras Geotechnique Sdn Bhd v Hasrat Sedaya Sdn Bhd (2005)* (KLHC) unreported by reason that the conduct of the main contractor constituted a triable issue which must be investigated at trial. However, where the parties had jointly agreed to the statement of final accounts, the sub contractor succeeded in obtaining summary judgment in *Suncast Sdn Bhd v Padang Indah Sdn Bhd.*[159]

The legal recourse available to the contractor for under-certification or non certification is to resort to arbitration on the assumption that there is an arbitration agreement in the contract. Furthermore, it is only commercially effective if the arbitration award can be obtained swiftly as the contractor has to otherwise finance the under certified portion of the work. If there is no arbitration agreement, the only legal recourse is to sue the owner for damages for breach of contract with slim possibility of getting summary judgment on it.

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[156] *Jetera Sdn Bhd v Maju Holdings Sdn Bhd* [2006] 2 MLJ 313 and *Jallcon (M) Sdn Bhd v Nikken Metal (M) Sdn Bhd* (No 2) [2001] 6 CLJ 23.
[157] *Simetech (M) Sdn Bhd v Yeoh Cheng Liam Construction Sdn Bhd* [1992] 1 CLJ 509.
[158] [2007] 3 CLJ 41 (CA).
[159] [1999] 1 LNS 332.

2.5.4 The Withholding of Payment Problem

a) Generally

As previously seen and discussed, cash flow is vital in the construction industry. The financing of the construction project in most construction contracts is expected to be from the owner or developer. The cash payment received by the main contractor has to progressively flow downwards to the other players in the chain. In other words, it is imperative that the down line sub contractors are progressively paid to ensure that the project construction progresses towards completion.

This requirement of "top down" fund flow has also been judicially recognized as far back as in the 1970s in *Woon Hoe Kan & Sons Sdn Bhd v Bandar Raya Developments Bhd*,[160] where Harun J (as he then was) in a building dispute between the main contractor and owner held that:

> "... A large volume of correspondence was entered into between the parties regarding these payments from early 1969. There were meetings and conferences and the plaintiff rendered monthly statement of accounts accompanied with demands for prompt payments. From the bulk of the correspondence it is apparent that both parties were short of funds. The plaintiffs had borrowed monies from other sources to complete the works and the defendants gave repeated assurances that they were about to come into funds. Both parties made every attempt to maintain goodwill between the parties but it was obvious that the contractual arrangements whereby the defendants, as employers, were to pay the plaintiffs, as contractors, for

[160] [1971] 2 MLJ 213 at 213, 214. In that case, summary judgment was obtained by the main contractor against the employer on interim certificates for the release of retention monies; see also *Trio Bina Sdn Bhd v Bijaya Corpn Sdn Bhd* [1992] 1MTC 89.

works done on a monthly basis had completely broken down...**Contractors rely on these progress payments to get on with their work. Without these financial arrangements, contractors will be put out of business ...**" **(emphasis added).**

In the aforesaid CIDB Survey,[161] it was noted that the three most common effects of late and non payment are the resultant cash flow problems, stress on contractors and financial hardship. It would in turn result in a devastating knock on effect down the contractual payment chain.

The interim certificate creates a debt. The recovery of certified payment should therefore be straightforward. The unpaid certificate should be resolvable promptly by way of a debt action in court followed by an application for summary judgment.[162]

In *Bank Negara Malaysia v Mohd. Ismail Ali Johor & Others*,[163] the then Supreme Court held in respect of summary judgment application that:

"The scope for O.14 proceedings meant for cases which are virtually uncontested or uncontestable is now determined by the Rules of the High Court 1980. Generally if the defendant shows that he has a fair case for defence, or reasonable grounds for setting up a defence, or even a fair probability that he has a bona fide defence, he ought to have leave to defend. Order 14 is not intended to shut out a defendant. The jurisdiction should only be decided in very clear cases...It was held in the well known House of Lords case of *Jacobs v Booth Distillery Co* [1901] 85 LT 262 that a complete defence need not be shown. The defence need only show that there is a triable issue or question or that for some other reason there ought to be a trial, and

[161] *Supra* n. 118.
[162] Order 14 Rules of the High Court 1980 or Order 26A Subordinates Court Rules 1980.
[163] [1992] 1 CLJ 627 at 636.

> leave to defend ought to be given. In fact even though the defence is not clearly established, but only reasonable probability of there being a real defence, leave to defend should be given...It was stated by Megarry J in *Miles v Bulls* [1969] 1 QB 258; [1968] 3 AER 632 that it sometimes happen that the defendant may not be able to pin-point any precise "issue or question in dispute which ought to be tried," nevertheless it is apparent for other reason there ought to be a trial, for example where a question of fact as to whether the plaintiff has fulfilled his part of the contract..."

It can therefore be surmised that the legal recourse in summary judgment can only be obtained in clear cut cases. A claim pursuant to an unpaid certificate particularly if certified by a professional consultant should be clear cut. The reality is however that there is too often withholding of payment by the owner or the main contractor on the pretext of over-valuation or cross claims for defective work or delayed completion or both. These cross claims can be in the nature of contractual set off by way of express provisions for deductions[164] or equitable set off under common law.[165] Generally, such allegations of cross claims are sufficient to constitute triable issue or a reason to go for trial, thus defeating the application for summary judgment.

As will be seen in Chapter 3, the Court of Appeal in England in *Dawnays Ltd. v F.G. Minter*[166] held that a certificate is as "good as cash" and is hence payable free of set off and this was followed in *Bandar Raya Developments Bhd v Woon Hoe Kan & Sons Sdn Bhd* [167] where the Federal Court said;

[164] Chapters 2.2.3.b.5 and 2.2.3.c.5.
[165] *Permodalan Plantations Sdn Bhd v Rachuta Sdn Bhd* [1985] 1 MLJ 57.
[166] (1971) 1 BLR 16.
[167] [1972] 1 MLJ 75 at 76.

> "We would also refer to the recent Court of Appeal decision in England reported in the case of *Frederick Mark Ltd v Schield.* The Court of Appeal in that case referred to *Dawnay's* case and categorically stated that the court agreed with every word Lord Denning said. That was to the effect that the purpose of interim certificates was to see that payments made under them were without correlative right to set off or counterclaim as that would run counter to the very purpose of interim certificates - to provide cash for the contractor or sub contractor to get on with the work. A debt due under an interim certificate was a debt of a class which ought not to be allowed to be made subject of a set off or counterclaim. We would respectfully follow the two decisions referred to ..."

Subsequently, the House of Lords in *Gilbert Ash Northern Ltd v Modern Enginering (Bristol) Ltd*[168] held that *Dawnay's* case was wrongly decided in that a debt created by an interim certificate does not enjoy any special status and is subject to remedies for breach of contract unless excluded by express agreement. It was succinctly held that cash flow is not only the very lifeblood of the building industry but to all the commercial enterprises engaged in the business of selling goods or undertaking work or labour. The Malaysian Federal Court in *Alliance (Malaya) Engineering Co Sdn Bhd v San Development Sdn Bhd*[169] followed the House of Lords accordingly. In that case, the unpaid nominated sub contractor sought summary judgment on certified sums against the main contractor as special debt. The Federal Court dismissed the nominated sub contractor plaintiff's summary judgment application but granted the main contractor defendant conditional leave to defend by paying the plaintiff's claim into court as the counterclaim for delay appeared to the court to be a sham. It is nevertheless clear that the status of a certificate under a building contract is thus no different from that of an ordinary

[168] (1973) 1 BLR 73.
[169] [1974] 2 MLJ 94

debt which can be subject to or defeated by cross claims of set off or counterclaim.

b) Main Contractor's Claims

It can be seen that there was a conflict between the Federal court cases of *Bandar Raya Development* and *Alliance (Malaya) Engineering Co* in respect of the status of payment certificates issued pursuant to building contracts where faced with the cross claim of set off. This conflict was resolved in the landmark building case of *Pembenaan Leow Tuck Chui & Sons Sdn Bhd v Dr Leela Medical Centre Sdn Bhd*,[170] which concerns an action on the penultimate certified payment under the PAM Conditions of Main Contract (1969 Edition). In the *Pembenaan Leow Tuck Chui* case, the Supreme Court reversed the High Court's decision denying summary judgment applied for by the main contractor.

Edgar Joseph Jr. FCJ in that case held, inter alia, as follows:[171]

> "...When, upon the proper construction of a particular contract which of course, is a question of law, there is no obligation on the part of an employer in a main contract, or a main contractor in a sub-contract, to pay upon being served with a progress payment certificate, because of pending disputes, allegations of defects in works or materials or claims for damages for delay, without giving some reasonable amount of detail and quantification, are unlikely to result in the dismissal of an application for summary judgment under O14 and leave to defend being given ..."

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[170] [1995] 2 MLJ 57; c.f. the earlier decisions in *Syarikat Yew Hock Seng Building Construction v Sim Lian Huat Holdings Sdn Bhd* [1989] 1 LNS 35, *Syarikat Soo Brothers Construction v Gazfin Sdn Bhd* [1988] 1 LNS 163, *Gunung Bayu Sdn Bhd v Syarikat Pembinaan Perlis Sdn Bhd* [1987] 2 CLJ 9, *Lee Brothers Construction Co v Teh Teng Seng Realty Sdn Bhd* [1988] 1 MLJ 459, *Pembinaan Sri Aman v Yong Poh Kah* [1987] 2 CLJ 238, *Haji Abu Kassim v Tegap Construction Sdn Bhd* [1981] 2 MLJ 149 and *Shen Yuen Pai v Dato Wee Hood Teck & Ors* [1976] 1 MLJ 16.

[171] *Id.* at 81.

Further, his Lordship also cited[172] the passage in the English case of *Ellis Mechanical Services Ltd v Wates Construction Ltd* [1976] 2 BLR 57 with approval:

> "If the main contractor can turn around, as the main contractor has done in this case and say, 'Well, I don't accept your account; therefore there is a dispute", that dispute must be referred to arbitration and the arbitration must take its long and tedious course. Then the sub-contractor is put into considerable difficulties. He is deprived of his commercial life-blood. It seems to me that the administration of justice in our courts should do all it can to restore that life blood as quickly as possible, ... In my judgment it can be done if the courts make a robust approach, as the Master did in this case, to the jurisdiction under O14."

It is important to note that in the *Pembenaan Leow Tuck Chui* case, the owner who contracted under the PAM Conditions of Main Contract refused to pay the main contractor because of his allegations of defective works or materials or over-valuation or both. The High Court refused the main contractor summary judgment. In the course of the Supreme Court reversing it, Edgar Joseph Jr. FCJ explained:[173]

> **"Having regard to the terms of the contract, if the employer had considered that the architect had failed in his duty to make the necessary deductions because of alleged defective work or materials as being not in accordance with the terms of the contract thus resulting in over-certification of the sums payable, the employer had three remedies open to him, namely: i) to request the architect to make appropriate adjustments in the next certificate; or ii) if**

[172] *Supra* n. 170. at 81.
[173] *Id.* at 71 and 80.

> **the architect declined to comply with that request, then to take the dispute to arbitration; or iii) to sue the architect** ... In all the circumstances, our conclusion therefore is that having regard to the meaning of the particular words of the contract, in particular the clauses that we have referred to and discussed, there is clear implication that the parties had intended that so far as claims for payment on certificates were concerned, the ordinary common law right of set-off was to be extinguished" **(emphasis added)**.

The *Pembenaan Leow Tuck Chui* case has given the inspiration to many players in the construction industry particularly main contractors and sub contractors that summary judgment against non payment of certified payment is easily obtainable notwithstanding cross claims of defective work or even delayed completion by the other party. This is however a mistaken view[174] as that decision is reached because of the usage of the PAM Conditions of Main Contract (1969 Edition) which has in the view of the court expressly and exhaustively set out the permissible set-offs under the contract.

Subsequent to the *Pembenaan Leow Tuck Chui* case, there were only several reported cases[175] in which the main contractor was successful when faced with cross allegations by the owner or developer particularly the subsistence of defects. Those cases used the same PAM Conditions of Main Contract. It is also to be noted that those unpaid interim certificate cases proceeded by way of the main contractor's winding up petition against the owner on the ground that the owner was unable to pay its debts.[176] The court in those cases was robust

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[174] Lim Chong Fong, *Pembenaan Leow Tuck Chui Revisited,* (MBAM 2003, 1st quarter Master Builders Journal, 2003) at 7.

[175] *Sri Binaraya Sdn Bhd v Golden Approach Sdn Bhd* [2000] 7 CLJ 320, *Mascon Sdn Bhd v Kasawa (M) Sdn Bhd* [2000] 1 LNS 203, *BMC Construction Sdn Bhd v Dataran Rentas Sdn Bhd* [2001] 1 CLJ 591 and *JB Kulim Development Sdn Bhd v Great Purpose Sdn Bhd* [2002] 2 CLJ 345.

[176] Section 218(2) of the Companies Act 1965 (Act 125).

and held that the disputes raised by the employer were not bona fide on substantial grounds.

On the other hand, there were also reported cases where despite the case of *Pembenaan Leow Tuck Chui* was relied upon by the plaintiff, the application for summary judgment[177] or petition to wind up[178] the owner or developer by the main contractor based on unpaid certificates failed. Though the PAM Conditions of Main Contract (1969 Edition) was also used in these cases, the court nevertheless held that the allegations raised by the employer constituted triable issues. In other cases[179] where the PAM Conditions of Main Contract were not used, the applications were similarly unsuccessful. In the *Kah Seng Construction* case,[180] Low Hop Bing J (as he then was) clearly held:

> "...Hence, the question of whether the defendant's common law right to set off sums of money for delay and defective work against sums payable to the plaintiff pursuant to an interim certificate was removed expressly or by clear implication would depend on the construction of the contract concluded by them. In the present contract the terms governing the contractual relation between the plaintiff and the defendant are rudimentary. There are no terms in the parties' contractual relationship that can either expressly or impliedly excluded the defendant's common law right of setting off its claim for delay and defective works against the sums claimed by the plaintiff in the interim certificates. Hence I hold that the defendant has correctly exercise its right to set off its claim for delay and defective works against sums payable to the plaintiff under the disputed certificates."

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[177] *IJM Corporation Bhd v Antara Bumi Sdn Bhd & Anor* [2002] 1 LNS 27 and *Kumpulan Liziz Sdn Bhd v Pembinaan OCK Sdn Bhd* [2003] 4 CLJ 709.

[178] *Kemayan Construction Sdn Bhd v Prestara Sdn Bhd* [1997] 1 LNS 717.

[179] *Kah Seng Construction Sdn Bhd v Selsin Development Sdn Bhd* [1997] 1 CLJ Supp 448; see also *Bovis (M) Sdn Bhd v Samaworld (M) Sdn Bhd* [1997] 1 LN 94, *Ruby Construction Sdn Bhd v Contipak Noron Sdn Bhd* [2001] 1 LNS 88 and *Ribaru Bina Sdn Bhd & Anor v Bakti Kausa Development & Anor* [2003] 8 CLJ 711.

[180] [1997] 1 CLJ Supp 448 at 450.

Thus, it is unsurprising that many similar cases were denied summary judgment and ended up at trial.[181] This position is also seen in the recent Court of Appeal decision in *Bukit Cerakah Development Sdn Bhd v L'Grande Development Sdn Bhd*[182] which reversed the High Court's decision[183] where judgment was earlier entered against the owner under an Order 14A application on a preliminary issue of law. The Court of Appeal, inter alia, held that on the construction of the contract (based on the PWD form of main contract), the owner in pleading to set off against the main contractor's certified claim need not produce a specific and final figure verified by a professional quantity surveyor but merely to put his claim in a bona fide way by reasonable means. It was sufficient for the owner to merely rely on a pleaded claim made against the main contractor in another suit. The court also emphasized that whether the alleged set off will succeed on the merits is a matter that must await the trial of the action. It is therefore clear that the prospect of success by way of summary application is slim.

c) Sub Contractor's Claims

Notwithstanding the *Pembenaan Leow Tuck Chui* case, most of the reported cases[184] revealed that the applications for summary judgment or winding up

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[181] *Invesco Ventures Sdn Bhd v Metro Jelita Sdn Bhd* [1999] 1 LNS 340 and *Enshinsaito Builders Sdn Bhd v Jayapurna Enterprises Sdn Bhd* [2005] 1 LNS 199

[182] [2008] 2 CLJ 645.

[183] *L'Grande Development Sdn Bhd v Bukit Cerakah Development Sdn Bhd* [2007] 8 CLJ 507.

[184] *Syarikat Lian Ping Enterprise Sdn Bhd v Cygal Bhd* [2000] 2 CLJ 814, *Mahkota Technologies Sdn Bhd v BS Civil Engineering Sdn Bhd* [2000] 7 CLJ 280, *Renofac Builder (M) Sdn Bhd v Chase Perdana Sdn Bhd* [2001] 5 CLJ 371, *Kejuruteraan Eletrik Usahamaju Sdn Bhd v Zilatmas (M) Sdn Bhd* [2001] 5 CLJ 563, *Pembinaan Thin Chai Sdn Bhd v Citra Muda Sdn Bhd & Anor* [2002] 3 CLJ 344, *Tajukon Sdn Bhd v UAT Air Conditioning Sdn Bhd* [2003] 1 LNS 685 and *PCM Bina Sdn Bhd v Syarikat Pembinaan Lal Sdn Bhd* [2004] 1 LNS 676; see also *Syarikat Perniagaan Tek Seng Hin v Merlin Inn Resort Cameron Highland Sdn Bhd* [1996] 1 LNS 40 and *Ley Boon Hee v Mohamed &*

petitions by sub contractors against the main contractors failed. This is primarily because the cross claims are found to constitute triable issues or bona fide disputes. Furthermore, the forms of sub contract used in these cases do not on their true construction exclude the right of set off by way of necessary implication as seen in the PAM Conditions of Main Contract (1969 Edition).

There were only several exceptions. The subcontractor was however successful in the case of *KM Quarry Sdn Bhd v Ho Hup Construction Co Bhd*[185] Although the case was filed based on unpaid certificates, there was no doubt that the main contractor had in clear and unambiguous words in its accountant's letter confirmed the balance due in the certificates. The court found that it was an admission of liability and the case can thus be said to have been decided based on its special facts. The sub contractor was also successful in *CM Indah Sdn Bhd v UB Usahabina Sdn Bhd*[186] where bare issues of delay, defects and others were unsuccessfully raised by the main contractor in an attempt to frustrate the sub contractor's application for summary judgment. A similar unmeritorious attempt also arose in *Mudajaya Corporation Bhd v Lankhorst Pancabumi Contractors Sdn Bhd*[187] and summary judgment was thus entered against the main contractor.

Sons Construction [1995] 4 CLJ 231 which were decided prior to the *Pembenaan Leow Tuck Chui* case.

[185] [2006] 7 MLJ 203. The sub contractor was also successful in *Bachy Soletanche (Malaysia) Sdn Bhd v Kin Hup Seng Construction Sdn Bhd* [2001] 1 CLJ 549 based on a binding final certificate issued by the consultant.

[186] [2006] 4 CLJ 733.

[187] [2004] 1 LNS 404.

Nevertheless, in *Ooi Boon Teong (t/a Mitsu-Da Construction) v MBf Construction Sdn Bhd*[188] (which was decided prior to the *Pembenaan Leow Tuck Chui* case), the sub contractor obtained conditional leave to defend where the court found the main contractor's complaints of defective work dubious. It is also noted that it can be financially fatal to the sub contractor if the claim has to await the resolution of the claim at trial that following the failure to obtain summary judgment. For instance, in *Ley Boon Hee v Mohamed & Sons Construction*,[189] the sub contractor went into bankruptcy in the course of the pursuit of his claim against the main contractor.

Besides, if payment against certificate or even agreed final account is subject to a "pay when paid" obligation under the sub contract, attempts by the sub contractor for summary judgment have in a number of cases failed.[190] In *Pernas Otis Elevator Co Sdn Bhd v Syarikat Pembenaan Yeoh Tiong Lay Sdn Bhd & Anor*,[191] the unpaid sub contractor even failed at trial. This is because the cause of action has not accrued to the sub contractor unless and until the main contractor has been paid. The sub contractor was however successful at summary judgment in *Royden (M) Sdn Bhd v Syarikat Pembenaan Yeoh Tiong Lay Sdn Bhd*[192] and again in *Siemens Building Technologies (M) Sdn Bhd v Geahin Engineering Bhd*[193] where it was doubtful if the sub contract incorporated the "pay when paid" obligation because of conflict between the printed terms and the written terms of the sub contract. In *Antara Elektrik Sdn*

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[188] [1994] 3 MLJ 413; see also *Alliance (Malaya) Engineering Co Sdn Bhd v San Development Sdn Bhd* [1974] 2 MLJ 94.
[189] [1995] 4 CLJ 231.
[190] For example, see *Procorp Realty Sdn Bhd v Sumpiles (M) Sdn Bhd* [2001] 8 CLJ 613.
[191] [2004] 5 CLJ 34.
[192] [1991] 3 CLJ 2935.
[193] [2001] 1 LNS 337.

Bhd v Bell & Order Bhd[194] the sub contractor was successful after a trial on the preliminary issue as to whether the sub contract was subjected to such an obligation where it was only then that it was answered in the negative.

In the recent case of *Antah Schindler Sdn Bhd v Ssangyong Engineering & Construction Co Ltd*[195] the Court of Appeal robustly reversed the High Court[196] by granting summary judgment in the face of the "pay when paid" clause notwithstanding that the main contractor had not yet received the money from the owner. In that case 10 years had elapsed since the payment certificate had been issued. The court held that the right to commence action for non payment depends on the construction of the clause as to whether there is any prohibition in the sub contractor getting paid at all if the main contractor has not been paid. Thus if the clause is not a "pay if paid" one, then the main contractor must pay the sub contractor after reasonable time has elapsed notwithstanding that the main contractor himself has not been paid.

If summary judgment fails, it is inevitable that the unpaid contractor has to pursue the claim at trial against the employer.[197]

d) Supplier's Claims

With regard to suppliers, it is ordinarily expected that the unpaid supplier should be entitled to summary judgment for the price of the goods or materials

[194] [2002] 1 LNS 205.
[195] [2008] 3 CLJ 641.
[196] [2006] 1 LNS 332.
[197] *Faber Merlin Malaysia Bhd v Ban Guan Sdn Bhd* [1980] 1 LNS 189, *How Loon Sim v Lipson Realty (Malaya) Sdn Bhd* [1976] 1 LNS 41 and *Woo Kam Seng v Vong Tak Kong* [1968] 2 MLJ 244.

delivered.[198] However, it is to be expected that the buyer would often attempt to raise triable issues of defective product or late delivery to avert the entry of judgment, commonly to "buy time" whilst the buyer is pursuing its claim against the main contractor or employer for payment. This was attempted by the buyer but the supplier was nevertheless successful in obtaining summary judgment in *Buildcon Concrete Sdn Bhd v Syarikat Pelaras Utara Sdn Bhd & Others*.[199] The supplier was also successful by way of winding up proceedings against the purchaser in *Platinum Heights Sdn Bhd v Sun Mix Concrete Sdn Bhd*.[200] In both these cases, the court found that the buyers' defence lacked bona fides and was a ploy merely to delay payment.

e) Professional Consultant's Claims

In regard to professional consultants, if there are clear standard contractual terms on fee payment such as those issued by the respective statutory boards governing the profession,[201] then the pursuit of the unpaid fee would be a summary judgment matter. However, more often then not, the parties contract via letters only and/or usually vary the standard statutory terms and as a result a trial, whether in court[202] or arbitration[203] is usually necessary to resolve payment

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198 *Panglima Aces Sdn Bhd v Highway Brick Works (Serendah) Sdn Bhd* [2006] 3 CLJ 628.

199 [2007] 1 LNS 291.

200 [1996] 1 LNS 119.

201 For instance, see Conditions of Engagement of Architect and Scale of Minimum Fees issued pursuant to the Architects Rules.

202 *Foo Sam Ming v Archi Environ Partnership* [2004] 1 CLJ 759, *Dataran Khas Sdn Bhd v Arkitek SE* [2002] 1 LNS 181, *Kinabalu Akitek Sdn v The State Government of Sabah* [1999] 1 LNS 53, *Goh Hock Guan Associates v Kanzen Bhd* [1998] 1 LN 237, *Akitek Tenggara Sdn Bhd v Mid Valley City Sdn Bhd & Anor* [1999] 3 CLJ 383, *Low Kok Hwa v Sime Darby Urus Harta Bhd* [1997] 1 LNS 234, *Chan Wing Kit & 3 Ors v The Green Coorperative Society Ltd* [1995] 1 LNS 43, *Alfred Kuan Yok Fau t/a Akitek KEP v Konsultant Proses Sdn Bhd & Ors* [1993] 1 LNS 9, *Datin Peggy Taylor v Peninsular Realty Co Sdn Bhd* [1990] 1 CLJ 254, *Akitek Berjasa v City Motors Sdn Bhd & Anor* [1986] 1 CLJ 31, *C S Khin Development Sdn Bhd v Chung Yoke On* [1985] 2 CLJ 345, *Datin Peggy Taylor v Udachin Development Sdn Bhd* [1984] 1 CLJ 36, *K C Lim & Associates Sdn Bhd v Pembenaan Udarama Sdn Bhd* [1980] 2 MLJ 26 and *Seniwisma S & O Architect & Planner v*

disputes thereunder. In addition, it is also usual that there would be cross claims for breach of contract and/or negligence for unsatisfactory services performed.[204] In the recent Federal Court decision of *Akitek Tenggara Sdn Bhd v Mid Valley City Sdn Bhd*,[205] the court finally decided in favour of the architect after a lengthy 16 years of litigation over professional services rendered in the 1980s.

It can therefore be discerned and summarized that the unpaid main contractor, sub contractor, supplier or professional consultant has to pursue legal proceedings either in court or in arbitration (provided there is an arbitration agreement). It is not uncommon that many of them attempt summary applications such as summary judgment applications or winding up proceedings. However many of such applications fail and must proceed to trial. The principal reason is that the triable issue/bona fide dispute test in summary judgment application/ winding up proceedings respectively is much too low a threshold for the non paying defendant to overcome to deny the plaintiff.

Besides, the unpaid main contractor, sub contractor or professional consultants cannot suspend work or services but must carry on working as envisaged by the contract (including financing the work in the meanwhile). It is otherwise a repudiatory breach of contract to suspend or slow down the rate of working.

Perusahaan Hiaz Sdn Bhd [1980] 1 LNS 69; but compare with *Mott MacDonald (M) Sdn Bhd v Hock Der Realty Sdn Bhd* [1997] 1 CLJ Supp 182 where summary judgment was granted.

[203] *YC Chin Enterprises Sdn Bhd v AKI Konsult* [2005] 1 LNS 296 and *AC Ho Sdn Bhd v Ng Kee Seng* [1998] 2 CLJ 645.

[204] *North South Properties Sdn Bhd & Ors v David Teh Teik Lim & Anor* [2005] 2 CLJ 510 and *Ong Teong Pin v Sim Kwang Meng & Anor* [1994] 4 CLJ 387.

[205] [2007] 6 CLJ 93.

However, if the breach is fundamental or repudiatory due to persistent non payments of sufficiently huge amounts, the unpaid main contractor, sub contractor or professional consultant concerned may decide to terminate the contract. This is nevertheless a precarious decision especially if there is excuse for non payment due to a cross claim, particularly that of a set off. A wrongful decision to terminate would certainly result in committing a repudiatory breach of contract instead.

2.5.5 The Dispute Resolution & Security of Payment Problem

a) Dispute Resolution

Construction disputes are often resolved either in the courts of law or via arbitration.

Actions in respect of building contracts are commonly commenced in the High Court by reason of disputes exceeding RM250,000.00 or the seeking of reliefs such as declarations or injunctions.[206] While the Rules of the High Court 1980 apply generally to actions in building and construction disputes, the complexity of the chain of contracts involved or the availability of an arbitration clause may make the disputes inappropriate for summary judgment applications. In other words, most construction court cases that do not get sent to arbitration would end up in lengthy trials.

[206] Lim Chong Fong & Lim Eng Chong, *Halsbury's Laws of Malaysia Vol. 5* (LexisNexis, 2006 Reissue) at 140.161 to 162.

There may also occasionally be proceedings arising out of the contract and even about the same subject matter before both the court and the arbitrator. However the court retains the jurisdiction to restrain an arbitrator from deciding matters which are being litigated or connected thereto before the court[207] or refusing leave from discontinuing the case in the High Court.[208] In the premises, once a concurrent dispute has been referred to litigation, it is difficult to have all the disputes sent to or resolved in arbitration. The correct choice of forum of dispute resolution is therefore paramount to ensure a neat and expeditious disposal of the dispute.

The High Court may however stay the action brought in court in breach of the arbitration agreement. Under the Arbitration Act 1952, the court has, before any step is taken in the court proceeding, the discretion and would normally stay the action to be arbitrated unless there was no dispute or the dispute concerned fraud or that multiple parties are involved.[209] The Arbitration Act 1952 has now been replaced by the Arbitration Act 2005.[210] Under the new Act,[211] the court is now mandatorily required to stay the action unless the arbitration agreement is null and void, inoperative or incapable of being performed or there is in fact no dispute between the parties. Since many construction contracts (particularly those using standard forms) have arbitration clauses,[212] it is now inevitable that these construction disputes would have to be resolved by arbitration.

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[207] *TNB Engineering & Consultancy Sdn Bhd & Anor v Bocaard Oil & Gas Sdn Bhd* [2008] 1 CLJ 452.

[208] *Wah Bee Construction Engineering v Pembenaan Fungsi Baik Sdn Bhd* [1996] 3 CLJ 858.

[209] *Tan Kok Cheng & Sons Realty Co Sdn Bhd v Lim Ah Pat (t/a Juta Bena)* [1995] 3 MLJ 273 interpreting Section 6 of the Arbitration Act 1952 (Act 93).

[210] Act 646.

[211] Section 10.

[212] For example, Clause 34 of the PAM form of main contract (1998 and 2006 Editions), Clauses 54 and 65 of the PWD form of main contract (Rev. 10/83 Edition) and (Rev. 2007 Edition) respectively and Clause 47 of the CIDB form of main contract.

The notion of party autonomy plays a significant role in the new Arbitration Act 2005 and it has been stated[213] that:

> "In the past few years the pressure for reform of the arbitration law in Malaysia has been growing. This pressure came mainly from the private sector which felt that the 1952 Act was outdated and needed replacement... While the Act has embodied many of the features of the English Arbitration Act 1996, including the concept of party autonomy, it has abandoned the wholesale adoption of English law. The Model law now takes centre stage."

Notwithstanding a higher degree of party autonomy accorded and conferment of wider powers to the arbitrator under the new regime, Section 20 of the Arbitration Act 2005 nevertheless provides and requires that the parties be treated with equality and each party be given a fair and reasonable opportunity of presenting that party's case. The intention of the section is to ensure that each party has enough time when presenting its case.[214] The tribunal must be mindful of the provision when fixing time limits for submissions and hearings.[215] In the new Arbitration Act 2005, it is still provided[216] that unless the parties agree that no oral hearings be held, the arbitral tribunal will have to hold oral hearings at the appropriate stage of the arbitral proceedings. No party who wants to delay proceedings will agree to the dispensation of oral evidence.

Another notable feature under the Arbitration Act 2005[217] is that the parties (unless otherwise agreed to be dispensed) in a domestic arbitration as defined

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[213] Sundra Rajoo & WSW Davidson, *The Arbitration Act 2005 UNCITRAL Model Law as applied in Malaysia* (Sweet & Maxwell Asia, 2007) at 1 and 2.

[214] *Id.* at 97.

[215] *Stockport Metropolitan Borough Council v O' Reilly No 2* [1983] 2 Lloyd's Rep 70.

[216] Section 26.

[217] Section 42; see also Section 41.

under the Act may refer questions of law arising from the arbitrator award for determination by the High Court. This section has no equivalent in the Model law on arbitration, and is also out of line with the recent Acts in the other jurisdictions.[218] Section 69 of the English 1996 Act provides for appeals on points of law only with the agreement of the parties or with the leave of the court and also contains statutory guidelines for the court to consider when dealing with leave applications.

In the circumstances, it can be discerned that even arbitrating under the Arbitration Act 2005 would not likely result in the speedy and final resolution of a dispute, particularly those involving issues of law. Construction disputes often involved both mixed issues of fact and law.

The high costs of some arbitrations and the lack of effective sanctions available to arbitrators has led to the evolution of other means of resolving disputes in the construction industry such as mediation.[219] However, some standard forms provide for the appointment of a person charged with making provisional decisions which are binding until decided otherwise in arbitration or litigation. Such decision is however not an award of an arbitrator.[220]

The Malaysian experience[221] reveals that many of the construction payment cases at the main contract and sub contract layers are argued in protracted

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[218] *Supra* n. 213. at 197.

[219] *Supra* n. 9.

[220] *Supra* n. 206. at 140.169. In this regard the PAM form of contract (2006 Edition) introduces contractual adjudication procedure in relation to set offs. However, there is no case to-date to analyse its swiftness and effectiveness.

[221] *Supra* n. 9. and dialogues with James Monteiro, Chang Wei Mun, Ivan Loo and P. Gananathan, Advocates & Solicitors and members of the Sub Committee for Construction Law Bar Council Malaysia at Committee Meetings between December 2007 and May 2008.

arbitrations which are private and unreported. Many cases have been litigated in the courts as well. In a recent academic paper,[222] it was stated that construction cases reported in the Malayan Law Journal from 1997 to 2007 totalled 73, out of which 37 involved construction payment cases and the rest involved performance bond injunction cases. This is indicative of many cases still pending disposal. That notwithstanding, the results of a limited e-survey done by the Bar Council in 2008 reveals that there is at least 1000 construction cases pending in the High Court filed since 2004.[223]

It can therefore be summarized that construction dispute resolution in arbitration and the High Court are presently protracted and may extend to a number of years if the dispute goes for trial. Despite the enactment of the new Arbitration Act 2005, construction dispute resolution by way of arbitration remains protracted.

b) Security of Payment

In view of the protracted disposal of disputes, it is the major concern of all unpaid main contractors, sub contractors, suppliers and professional consultants that there should finally be some security of payment. In other words, nobody wants to be saddled with a mere paper victory.

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[222] Dr Rosli Abdul Rashid, *Profiling Construction Cases for Strategic Construction Contract Management* (unpublished 2007).

[223] Bar Council Malaysia, *Memorandum – A Plea Towards Creating a Specialist Construction Court* (unpublished, July 2008) at 3.

1) Financing Charges and Interest

It is clear that the unpaid main contractor, sub contractor, supplier or consultant is entitled to interest as the result of non-payment in breach of contract by the other.[224] Compensation in interest is normally seen as the relief against protracted recovery. The interest may be in the form of an agreed rate by the parties in indemnification of the loan and bank overdraft facilities and is enforceable simpliciter,[225] Alternatively, the interest claimed may be such financing charges incurred as proved and assessed.[226]

Alternatively, if an action is pursued for a debt or damages for breach of contract, there is the entitlement[227] to discretionary interest on the unpaid sum at such rate (on a simple basis) and for such period as the Court deems fit till judgment. Post judgment interest is awardable pursuant to the Rules of the High Court 1980.[228] The entitlement is similarly available if the dispute is brought in arbitration.[229]

In any case, the problem is that the payment of interest or financing charges is only collectable after the conclusion of the action in court or arbitration as a consequential relief. The unpaid main contractor, sub contractor, supplier or professional consultant must therefore in the meanwhile have its own other

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[224] Section 74 Contracts Act 1950 Illustration (n).

[225] *Woon Hoe Kan & Sons Sdn Bhd v Bandar Raya Development Bhd* [1974] 1 MLJ 24.

[226] *Majlis Perbandaran Seremban v Maraputra Sdn Bhd* [2004] 5 MLJ 469.

[227] Section 11 Civil Law Act 1956 (Act 67) but see also *Cheng Chuan Development Sdn Bhd v Ng Ah Hock* [1982] 2 MLJ 222 where the court refused to exercise its discretion where the plaintiff could not be said to have been deprived of the use of money and the principal amount was unascertainable at the time of the breach.

[228] Order 42 Rule 12 Rules of the High Court 1980.

[229] *Lian Hup Maufacturing Co Sdn Bhd v Unitata Bhd* [1994] 2 MLJ 51 and Section 33 (6) Arbitration Act 2005 (Act 646).

financing means to stay operationally afloat. This is unsatisfactory if it takes years to conclude the action or arbitration.

The crux of the problem remains that there is generally no security of payment of both the principal debt or damages and interest for the unpaid party after the conclusion of an often lengthy court action or arbitration. In the present circumstances, the ability to obtain summary judgment to follow with swift enforcement is thus crucial.

Furthermore the unpaid main contractor, sub contractor, supplier or consultant is always an unsecured creditor. If the non paying party goes into bankruptcy or liquidation, the unpaid party stands in pari pasu[230] with other unsecured creditors even after judgment or award has been obtained. In the premises, the unpaid party has to share and collect whatever surplus that remains after all secured creditors, particularly the financial institution that has loaned money to the non paying party, have been settled. There is often nothing left as surplus.[231] Mere compensation in interest or financing charges is thus inadequate.

It is therefore paramount for the unpaid party to try to seek interlocutory remedies pending the disposal of dispute resolution to obtain security of payment or if not, at least, to preserve the financial status quo. Each of them is in turn considered hereinafter.

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[230] Section 43 of the Bankruptcy Act 1967 (Act 360) & Section 292 of the Companies Act 1965 (Act 125).

[231] For example, see *IJM Corporation Bhd v Riveria Bay Resorts Sdn Bhd* (1998) (Malacca HC) unreported.

2) Progress and Final Payment

All payment debts including those arising from certificates under most construction contracts, whether or not in the standard forms are ordinary unsecured debts. Nevertheless, the Court of Appeal (reversing the High Court) in *ESPL (M) Sdn Bhd v Radio & General Engineering Sdn Bhd* [232] imputed an express trust with regard to payments due to the sub - sub contractor because the sub contract contained a provision that stated:

> "Sub-Contractor will receive the payments made by Contractor and will hold the right to receive such payment as a trust fund to be applied first to the payment of labourers, suppliers, Sub–sub contractors and others responsible for the Work justifying such payments, and all taxes and insurance applicable thereto, the Sub-Contractor will so apply the payment from Contractor."

The Court of Appeal held that the sub-sub contractor was entitled to make an application for an interlocutory mandatory injunction to secure the payment pending the trial of the dispute between the sub contractor and the sub-sub contractor on the basis of an express trust. However, the court did not find an implied or constructive trust which is in any event, absent in a normal sub contract relationship. The trust makes the unpaid payment a secured debt not subjected to the pari pasu rule.[233] This is critical in that if *ESPL (M) Sdn Bhd* ultimately succeeds at trial, it takes priority over other unsecured creditors of the judgment debtor during enforcement of the judgment.

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[232] [2004] 4 CLJ 674.

[233] Section 293(1) of the Companies Act 1965 (Act 125) read together with Section 48(1)(a)(i) of the Bankruptcy Act 1967 (Act 360).

There is no other reported Malaysian case where a trust was found in respect of progress payment under a building contract. This is probably because the normal commercial relationship of the parties in construction contracting does not satisfy the incidents of trust.

3) Retention

The retention monies held pursuant to progress payments attracts a trust if so expressly provided by the construction contract.[234] Nevertheless, it is imperative that the beneficiary main or sub contractor must request that the retention monies be kept separately in a special designated trust account,[235] otherwise the money would be mixed and not traceable. In this respect, the Court would on application grant a mandatory injunction to require that the retention money be placed into such an account.[236] The application must however be made during the subsistence of the contract but not after completion[237] or termination.[238]

That notwithstanding, the employer or main contractor as a fiduciary trustee is entitled to have recourse against the retention money held in trust in respect of deductions permitted under the contract[239] which will often reduce or extinguish the money held altogether.

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[234] For example, see. Clause 30.5(i) of the PAM form of main contract (1998 Edition) and clause 11.11 of the PAM form of nominated sub contract to be used in conjunction therewith.

[235] *Rayack Construction Ltd v Lampeter Meat Co Ltd* (1979) 12 BLR 30.

[236] *Supra* n. 229. and followed in *Lee Kam Chun v Syarikat Kukuh Maju Sdn Bhd* (*Syarikat Perumahan Pegawai Kerajaan Sdn Bhd*, Garnishee) [1988] 1 MLJ 444; see also *Syarikat Pembinaan Woh Heng Sdn Bhd v Meda Property Services Sdn Bhd* [2002] 1 LNS 49.

[237] *Teknik Cekap Sdn Bhd v Villa Genting Development Sdn Bhd* [2000] 7 CLJ 385.

[238] *LEC Contractors (M) Sdn Bhd v Castle Inn Sdn Bhd* (No 2) [2001] 5 MLJ 510.

[239] *Henry Boot Building Ltd v The Croydron Hotel & Leisure Co Ltd* (1985) 36 BLR 41.

4) Mareva Injunction and the Debtor's Act 1957

In pursuing the unpaid progress or final claim in a court action, the unpaid contractor, the professional consultant or supplier may apply to the court for a Mareva injunction if it can be established that there is a real risk that the non paying party is dissipating its assets to avoid satisfying the judgment. It was held by Edgar Joseph J (as he then was) in the construction case of *Pacific Centre Sdn Bhd v United Engineers Bhd*[240] that a Mareva injunction would be granted if the court is satisfied that the following 3 conditions are fulfilled:

i) that the applicant has a good arguable case and in this regard the applicant must demonstrate a likelihood of success which is capable of serious argument but not necessarily to have more than an even chance of success;
ii) that the defendant has assets within the jurisdiction; and
iii) that it would be sufficient for the plaintiff to merely show a risk of disposal of assets which has the effect of frustrating the plaintiff in its attempt to recover the fruits of the judgment it is likely to obtain against the defendant.

The court was satisfied that the impecuniosity and timing cum surrounding circumstances of the intended sale of the substantial landed asset of the defendant constituted a risk of disposal of asset. Hence, the court granted the order restraining the defendant from disposing the proceeds of the sale of that landed asset. In *Salcon Engineering Sdn Bhd v PRM Energy Systems (M) Sdn*

[240] [1984] 2 CLJ 319.

Bhd,[241] the Mareva injunction was granted where the defendant had no proven trading record in Malaysia and failed to show with any degree of conviction that it has secured any future business. The Mareva injunction was also granted in *Petowa Jaya Sdn Bhd v Syarikat Binaan Nasional Sdn Bhd*[242] where the court was of the view there was solid probity that the defendant's evidence could not be relied upon such as the undisputed detention of the plaintiff's equipment and retention sum without consent.

The application for Mareva injunction can also be made if the disputes are being fought in arbitration. In the *Kwang Fook Seng Co v Yee Hoong Loong Corp*,[243] the injunction was granted because the court was of the view that the probity of the defendant could not be relied on due to the failure to pay the plaintiff's interim certificates as well as the unsoundness of the defendant's corporate structure coupled with the unauthorized assignment of the proceeds of the housing development built by the plaintiff. The Mareva injunction was also granted in *Jasa Keramat Sdn Bhd v Monatech (Malaysia) Sdn Bhd*[244] case where the defendant in the course of the application transferred its landed assets to related undercapitalized companies in guise of a normal sale as a device to deny the plaintiff of the fruits of the judgment. It is also seen that the attempt by the employer to dissipate the assets in the course of the Mareva injunction application constituted contempt of court.[245]

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[241] [1994] 1 CLJ 295.
[242] [1987] 1 LNS 57.
[243] [1990] 2 CLJ 635.
[244] [1999] 4 CLJ 30.
[245] *Monatech (M) Sdn Bhd v Jasa Keramat Sdn Bhd* [2002] 4 CLJ 401.

The grant of a Mareva injunction does not make the plaintiff a secured creditor as held *in S & F International Ltd v Trans-Con Engineering Sdn Bhd.*[246] In that case, the sub contractor was also successful in obtaining the injunction where the corporate structure of a foreign owned single purpose company without any current project at hand was held unreliable and posed a real risk of dissipation of its assets.

There are however many unreported cases of unsuccessful Mareva injunction applications. It is often practicably difficult for the plaintiff to succeed in obtaining the Mareva injunction pending the conclusion of the dispute resolution principally due to lack of sufficient evidence to move the court that there is a real risk of the defendant dissipating its assets.

The Mareva injunction order operates in persona and not in rem unlike a pre trial attachment order pursuant to Section 19 of the Debtors Act 1957[247] which provides that:

> "(1) If it is shown to the satisfaction of the court, at any time after the issue of the writ of summons, by evidence on oath, that the plaintiff has a good cause of action against the defendant and-
>
> (a) that the defendant is absent from the State and his place of abode cannot be discovered;
>
> (b) that the service of the writ of summons cannot without great delay or difficulty be effected; or
>
> (c) that the defendant , with intent to obstruct or delay the execution of any judgment which has been or be made against him has removed, or is about to

[246] [1985] 2 CLJ 228.
[247] Act 256.

remove, or has concealed, or is concealing, or making away with, or handing over to others, any of his movable or immovable property,

the court may order that the property of the defendant or any part thereof, be forthwith seized or attached by the appropriate officer as a pledge or surety to answer the just demand of the plaintiff, until the trial of the action and satisfaction of any judgment that may be made against the defendant; but such order shall not constitute the plaintiff a secured creditor if the defendant is adjudicated bankrupt."

The pre trial attachment order, like the Mareva injunction, does not render the plaintiff a secured creditor of the asset attached. There is only one reported building case[248] where such pre trial attachment order was granted because the defendant was actively in the course of disposing its assets. In the *Pacific Centre* case,[249] the Mareva injunction order was granted in place of the pre trial attachment order which was set aside. This is because the application for the pre trial attachment order is more onerous requiring the plaintiff to establish a good cause of action and intent on the part of the defendant to obstruct or delay the execution of the judgment.

5) Performance Bond Injunctions

It is common that most construction disputes result in the employer or the main contractor making demand against the performance bond furnished simultaneous with the commencement of the dispute resolution. In this regard, the main contractor or the sub contractor, as the case may be, is often

[248] *Kang Wah Construction Sdn Bhd v Chan Ai Min Property Sdn Bhd & Anor* [1999] 1 LNS 38.
[249] *Supra* n. 240.

constrained to apply to the court to either restrain the demand against the performance bond or the payment thereunder.

There are many construction cases decided by the Courts and reported on performance bond injunctions.[250] It can be seen that the Courts are hesitant to allow the injunction and have always set aside the injunction where an ex-parte has been obtained earlier. It was held by the Federal Court in *Kerajaan Malaysia v South East Asia Insurance Bhd*[251] that if the performance bond is an on-demand bond, all that was required to activate it is a simple demand in writing. In *LEC Contractors (M) Sdn Bhd v Castle Inn Sdn Bhd and Anor*,[252] it was held by the Court of Appeal quoting *R.D. Harbottle (Mercantile) Ltd v The National Westminster Bank Ltd*[253] that:

> "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration ...The courts are not concerned with their difficulties in enforcing such claims; these are risks which the merchants take. In this case the plaintiff took the risks of the unconditional wording of the guarantees. The machinery and commitment of the banks are on a different level. They must be allowed free from interference by the courts. Otherwise, trust in international commerce will be irreparably damaged."

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[250] For example, see *Sri Palmar Development & Construction Sdn Bhd v Transmetric Sdn Bhd* [1994] 1 CLJ 224, *The Radio & General Trading Co Sdn Bhd v Wayss & Freytag (Malaysia) Sdn Bhd* [1997] 1 MLJ 346 (This case was reversed on appeal by the Court of Appeal), *Lotteworld Engineering & Construction Sdn Bhd v Castle Inn Sdn Bhd* [1998] 1 LNS 334, *Cygal Bhd v Bandar Subang Sdn Bhd* [1998] 1 LNS 414 and on appeal [2004] 3 CLJ 67 (CA) and *Autoways Construction Sdn Bhd v Desa Samudra Sdn Bhd & Anor* [1999] 4 CLJ 601 where the author was involved as counsel.

[251] [2000] 3 CLJ 705.

[252] [2000] 3 CLJ 473.

[253] [1978] QB 146 at 155-156.

Fraud is thus the only exception to warrant the grant of the injunction. This position may be contrasted with the position in Singapore where besides fraud, unconscionability is another exception.[254]

In the premises, it is seen that monies demanded pursuant to performance bonds will have to paid out first whilst the underlying disputes will have to be argued later. The unpaid contractor would in the meanwhile be even further financially exposed pending the conclusion of the dispute resolution.

2.5.6 Summary

It can be concluded that the present contractual, statutory and common law recourse in Malaysia are clearly inadequate to safeguard the commercial interests of unpaid claimants who have carried work, supplied materials or rendered services. The present position is unsatisfactory because the remedies currently available are insufficient or ineffective in dealing with the Malaysian Construction Payment Problems critically faced by the construction industry. In particular, construction dispute resolution would be protracted. The modes of dispute resolution available are only court litigation or arbitration but they simply take too long. In the meanwhile pending resolution, there are very limited effective interlocutory remedies and no ultimate security of payment. The claimants require a swift and binding decision which is enforceable so that cash can flow. The present position however favours non paying defendants who want to delay the judgment day.

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[254] *GHL Pte Ltd v Unitrack Building Construction Pte Ltd & Anor* [1999] 4 SLR 604 (CA).

Subject to the understanding and comparison with the position in other countries to be examined in Chapters 3 and 4, the three hypotheses set out in Chapter 1 may prima facie be answered in the affirmative at this point.

CHAPTER 3

THE UNITED KINGDOM AND COMMONWEALTH CONSTRUCTION INDUSTRY PAYMENT – EXPERIENCE AND SOLUTIONS

3.1 Introduction

This chapter presents a comparative study of the construction payment problems encountered in a number of Commonwealth jurisdictions which have similar construction norms as that in Malaysia. These jurisdictions are the United Kingdom, Australia, New Zealand and Singapore. In addition, the chapter also discusses the solutions which these jurisdictions have adopted to counter the payment problems faced in their respective construction industries. The position in the United Kingdom is explored in greater detail than the other jurisdictions because the construction norms in Malaysia are, to a large extent, adopted from the United Kingdom. This is a direct result of Malaysia's historical position under British rule colony. The chapter also examines payment problems in the construction industry of other developed Commonwealth countries of Australia, New Zealand and Singapore which have similar construction norms as that of the United Kingdom, also because of their earlier status as British colonies. In each of the jurisdictions under consideration, several facets of the construction industry are examined for comparative purposes. These include the structure, funding and contractual arrangements in the construction industry. The position of the Commonwealth country of Canada is treated separately in the next chapter together with the position in the United States of America.

3.2 The Position in the United Kingdom

3.2.1 Generally

The legal system in Malaysia has many similarities with the English legal system. By the Civil Law Act 1956,[1] the common law and the rules of equity as administered in England apply to Malaysia subject to such qualifications as local circumstances render necessary. The construction industry is also not dissimilar to that in Malaysia as many of the procurement methods and contractual arrangements in Malaysia were imported from England. In this regard, the PAM Conditions of Building Contract (1969 Edition) were adopted from the English JCT Conditions of Contract (1963 Edition).[2] Likewise, the PWD Conditions of Contract were adopted from the English RIBA Conditions of Contract (1931 edition).[3] As with the Malaysian contracts, the RIBA and JCT contracts in England had undergone various revisions over the years.[4]

The construction industry in the United Kingdom provides a tenth of the Gross Domestic Product and is worth around 65 billion GBP annually.[5] Thus, the Malaysian construction industry is comparatively a third of that in the United Kingdom in terms of the proportion to the Gross Domestic Product. Public sector in the United Kingdom is a less dominant construction client. Local authority house

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[1] Section 3(1).
[2] Vincent Powell-Smith, *The Malaysian Standard Form of Building Contract* (Malayan Law Journal Sdn Bhd, 1990) at 1.
[3] Lim Chong Fong, *The Malaysian PWD form of Construction Contract* (Sweet & Maxwell Asia, 2004) at 1.
[4] In 1980,1998 and 2005; see Stephen Furst & Vivian Ramsey, *Keating on Construction Contracts* (Sweet & Maxwell, 8th ed., 2006) at 687.
[5] Corporate Watch Website – UK Construction Industry Overview 2008.

building has been greatly reduced and other work is now either partly funded by private investment or have been totally privatized. Privatization has also resulted in the transfer of many professional services to the private sector which was previously carried out by the Government.[6] The United Kingdom construction industry is also multi-player and multi-tier in nature.

The late 1980s were the tumultuous years for the construction industry in the United Kingdom. There were many construction company insolvencies. As a result, the UK Government and the industry jointly commissioned a consultation process led by Sir Michael Latham to recommend reforms to reduce conflict and litigation and encourage the industry's productivity and competitiveness. The report entitled "Constructing the Team" was the result of the consultation process within a very tight pre determined timetable to discharge extremely wide terms of reference.[7]

At that point in time, it was reported that the recession of recent years has hit the construction industry very hard. It affected the construction industry more deeply than other industries. By 1993, construction output was still some 39% below its 1990 peak. It is further reported in Constructing the Team that:

> "Many of the industry's problems have been worsened by economic difficulties, and if the economy is weak, the industry will suffer. **Its participant will try to alleviate the suffering at the expense of others (including clients)** ... If there is

[6] Sir Michael Latham, *Constructing the Team - Final Report of Government/Industry Review of Procurement and Contractual Arrangements in the UK Construction Industry* (HMSO, 1994) at 7.
[7] *Id.* at 113.

> more work around, there may be more money for efficient firms. If there is more money, there may be more trust. It is a simple statement of commercial reality. It pervades virtually every decision taken every day by every participant in the construction process."[8] **(emphasis added).**

It is hence seen that the United Kingdom construction industry has also faced major construction industry payment problems.

3.2.2 Project Funding

For public sector projects, central government funds for construction works are obtained from both internal and external sources. There are limited internal sources depending on the governmental approved budget that provides a source of finance for the industry's investment. The external sources of finance are taxes and borrowing. In the case of local authorities, money may be obtained by grant from central government funds. It may also be raised by the local authority's own borrowing or taxation by way of rates collected. Local authorities borrow money for capital investment by issuing securities in the ordinary market. Alternatively, the local authorities may also borrow from the central government agency.[9]

The source of private property development is influenced by whether money is required short term or long term. Where the owner or developer intends to build and then sell the completed development, the developer will only require finance for a limited period. If, on the other hand, the owner or developer wishes to retain

[8] *Supra* n. 6. at 9.
[9] Ivor H. Seeley, *Building Economics* (Macmillian Press Ltd 2nd ed.,1982) at 274-283.

the building as a permanent investment, then the owner or developer will be required to raise two types of finance. Firstly, short term finance is required to purchase land and pay the contractor. Thereafter, there is long term finance which can be raised either by selling an interest in the development or by borrowing against the security of the completed building.

The short term finance lender places importance on the loan principal lent and the prospects of receiving interest until the loan is repaid. Both principal and interest income are at an appreciably high rate of risk. Generally, a well-established property development companies will not experience any great difficulty in raising short term finance, as interest payments can be recovered from income accruing from other property. The loan principal advanced is additionally secured by the value of the uncharged equity of the development company. Long term finance is however often secured on completed buildings.

The borrower of money for property development is competing in the general market for finance. Therefore, interest rates will tend to follow the general market trend. There are merchant banks prepared to lend money at fixed rates of interest for periods up to two years. These banks will often finance property development on favourable terms where an equity interest in the development company is obtainable. In such cases it is often possible to arrange a revolving credit of short term money so that as one project is completed and the money repaid, it is immediately available for another. Nevertheless, merchant banks are unlikely to lend money for longer term than two years and hence cannot normally assist with

the development of major projects, such as large office blocks and shopping centres. Long term finance is normally provided by institutions such as insurance companies, pension funds and investment trusts.

A property company can also raise capital by selling shares whereby the purchaser is entitled to receive a share of the profits as and when distributed. There is however legislation which imposes controls on raising money from the general public. Equity capital is used initially for the purchase of sites and for financing building contracts to the extent that this money cannot be raised by normal loans in the money market. The long term capital requirements of a development company are provided either by borrowing against the security of the completed building or by disposing of an interest in it for cash in return for the payment of an amount to the purchaser.[10]

It can be therefore seen that the construction industry funding is not regulated by statute in the United Kingdom but subject to normal market norms and forces of a capitalist economy. It is hence subject to the Project Finance problem discussed in Chapter 2, to wit, availability and sufficiency of funds to complete the project. It is particularly vulnerable as to whether the project is saleable or otherwise.

In Constructing the Team,[11] the state and realities of the United Kingdom construction industry problems are succinctly summarized as follows:

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[10] *Supra* n. 9. at 283.
[11] *Supra* n. 6. at 93.

"The cascade system of payment in the industry – normally client to main contractor, main contractor to sub contractor, and so on down the chain makes the exposure of different parts of the process to the insolvency of one participant particularly serious. The chain may begin above the owner with the banks or other funders who are financing the project. If the main contractor fails, sub contractors will be treated as unsecured creditors in respect of work which they have already carried out (or purchased equipment), whether on or off site. Even retention monies will be at risk, since domestic sub contracts make no express provision for secure trust fund... **It is absolutely fundamental to trust within the construction industry that participants should be paid for the work which they have undertaken.**

It may be argued that there is no need for any action because;

i) Clients may exercise responsible prequalification procedures to ensure that work is only awarded to stable firms. They can also insist upon knowing who the subcontractors are, or they can nominate or name them, so as to prevent disruption of the work through failure there.

ii) Equally contractors (or sub contractors) can decline to work for an owner (or main contractor) or can require prepayment bonds/indemnities from them. Bad debt is not only a problem in the construction and it is possible to insure against it.

iii) All businesses in all industries are at risk if insolvency affects their clients against it.

Such arguments ignore the practical realities of construction. However diligently clients, contractors or sub contractors check on each other, the causes of the

failure of any participant may be unrelated to the particular contract, or even to work in this country. In a difficult trading climate for construction, firms will undertake work for low (or no) margins, and will not endanger their chances of being selected by demanding prepayment or indemnities, even if they are aware that there might be a payment problem. Bad debt insurance is possible, but it is another cost overhead at a time when most firms are cutting their overheads in order to reduce their quotations for "preliminaries" and remain competitive. The construction industry has a unique characteristic. Its goods and services become part of the land once incorporated within the building, and thus the property of the landowner. Any "retention of title" clause devised by suppliers or contractors who are delivering materials to site ceases to protect them once the materials are incorporated within the works. In construction, the contractor is likely to be well down the queue for payment if the employer fails, behind the funders or others who have charges on the land." **(emphasis added).**

Hence the construction industry funding in the United Kingdom is also "top down" from the owner right to the main contractor to sub contractors and suppliers. The sources of funds of the owner has to be raised either internally, otherwise externally, more often the latter. The main contractors and sub contractors and suppliers are dependent on progress payment for cash flow to see through completion of the project. There is no security of payment.

3.2.3 Construction Contracts

a) Generally

In the United Kingdom, the owner is faced with a wide choice of standard forms of contract for a building project. Most building work is undertaken under main contracts produced by the Joint Contracts Tribunal (JCT), though they are frequently amended. Civil engineering projects are usually undertaken under Institution of Civil Engineers (ICE) Conditions of Contract, either the 5th or 6th Editions, which have separate designer-led or design and construct versions. Central Government work is procured under GC/Works/1, prepared and published by the Department of Environment but also used by other Departments sometimes with amendment.

The choice of contract conditions is a matter for the owner who arranges for the funding for the project and/or who pays for it. Where both main parties in the process, to wit, employer and contractor are equally matched technically and financially, the choice of contract may be mutually agreed. In practice, market forces usually make one party dominant.[12]

[12] *Supra* n. 6. at 31 to 32.

b) Main Contracts

The dominant main contract form presently still in use in the United Kingdom is the JCT form 1980 Edition though it is being replaced by the 2005 Edition. The provisions in the GC /Works/1 and the JCT forms of contract provide for interim progress and final payments respectively as well. They are also conditioned upon the certification of a third party such as the superintending officer or architect/contract administrator.[13] There is nevertheless provision for retention too in all these contracts.[14] Under the JCT forms the retention money is held by the employer as fiduciary trustee,[15] though there is the alternative provision for the contractor to furnish a retention bond in lieu of retention to facilitate the cash flow of the main contractor.[16]

In the event of non certification, only the JCT form 1980 Edition provides for the specific remedy of arbitration on the basis of withholding of certificate.[17] At common law, if the main contractor ordinarily fails to obtain the certificate required for payment, the contractor has no present claim[18] unless the main contractor can

[13] For interim payment, see Clauses 40 and 42 of the GC/Works /1 form of main contract and 4.9 to 4.13 and 4.16 to 4.17 of the JCT form of main contract 2005 Edition; see also Clauses 30.1 to 30.4 of the JCT form of main contract (1980 Edition) pre the issuance of Constructing the Team. As to final payment, see Clause 41 of the GC/Works/1 form of main contract and Clauses 4.15 and 30.6 to 30.8 of the JCT form of main contract (2005 and 1980 Editions) respectively.

[14] Clause 40 (1) of the GC/Works/1 form of main contract and Clauses 4.10.1 and 4.18 to 4.20 of the JCT form of main contract (2005 Edition) and Clauses 30.4 and 30.5 of the JCT form of main contract (1980 Edition).

[15] Clauses 4.18 and 30.5.1 of the JCT form of main contract (2005 and 1980 Editions) respectively.

[16] Clause 4.19 of the JCT (2005 Edition) only.

[17] Article 5.1.2.

[18] *Morgan v Lariviere* (1875) LR 7 HL 423.

show that there are special circumstances such as disqualification of the certifier[19] or prevention by the owner[20] enabling recovery of payment without a certificate.

If there is non payment of the certified sum, there is no express contractual remedy provided in the GC/Works/1 form of contract. The JCT form 2005 Edition provides for remedies of payment of simple interest,[21] the right of suspension of execution of work[22] and termination of the main contractor's employment under the contract.[23] The earlier JCT form 1980 Edition however only provided for the remedy of termination.[24]

The rights of the owner in the event of non performance by the main contractor are wide under the GC/Works/1 form.[25] The recovery includes liquidated damages for delay[26] and damage to the works.[27] In regard to the JCT form 2005 Edition, there is no specific recovery clause but there are recovery provisions scattered throughout the contract such as for liquidated damages for delay[28] and work not in accordance with the contract.[29] There are similar provisions in the earlier JCT form 1980 Edition.[30] Nevertheless both these JCT contracts in the payment clause require the employer to give a written notice with grounds for withholding or

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[19] *Hickman & Co. v Roberts* [1913] AC 229.
[20] *Roberts v Bury Commissioners* (1870) LR 5 CP 310.
[21] Clause 4.13.6 JCT form of main contract (2005 Edition).
[22] Clause 4.14.
[23] Clause 8.9.1.
[24] Clause 28.1.1 JCT form of main contract (1980 Edition).
[25] Clause 43 GC/Works/1 form of main contract.
[26] Clause 29(3).
[27] Clause 26(2)(c).
[28] Clause 2.32. This clause is strict as it requires not only the usual certificate of non completion issued by the architect/contract administrator but also advance notification of intended recovery by the employer.
[29] Clauses 3.18.2 and 3.19. It is seen that the operation of the clauses unusually require prior consultation between the architect/contract administrator and the contractor.
[30] Clauses 24 and 4.1.2.

deducting money due in the interim certificates.[31] Otherwise, it is fatal to the owner in defence of a summary judgment application by the main contractor for payment against certificates.[32] The object is to curb against the abuse of unjustified deduction or set off against payment by owners.

c) Nominated Sub Contracts

The standard forms of nominated sub contract widely in use in the United Kingdom are the JCT Nominated Sub Contract NSC/A and C forms.[33] They are used in conjunction with the JCT form 1980 Edition and contain provisions for progress payment conditioned upon certification of the architect under the main contract.[34] The payment to the nominated sub contract by the main contractor is not on a "pay when paid" but "pay against certificate" basis.[35] There is nonetheless also provisions for retention[36] as security for performance.

To ensure progress payment is made, the forms include the express provision that if the main contractor fails to pay the nominated sub contractor, the owner will pay the nominated sub contractor directly and recover from the main contractor upon the architect's certification that the main contractor has failed to provide reasonable

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[31] Clauses 4.13.4 and 30.1.1.3 of the JCT form of main contract (2005 and 1980 Editions respectively) though the latter is of lesser stringency on the requirement of providing grounds for withholding or deducting money.

[32] *Chatbrown Ltd v Alfred McAlphine Construction (Southern) Ltd* (1986) 35 BLR 44; see also *Mellowes Archittal Ltd v Bell Projects Ltd* (1987) 87 BLR 26.

[33] These forms amend the NSC/4 and 4A which were the successor forms to the Green Form of Nominated Sub Contract. The Green Form is the basis in which the Malaysian PAM form of nominated sub contract adopted.

[34] Clauses 4.14 to 4.25 of the NSC/A and C form of nominated sub contract read together with Clause 35.13 JCT form of main contract (1980 Edition).

[35] Clause 4.16.1.1.

[36] Clauses 4.18 to 4.19 and also held as a fiduciary under trust following Clause 4.22.

proof of payment to the nominated sub contractor.[37] The final payment under the nominated sub contract is similarly subject to the certification of the architect[38] though the architect has the discretion to make early certification and hence early payment to the nominated sub contract pursuant to the main contract.[39]

The contractual remedy available to the nominated sub contractor aggrieved with undercertification of the architect is to allow the sub contractor to use the main contractor's name and if necessary join with the nominated sub contractor in arbitration proceedings with the owner at the instigation of the nominated sub contractor in respect of the certification dispute.[40] However, if there is however no or insufficient payment received by the nominated sub contractor from the main contractor (unless the owner has otherwise paid directly to the nominated sub contractor on the default of the main contractor), the nominated sub contractor then has the remedy to suspend work accordingly after due notification has been given to the main contractor.[41]

Nevertheless, the payment rights of the nominated sub contractor are also subject to set off by the main contractor. There is express provision in the JCT NSC/A and C forms of nominated sub contract permitting the main contractor to deduct from any money including retention any amount agreed by the nominated sub contractor as due to the main contractor or any amount awarded in favour of the main contractor

[37] Clauses 35.13.5.3 and 35.13.5.4 of the JCT form of main contract 1980 Edition.
[38] Clauses 4.24 to 4.25 of the NSC/A and C form of nominated sub contract.
[39] Clauses 35.17 to 35.19 of the JCT form of main contract (1980 Edition).
[40] Clause 4.20 of the NSC/A and C form of nominated sub contract.
[41] Clause 4.21.

in arbitration or litigation which arises out of or under the contract.[42] In addition, the main contractor can also set off its claim for loss and/or expense and/or damage which he has suffered or incurred by reason of such breach or failure on the part of the nominated sub contractor provided the claim has been quantified in detail with reasonable accuracy and notified to the nominated sub contractor of the intention to set off within the prescribed time.[43]

It is however important to note that under the NSC/A and C forms,[44] the rights of the parties in respect of set off are expressed as fully set out in the sub contract conditions and no other rights whatsoever would be implied as terms of the sub contract relating to set off.[45] If the nominated sub contractor is aggrieved with the intended set off of the main contractor, then the nominated sub contractor is entitled to bring the dispute over the intended set off for contractual adjudication.[46] The decision of the adjudicator is binding unless reviewed and revised in arbitration. The powers of the adjudicator include deciding whether the payment should be retained by the main contractor or paid to the nominated sub contractor or to a trustee–stakeholder pending arbitration or a combination of them.[47]

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[42] Clause 4.26.

[43] Clause 4.27, the words "has suffered or incurred" herein is more lenient compared to the earlier words "actually been incurred" in the NSC/4 form of nominated sub contract which was decided in *Chatbrown Ltd v Alfred McAlpine Construction (Southern) Ltd (1986)* 35 BLR 44 that it was not sufficient that liability should have been (as opposed to in fact) incurred which would or liable to lead to loss and/or expense or damage in the future.

[44] Clause 4.29.

[45] In *Hermcrest v G. Percy Tretham* (1990) 53 BLR 104, it was held that the wordings were effective to limit the parties rights of set off.

[46] Clauses 4.30 to 4.37 of the NSC/A and C form of nominated sub contract.

[47] Clause 4.32.1.

d) Domestic Sub Contracts

In the United Kingdom, besides nominated sub contracts, the standard form of domestic sub contract published by the JCT known as the DOM1 form of contract used in conjunction with the JCT form 1980 Edition is widely in use.

In this regard, there are also express provisions on progress and final payments in the DOM1 form though not subject to any certification by the architect administering the main contract.[48] In other words, it is to be administered by the parties in accordance with the expressed provisions therein. The frequency of progress payment is calculated monthly from the date the first payment was due. These progress payments are subject to retention. The payment provision is also not expressed to be in the nature of "pay when paid".

There is also express contractual remedy provided to the unpaid sub contractor to suspend the execution of the work[49] after due notification of non payment and intended suspension of work.

As with the nominated sub contract form, there are identical provisions of limited set off by the main contractor together with the set off dispute resolution procedure of contractual adjudication.[50]

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[48] Clause 21.1 to 21.4.
[49] Clause 21.6 of the DOM1 form of sub contract.
[50] Clauses 23 and 24 respectively.

e) Supply and Professional Consultancy Contracts

There is no standard form of supply contract in the United Kingdom, thus every supply contract is unique.

As to professional consultancy agreements, the Royal Institute of British Architects (RIBA) produces its Memorandum of Agreement and Standard Conditions of Appointment of Architect in the United Kingdom. Payment is also made in stages of architectural services rendered and there is no express provision for set off or remedies for non payment of fees. As for engineering and quantity surveying services, there are similar Standard Conditions of Engagement of Consulting Engineer and Standard Conditions of Engagement for the Appointment of a Quantity Surveyor published by the Association of Consulting Engineers and the Royal Institution of Chartered Surveyors respectively. Payment is also made in stages of architectural services rendered and there is no express provision for set off or remedies for non payment of fees. As for engineering and quantity surveying services, there are similar Standard Conditions of Engagement of Consulting Engineer and Standard Conditions of Engagement for the Appointment of a Quantity Surveyor published by the Association of Consulting Engineers and the Royal Institution of Chartered Surveyors respectively. Payment is also made in stages based on an agreed schedule. Both forms contain express provisions for

payment of interest for late payment of fee.[51] Since there is no arbitration clause in all the forms, the dispute on fee payment would have to be resolved in court.[52]

It is therefore observed that there is widespread usage of standard forms of construction contracts in the United Kingdom at various layers of the construction industry. The provisions on payment, set offs and contractual remedies in the standard forms are clearly defined. Moreover, the standard forms in particular the JCT forms are being continually refined over the years to prevent abuse through unjustified deductions by the paying party. Thus the Unfair Contract Terms problem discussed in Chapter 2 will not arise if the standard forms are used free of amendment or modification.

3.2.4 Construction Payment Problems

a) Generally

In the United Kingdom construction industry, tightness of cash flow and financial woes beset both contractors and owners too. This is notwithstanding wide usage of well thought out construction industry standard forms of contract. The payment problems are succinctly set out as follows:[53]

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[51] Clauses 20.3 and 1.6 respectively.

[52] For instance, see *Mander Raikes & Marshall (a firm) v The Seven-Trent Water Authority* (1980) 16 BLR 34 based on the earlier Conditions of Engagement of Engineer very similar to the BEM form used in Malaysia drawn up by the Board of Engineers Malaysia.

[53] Paul Newman, *Bonds Guarantees and Performance Security in the Construction Industry* (Jordans, 1999) at 3 and 4.

"Employers particularly in the late 1980s and early 1990s, took on speculative development. They were only as good as the last draw-down from the funding institution and contractors often found themselves in the position where the employer was "robbing Peter to pay Paul". This led to many and various (and often spurious) set offs being raised against contractors and other claims being made in abatement. Equally, contractors have on occasions been keen to buy work and have tendered for work at unrealistically low rates ... The contractors have deployed a number of techniques to counteract uneconomic tendering. First the allowance for profit has almost been eradicated, with the contractor looking to make good the shortfall under a variety of heads, including delay and disruption. Secondly, in order to accelerate cash flow, contractors have "front loaded" their contract bills, perhaps without any specific link to the value of the work executed ... In the construction industry, there has been much confusion regarding the status of certificates. However the combination of case-law, which has demonstrated that the mere issue of an architect's or engineer's certificate is no bar to cross claims being raised on behalf of the employer, and the wordings of standard form contracts, has made the question of easy recovery of monies under standard form contracts (traditionally by summary judgment) a legal minefield ... Further the problems have now been compounded by the provisions of the Arbitration Act 1996 calling for the mandatory stay of proceedings to arbitration whenever the contract contains an arbitration clause ... In *Halki Shipping Corporation v Sopex Oils Limited*,[54] the judge held that save in very limited circumstances, all disputes fell within the arbitration clause and had to be referred to arbitration. Even claims for which there was obviously no answer in fact or law was no longer was justifiable by legal process and had to be referred to arbitration. All this is bad news for potential claimants under building contracts (which contain an arbitration clause, although the Joint Contracts Tribunal (JCT) in the latest suite of contracts, including JCT 84, have discarded arbitration) which

[54] [1996] 3 All ER 833 and affirmed by the Court of Appeal in [1998] 2 All ER 23.

might otherwise have made summary judgment or interim payment applications under RSC Ord 14 or RSC Ord 29 respectively. Parties, requiring a quick release of monies, will now rely principally upon s39 of the Arbitration Act 1996, which leaves the parties under contracts, where there is an arbitration clause, free to agree that the arbitral tribunal shall have power to make provisional awards (i.e. early release of monies in favour of one or other of the parties)." **(emphasis added).**

It is therefore seen that the United Kingdom has also been plagued with the Project Finance problem, Withholding of Payment problem and Dispute Resolution & Security of Payment problem discussed in Chapter 2.

b) Cross Claims and Abatement

In a contractor's application for payment including for certified payment, it is always open for the owner to dispute liability to pay and raise all manner of cross claims. For a while, the architect's certificate was thought as "good as cash" and actions on unpaid certificates were treated akin to actions on dishonoured cheques. This proposition stemmed from the Court of Appeal case of *Dawnays Ltd v F.G. Minter Ltd.*[55] The proposition was however eroverruled by the House of Lords in *Gilbert Ash Northern Ltd v Modern Engineering (Bristol) Ltd*[56] and re-affirmed in *Mottram Consultants Ltd v Sunley & Sons Ltd.*[57] In the *Gilbert Ash* case, Lord Salmon said:

[55] (1971) 1 BLR 16 and followed in *Frederick Mark Ltd v Schield* (1971) 1 BLR 32 and again in *GKN Foundations v Wandsworth London Borough Council* (1972) 1 BLR 38.
[56] (1973) 1 BLR 73.
[57] (1974) 2 BLR 28.

> "The [JCT] provisions relating to interim certificates as a rule ensure a steady cash flow in normal conditions ... when, however, a bona fide dispute arises, I do not think [they are] designed to put the Plaintiff [Contractors or Sub Contractors] in a fundamentally better position than any ordinary Plaintiffs or the Defendants in any worse position than any ordinary Defendants."

Architect's certificates are therefore not as good as cash because there are no special rules limiting cross claims in the construction industry. This has resulted in a severe impediment on the ability to obtain summary judgment or interim payment in a court action based on certificates. Generally, in respect of legal set off under English law the cross claim has to be a debt but not damages (including liquidated damages).[58] However with the intervention of equity, the defendant may be able to raise equitable set off as a defence if the cross claim arises out of the same transaction as the claim or out of a transaction that is so closely related to the claim so as to make it unfair that the defendant should pay the plaintiff without deducting the amount of the cross claim.[59] The availability of this defence of equitable set off has significantly fend off swift summary disposal of payment claims whether in court or arbitration.[60]

Be that as it may, the common law doctrine of abatement[61] should be noted. According to that doctrine, the defendant may also defend himself by showing how much less the subject matter is worth by reason of breach of contract. This is a

[58] *B Hargreaves Limited v Action 2000 Limited* (1993) 62 BLR 72.
[59] *Hanak v Green* (1958) 1 BLR 1.
[60] *The Modern Trading Co Ltd v Swale Building and Construction* (1990) 6 Cons LJ 251.
[61] *Mondel v Steel* (1841 Ct. of Exch.)1 BLR 73.

remedy which the common law provides for breach of warranty in contracts for sale of goods and for work and labour. It is available as of right to a party to the contract and is independent of the doctrine of equitable set off.[62] Thus in *Acsim (Southern) Ltd v Danish Contracting & Development Co Ltd*[63] it was held that the contractor was able to defend the sub contractor's claim on the basis that because of defective performance of the work, the sub contractor was only entitled to a lesser sum than the sum claimed. It is pertinent that the contractor in that case resorted to abatement because of its failure to apply properly the set off procedure stipulated in the sub contract.

It can hence also be concluded that the Withholding of Payment problem discussed in Chapter 2 is similarly found in the United Kingdom.

c) Limited Remedies

There is no right to suspend work for non payment under English common law.[64] This is consistent with the principle that except where there is a breach of condition or fundamental breach of contract, breach by one party does not discharge the other party from the performance of his unperformed obligations. In the *Lubenham Fidelities & Investment Co Ltd v South Pembrokeshire District Council & Anor* case, the contractor's unilateral suspension of work and eventual termination of the

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[62] *Modern Engineering (Bristol) Ltd v Gilbert Ash (Northern) Ltd* (1974) 1 BLR 73.
[63] (1989) 47 BLR 55; see also *A Cameron Ltd v John Mowlem and Company Plc* (1990) 52 BLR 54.
[64] Stephen Furst & Vivian Ramsey, *Keating on Construction Contracts* (Sweet & Maxwell, 8th ed., 2006) at 216 and 625; see also *Lubenham Fidelities & Investment Co Ltd v South Pembrokeshire District Council & Anor* (1986) 33 BLR 39 and *Channel Tunnel Group Ltd v Balfour Beatty Construction Ltd* (1993) 61 BLR 1.

building contract due to alleged under-certification of payment was found to be wrongful. There is also no right of the contractor to reduce the rate of execution of work for non payment.[65] This is premised upon the same principle that the contractor is not entitled to suspend work. Further, it was held[66] pursuant to the JCT form of main contract 1963 Edition that the contractor by going slow has been guilty of repudiatory breach of contract. The sole recourse is to terminate the contract if non payment is persistent. Thus, in *Jefco Mechanical Services Ltd v London Borough of Lambeth*[67] it was held that repeated late and underpayments might so shatter the confidence of the contractor in the ability of the owner to perform his obligations under the contract, and the contractor was justified to treat the contract as repudiated by the owner.

As for sub contractors, it has been observed[68] that sub contractors encountered difficulty recovering payment for work done from main contractors. Besides the complex law of set off, many main contractors have produced an array of amendments to the standard form of contracts including deleting remedies provided expressly thereunder. They are the removal of the right to suspend performance for non payment and removing the protections in standard form contracts against arbitrary set off which requires prior written notice of the intended set off with a detailed quantification. Moreover there is frequent use of the so called "pay when paid" approach to payment.

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[65] *Supamarl v Federated Homes Ltd* (1987) 9 ConLR 26.
[66] *J M Hill & Sons v London Borough of Camden* (1981) 18 BLR 31.
[67] (1983) 24 BLR 1.
[68] *Supra* n. 53. at 6.

Besides the Withholding of Payment problem, the Unfair Contract Terms problem discussed in Chapter 2 is hence similarly found in the United Kingdom at least at the sub contract level.

d) The Construction Industry Inquiry

The understanding that all was not well in the construction industry led to the appointment of Sir Michael Latham to report on the ills of the industry in a government based move in the early 1990s.[69] Two reports were produced. The first report was an interim report entitled "Trust and Money" being two factors seen as continually lacking in the UK construction industry. The second report was the final report made in July 1994 entitled "Constructing the Team".

The concerns and recommendations in "Constructing the Team" include, amongst others:

1) Unfair Contractual Conditions

It is recognized and encouraged[70] that all parties should use standard forms (particularly the JCT Contracts and the New Engineering Contract (and their accompanying sub contracts) with suggested amendments outlined in the Report). To aid confidence and promote the use of such forms, their central provisions

[69] *Supra* n. 6. at 14.
[70] *Id.* at 8.9.

should be underpinned by legislation. The legislation must declare the following actions unfair and invalid:

a) any attempt to amend or delete the sections relating to times and conditions of payment including the right of interest on late payment;
b) to seek to exercise any right of set off or contra charge without giving notification in advance and specifying the exact reason for the deducting the set off;
c) to seek to set off in respect of any contract other than the one in progress; and
d) to include a clause with the effect of introducing "pay when paid" conditions.

2) Dispute Resolution

It is stated[71] that there is considerable dissatisfaction with arbitration within the construction industry because of its perceived complexity, slowness and expense. Arbitration has a continuing role to play in dispute resolution within the construction industry but it should be the last resort after practical completion if a party to a dispute remains aggrieved by the decision of the adjudicator even though that decision has already been implemented. As to the courts, reference is made to the speech of Lord Justice Lawton in *Ellis Mechanical Services v Wates Construction Ltd*[72] that:

[71] *Supra* n. 6. at 9.10, 9.13 and 9.14.
[72] (1976) 2 BLR 57 at 64.

> "The courts are aware of what happens in these building disputes; cases go either to arbitration or before an Official Referee; they drag on and on; the cash flow is held up ... that sort of result is to be avoided if possible."

The recommendation is to introduce a system of adjudication underpinned by legislation. There should be no restriction on issues capable of being referred to the adjudicator and the award of the adjudicator should be implemented immediately. Any appeals to arbitration or the courts should be made only after practical completion of the works and resort to the courts should be immediately available if a party refuses to implement the award of the adjudicator.

3) Insolvency and Security of Payment

It is absolutely fundamental to create trust within the construction industry that participants should be paid for the work which they have undertaken.[73] An effective way to deal with the problem of insolvency and payment security is by setting up trust accounts for interim payments and also retention.[74] In this regard,[75] the owner is required to set up a trust account and pay into it in the beginning of each payment period the amount due for the next activity schedule or milestone. Payment must be released at the appropriate time in an effective manner. The sum allocated should correspond to a pre agreed programme and the main contractors and sub contractors should be advised by the owner's representative of the amount so deposited. If any of them consider that the sum is inadequate, they should have

[73] *Supra* n. 6. at 10.3.
[74] *Id.* at 10.6.
[75] *Id.* at 10.8 and 10.9.

the right to approach an adjudicator for a ruling on whether this sum should be increased. If after decision by the adjudicator there is failure to increase the sum, this should entitle an aggrieved person to suspend the work until the sum in the trust account is increased. There must be a suitably drawn up trust account so the sub contractors know that their payment will be safe even if the main contractor fails. Legislation will therefore be needed to ensure that in the event of the failure of the main contractor, trustees will have the duty of making due payments out of the trust account to sub contractors for work done and materials supplied. If the owner fails, the trustees will pay the contractor who will contractually be required to pay the sub contractors.

The problems identified in Constructing the Team are significantly similar to the Malaysian Construction Payment problems discussed in Chapter 2 particularly the Unfair Contract Terms problem, Withholding of Payment problem and the Dispute Resolution and Security of Payment problem.

3.2.5 The Housing Grants Construction and Regeneration Act 1996

a) Generally

The recommendations of the Latham Reports led to the enactment of the Housing Grants Construction and Regeneration Act in the UK in 1996 (hereinafter referred to as the HGCRA).

That the statutory response to Constructing the Team has been limited. The provisions which affect the construction industry are found in Part II of the HGCRA. Most excitedly discussed were the provisions relating to statutory adjudication. Provisions relating to payment are to be found in Sections 109 to 113 of the HGCRA.

The recommendation in Constructing the Team on unfair contract conditions has only been partly addressed by prohibiting certain types of "pay when paid" clauses in the HGCRA. The recommendation in respect of dispute resolution by creating a new adjudication procedure was adopted in the HGCRA. However the recommendation on insolvency and security of payment by setting up a trust account has not been adopted at all in the HGCRA.

The relevant provisions of the HGCRA on construction payment seek to address the following five issues:[76]

i) A right to refer disputes to adjudication that will have interim binding effect (section 108 HGCRA).
ii) An entitlement to periodic payments, with an "adequate mechanism" for determining what payments become due under the contract (sections 109 and 110 HGCRA).

[76] *Supra* n. 64. at 594-595.

iii) A mechanism for ensuring that unless the appropriate notice is given in time, moneys may not be withheld (sections 110 and 111 HGCRA).

iv) A right to suspend performance for non payment (section 112 HGCRA).

v) A partial prohibition of "pay when paid" clauses (section 113 HGCRA). The prohibition does not apply in the event of insolvency of the head payor.

b) Scope of Coverage

The scope of the Act is dealt with in section 104 of the HGCRA. The Act only applies to construction contracts which meant contracts for the carrying out of construction operations which have been defined in section 105. In the definition, the categories of work excluded from the ambit of the HGCRA include oil and gas, mining, process engineering and contracts for the manufacture and supply of goods and materials. Residential occupier building contracts are also excluded. Further section 107 provides that the Act only applies to agreements made in writing.

The operation of the HGCRA has been further extended by the Scheme for Construction Contracts (England and Wales) Regulations 1998 to provide for situations where the construction contract does not comply with Section 108(1) to (4) or where the parties are unable to reach agreement for purposes mentioned in Sections 109, 111 and 113 or where the construction contract does not make provision required by Section 110 of the HGCRA. Likewise, the operation of the HGCRA has also been extended by the Scheme for Construction Contracts

(Scotland) Regulations 1999 and Scheme for Construction Contracts in Northern Ireland Regulations (Northern Ireland) 1999.

c) Adjudication

The key feature in the HGCRA is the introduction of adjudication which is a swift dispute resolution specifically targeted at payment related disputes. It is thus seen that by Section 108(2)(c) and (d) HCCRA, the adjudicator must reach a decision within 28 days of referral (with a possibility of extension by 14 days with the consent of the referral party) or such longer period as agreed by the parties after the dispute has been referred. The adjudicator is nevertheless duty bound to determine the application impartially.[77]

It has been said that construction industry adjudication is a unique process. It is not adjudication as judges and arbitrators know it. It is far wider than that. It is also not mediation or conciliation. It is not expert determination. It is not arbitration. It is certainly not litigation. Adjudication has been described as a procedure where, by contract, a summary interim decision making powering respect of disputes is vested in a third party individual (the adjudicator) who is usually not involved in the day-to-day performance or administration of the contract and is not an arbitrator.[78]

[77] Section 108(e) HGCRA.
[78] John L. Riches and Christopher Dancaster , *Construction Adjudication* (LLP Limited, 1999) at 17.

The enforcement of the adjudicator's decision is not dealt with in the HGCRA but there are views that the appropriate procedural route for enforcement is by way of summary judgment.[79]

In *Macob Civil Engineering Ltd v Morrison Construction Ltd*[80] which was the pioneer case on adjudication that reached the English court, Dyson J said:

> **"The intention of parliament in the Act was plain. It was to introduce a speedy mechanism for settling disputes and construction contracts on a provisional interim basis, and requiring decisions of adjudicators to be enforced pending final determination of disputes by arbitration, litigation or agreement** ... The timetable for adjudication is very tight ... many would say unreasonably tight, and likely to result in injustice. Parliament must have been taken to have been aware of this ... It is clearly Parliament's intention that the adjudication should be conducted in a manner which those familiar with the grinding detail of the traditional approach to the resolution of the construction disputes apparently find it difficult to accept. But Parliament has not abolished arbitration and litigation of construction disputes. It has merely introduced an intervening provisional stage in the dispute resolution process. **Crucially it has made it clear that decisions of adjudicators are binding and are to be complied with until the dispute is finally resolved." (emphasis added).**

This dictum has been approved in several of the later English Court of Appeal cases[81] stemming from enforcement of adjudication decisions.

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[79] *Supra* n. 64. at 607.

[80] [1999] BLR 93 at 97.

[81] *Bouygues (United Kingdom) Ltd v Dahl-Jensen (United Kingdom) Ltd* [2000] BLR 522, *C & B Scene Concept Design Ltd v Isobars Ltd* [2002] BLR 93, *Fersons Contractors Ltd v Levolux A T Ltd* [2003] BLR

The authors of Keating on Construction Contracts have stated that the approach of the parties to adjudication has shown certain developments.[82] The magnitude of the legal and expert costs that parties to adjudications are incurring appears to be significant and the adjudicators own fees and costs are not insignificant. This may reflect the increasing importance attributed to the adjudication process and a realization that success or failure in such proceedings is often finally determinative of the dispute. In many cases the parties seem to accept the decisions of the adjudicators and the number of adjudication decisions which are revisited in arbitration or the courts is small.

In Construction Contracts Law & Practice, it is stated succinctly that the policy of the HGCRA is as follows:[83]

> "Pay first, argue later". One of the main mischiefs of the Act was designed to deal with the gross inequality of the financial strength between the various players in construction contracts, from developer to main contractor to sub contractor, sub sub contractor and so forth. Given the fact that the law did not permit a financially weak sub contractor to simply stop work because it had not been paid sufficiently, if a financially strong main contractor starved the sub contractor of funds by making deductions on account of unjustified claims, there was little the sub contractor could do about it.

118, *Pegram Shopfitters Limited v Tally Weijl (UK) Limited* [2004] BLR 65 and *Carillion Construction Limited v Davenport Royal Dockyard Limited* [2006] BLR 15.

[82] *Supra* n. 64. at 602.

[83] Richard Wilmot-Smith, *Construction Contracts Law & Practice* (Oxford University Press, 2006) at 18.07 to 18.10.

The reality was that summary judgment was rarely available as a remedy and litigation and arbitration was a slow and expensive process. So the sub contractor or to use the term the "financially weak party" would be starved of cash whilst the works were proceeding and have to pay substantial sums to its lawyers in order to try and get restitution at the end of the job. It was hardly surprising that many contractors and sub contractors would be forced either into insolvency or into a settlement which was worth to them far less than their true rights. Therefore a contractor could obtain a job in free market competition but founder financially because of the legal and arbitral system gave it no remedy which it could afford in the time in which it could properly survive. It was clear that something had to be done in order to redress the balance between the paying parties and the paid parties.

The solution was to create a fresh legal framework for the resolution of construction disputes on an interim basis. Thus the emergence of "pay first, argue later", which was a radical change from the old position of 'complete the work first and if you are financially strong enough, litigate to receive the price later. The new framework was adapted from the adjudication procedure which was written into the JCT standard forms of sub contracts which was designed to have similar results. The procedures in that standard form were used but infrequently ... The breakthrough was to have legislation which required adjudication in all forms of building contract, with few exceptions and thereby have the process required by all who enter into building contracts." **(emphasis added).**

The introduction of statutory adjudication through the HGCRA is therefore a refreshing reform that has occurred in the United Kingdom to effectively curb the problems of construction industry payment.

d) Adjudication versus Arbitration

It must be noted that at the time of the enactment of the HGCRA, the English Arbitration Act 1996 (hereinafter referred to as the AA) was also introduced to replace the Arbitration Acts 1950 and 1979. One of the objects of the AA is for parties to obtain the fair resolution of disputes by an impartial tribunal without unnecessary delay and expense.[84] Nevertheless, the arbitral tribunal is subject to party autonomy on procedural and evidential matters[85] and rules of natural justice[86] which includes giving each of the parties a reasonable opportunity of putting his case and dealing with that of his opponent. Prior to the introduction of the AA, it was commented[87] that there was dissatisfaction with the tendency for construction and engineering arbitrations to resemble court proceedings so closely that the principal difference was the considerable extra cost in arbitration of paying the cost of the venue and the tribunal fees. Thus the expanded powers now available[88] to the tribunal were greeted with enthusiasm. Be that as it may, it remains[89] that the AA does not in general give the arbitrators the freedom to depart from the task of "litigation in the private sector". It must also be appreciated that the AA is of general application to all commercial disputes and has not been specifically designed to cater only for the construction industry.

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[84] Section 1(a) AA.
[85] Section 34(1).
[86] Section 33(1).
[87] Peter Sheridan, Construction *and Engineering Arbitration* (Sweet & Maxwell, 1999) at 14.05.
[88] Section 34(2) AA.
[89] Supra n. 87. at 14.06; see also the speech of Sir Johnson Donaldson MR in *Northern Regional Health Authority v Derek Crouch Construction Co Ltd* (1994) 26 BLR 1 at 32 that "Arbitration is usually no more and no less than litigation in the private sector. The arbitrator is called upon to find the facts, apply the law and grant relief to one or other or both of the parties."

Unlike adjudication under the HGCRA, there is no special procedure for summary and swift determination of the dispute in the AA other than the power to make provisional award for payment of money or interim payment on account if the parties confer such powers on the arbitral tribunal.[90] Furthermore it is seen[91] that the arbitral tribunal may only make an interim award akin to the summary judgment procedure in court in exceptional circumstances where it can properly find that it is not satisfied that the defences advanced are made in good faith or on reasonable grounds.

It can hence be discerned that statutory adjudication and arbitration co-exist in the United Kingdom. The former is a "rough justice" procedure whereas the latter is a "fine justice" procedure. They complement each other wherein arbitration may be resorted to re-open the resolution of the dispute if any party is aggrieved with the adjudication decision.

Statutory adjudication in the United Kingdom is also robustly supported by the judiciary through the Technology and Construction Court (TCC) which is a specialized court dealing with construction related disputes.[92] The TCC is housed with judges who are formerly construction silks. By their experience, these judges are better able to comprehend and dispose the intricacies and difficulties posed from adjudications pursuant to the HGCRA. This is seen mostly from enforcement

[90] Section 39 AA.
[91] *The Modern Trading Co v Swale Building and Construction* (1990) 6 Cons LJ 251.
[92] Peter Coulson, *The Technology and Construction Court* (Sweet & Maxwell, 2006) at 1-13 to 1-17 and 9-01 to 9-06.

of adjudication decisions by the TCC which have been mostly confirmed on appeal.[93]

e) The Post HGCRA Position

The effect of the enactment of the HGCRA has produced mixed results.[94] The adjudication determination can decide not just the outcome of the dispute but the profitability or even the survival of the parties. The stakes are often high. There is the avenue for the losing party in the adjudication to resort to arbitration or court to re-determine the dispute in the usual way. Typically that would happen between 18 months to 2 years after the adjudication determination. The losing party may still feel that it is worth trying to forthwith challenge the enforcement of the adjudication determination by questioning the legality of some aspects of the adjudication process in an attempt to avoid payment. Thus, an ever growing number of cases are subsequently brought to the courts. There are well over 200 reported cases whereas the intention in Constructing the Team was to avoid the courts.

That notwithstanding, the advent of adjudication has totally transformed the construction dispute landscape.[95] It had a profound effect on all other forms of

[93] *RJT Consulting Engineers v DM Engineering* [2002] BLR 217, *Carillion Construction Ltd v Davenport Royal Dockyard Ltd* [2006] BLR 15, *AMEC Capital Projects Ltd v Whitefrairs City Estates Ltd.* [2005] BLR 1.

[94] Adam Constable, *Adjudication Legislation : Learning Positive Experience from the UK Experience* (CIDB International Forum 2005).

[95] Dr Robert Gaitskell QC, *Adjudication: Its Effect on Other Forms of Dispute Resolution (the UK Experience)* (Society of Construction Law UK, July 2005).

dealing with construction disputes. The number of court and arbitration cases has reduced. Adjudication is now the dominant construction dispute resolution process. It has been so successful that the United Kingdom government is regularly reviewing ways of improving the procedure so as to encourage more disputes to be adjudicated rather than dealt with in any other way. With times more parties will become more familiar with adjudication. As its procedures are streamlined to meet the needs of the construction industry, it is to be expected that the incidences of arbitration and litigation will reduce.

3.3 The Position in Selected Commonwealth Countries

The norms of the construction industry in many of the Commonwealth countries, especially the developed countries such as Australia, New Zealand and Singapore also follow the English construction industry. The contracting arrangements are thus similar though their own standard forms of construction contract have evolved over the years to suit their local conditions. Nevertheless, the key features on payment such as certification, set offs and contractual remedies are largely the same. Since their legal system is also English common law based, the modes and mechanics of construction dispute resolution are also similar, arbitration being traditionally the most popular mode. By virtue of the close similarities, the construction industry problems in these countries are likely to be similar to that in the United Kingdom. Accordingly, the payment problems would also not be far different from the Malaysian Construction Payment Problems discussed in Chapter 2.

3.4 Australia

3.4.1 Introduction

The construction industry in Australia is also based on chain of contracts. When one party fails to fulfill payment, there is a domino effect which stalls the payment process down the chain.[96] The importance of cash flowing top down in construction progress payment to sustain the viability of carrying out construction work is also judicially acknowledged in the case of *Novavest Contracting Pty Ltd v Tara Nominees Pty Ltd*[97] where Gillard J held:

> "The law is clear with respect to parties interfering with common law rights by contract. It has been long established that to exclude common law rights the intention must be clearly and unequivocally spelt out ... In my opinion, the provisions of clause 42.1 (pursuant to the AS2124 standard form of contract) which I have summarized and referred to make it clear that once the certificate is issued it must be paid without deduction. **There must be cash flow in the building trade. It is the very lifeblood of the enterprise." (emphasis added).**

As to construction dispute resolution, it has been stated[98]:

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[96] see RICS Dispute Resolution Service (www.ricsdrs.com.au) (accessed in August 2007 and again in November 2009).

[97] [1998] VSC 205.

[98] DJ Cremean, BA Shnookal and MH Whitton, *Brooking on Building Contracts* (LexisNexis Butterworths, 4th ed., 2004) at 18.11 and 18.12.

"There has been strong growth in ADR in recent years ... As Menhennit J observed in *C W Norris & Co Pty Ltd v World Services and Construction Pty Ltd* [1973] VR 753; "It is notorious that many building case proceedings have been bedeviled by complexity and detail, interlocutory proceedings have been tortuous and slow, trials have been long and expensive, the real issues have often emerged only during the course of the trial and parties, often both of them have been disillusioned". A most important development in ADR has been the passage of uniform commercial arbitration legislation in the states and territories. The arguments usually put in favour of arbitrations against litigation are that it tends to be quicker and cheaper (although the fees payable to the arbitrator must be borne in mind), that the parties have the benefit of the specialized knowledge and experience of the expert who may be appointed arbitrator and the proceedings are private. But not every arbitration runs smoothly. Kirby P made observations about this in *Update Constructions Pty Ltd v Rozelle Child Care Centre Ltd* (1990) 20 NSWLR 251 as did Brooking J in the earlier case of *SMK Cabinets v Hili Modern Electrics Pty Ltd* [1984] VR 391 at 392. These days, the choice is not only between litigation and arbitration. Arbitration is the main but not the only form of ADR."

The construction payment problems that besieged the United Kingdom also appear to be so in Australia especially the problems of withholding of payment and dispute resolution and security of payment.

3.4.2 The Security of Payment Legislations

As with the development in the United Kingdom, the New South Wales government saw it fit in the mid nineteen nineties to pioneer security of payment

legislation that establish new rights for parties seeking payment for work done and plant and material supplied to construction projects. The object of the governmental move was to maintain stability and efficiency in the construction industry by providing a fairer and quicker payment system.[99]

There has been in recent years legislative intervention to regulate construction payment in Australia which primarily includes providing the right to statutory adjudication for resolution of payment dispute. The legislative intervention occurred at state level beginning with New South Wales which enacted the Contractors Debts Act 1997 and the Construction Industry Security of Payment Act 1999. The latter Act was amended by the Building and Construction Industry Security of Payment Amendments Act 2002 (hereinafter referred as the NSW Act). In Victoria, the Building and Construction Industry Security of Payment Act 2002 (hereinafter refereed as the Victoria Act) was enacted. The scheme in Queensland is jointly regulated by the amended Subcontractor's Charges Act 1974, the Queensland Building Services Authority Act 1991, and the Queensland Building Tribunal Act 2000 which is consolidated into the Building and Construction Industry Payments Act 2004 (hereinafter referred to as the Queensland Act). The Construction Contracts Act 2004 (hereinafter referred to as the Western Australia Act) was enacted for Western Australia. The Northern Territory introduced the Northern Territory Security of Payment Act in 2005 (hereinafter referred as to the Northern Territory Act). The South Australia Security of Payment bill has not yet been passed by parliament.

[99] see New South Wales Department of Commerce: Security of Payment (www.dpws.nsw.gov.au.) (accessed in August 2007 and again in November 2009).

The objectives of the Australian statutes are, firstly, to ensure that persons who carry out construction work are entitled to timely payment for their work, and secondly, to provide a procedure for securing payments to persons who become entitled under the statutes.

The provisions in the Australian statutes are not identical with the HGCRA of the United Kingdom though many concepts therein are similar. In this regard, differences are seen in the scope of coverage. The Australian statutes apply to any construction contract whether written or oral or partly written and partly oral.[100] The statutes bind the Crown.[101] The coverage of the statutes is also very wide, encompassing construction work and related goods and services.[102] In *Parist Holdings Pty Ltd v WT Partnership Australia Pty Ltd*,[103] it was held the NSW Act applies to consultancy services provided to a development project. Nevertheless, the application of the statutes in New South Wales and Victoria specifically exclude construction loan contracts and residential building work.[104]

The Australian statutes also contain elaborate provisions on prescription of construction payments, consequences of payment defaults, adjudication mechanism and enforcement of adjudicator's determination. There are differences in

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[100] Section 7(1) of the NSW and Victoria Acts, Section 7(2)(a) of the Western Australia Act, Section 3(1) of the Queensland Act and Section 9 of the Northern Territory Act.

[101] Section 33 Of the NSW Act, Section 8 of the Victoria and Western Australia Acts, Section 6 of the Queensland Act and Section 11 of the Northern Territory Act .

[102] Section 4 of the NSW and Victoria Acts, Section 2 of the Western Australia Act, Section 3(1) and Section 9 of the Northern Territory Act.

[103] [2003] NSWSC 365.

[104] Section 7(2)(a) and (b) of the NSW and Victoria Acts and Section 3(2) of the Queensland Act.

procedural details with the UK HGCRA though the concept is the same. In gist, the statutes confer a statutory right to progress payment where the construction contract does not expressly provide for progress payment. "Pay when paid" type terms of payment are prohibited. In the event of non payment, the aggrieved claimant party exercises its right under the statutes by presenting a payment claim to the defaulting respondent party. The payment claim must contain the necessary particulars required by the statutes. The respondent party is required to reply by issuing a payment schedule stipulating the amount it proposes to pay which may range from zero to the sum as claimed, otherwise the respondent will be treated as having accepted the full claim. In the circumstances, the claimant party may proceed to recover the claim as a debt and suspend the performance of the contract after due notification.

If the respondent fails to pay the whole or part of the scheduled payment or fails to provide a payment schedule and does not pay the whole or part of the amount claimed by the due date, then the claimant may invoke the adjudication process. In this respect, the claimant under the NSW and Queensland Acts must notify the respondent of the claimant's intention to apply for adjudication and await the respondent's reply with a payment schedule. It is important to note that the adjudicator's jurisdiction is determined primarily by the claimant's payment claim and the respondent's payment schedule in reply thereto. The position is different in the statutes of the other states where adjudication can be invoked without the requisite notification of the intention to adjudicate and the reply thereto. However,

the statutes do not provide a mechanism for the respondent to counterclaim damages.

As to time limits, the adjudicator under the NSW and Victoria Acts must determine an adjudication application within 10 days after the adjudicator has notified the parties of the adjudicator's acceptance of the reference[105] subject to such extension as agreed to by the parties. Under the Western Australia Act, the adjudicator has 14 days from the service (or the date the response ought to be served, if no service is made) of the adjudication response to determine the application.[106] The Queensland and Northern Territory Acts require the determination within 10 working days from the receipt or time limit for the receipt of the adjudication response.[107] As with the UK HGCRA, the determination of the adjudicator binds the parties until finally determined in legal proceedings, arbitration or agreement between the parties.

Under the NSW Act, the successful claimant in the adjudication can either enforce the determination in court based on the adjudication certificate or suspend the performance of the contract until payment.[108] In addition by virtue of the Contractors Debt Act the successful unpaid claimant under a sub contract may seek recourse to payment owing by the employer to the main contractor. As to the Victoria Act, the successful claimant can recover the unpaid amount as debt or suspend performance of the contract until payment or apply to court for a debt

[105] Section 21(3)(b) of the NSW Act and Sections 20(2) and 22(4) of the Victoria act read together.
[106] Sections 31(a) and (b) of the Western Australia Act.
[107] Section 25 of the Queensland Act and Section 33 of the Northern Territory Act.
[108] Sections 24(1) and 24(2) respectively.

certificate which entitles the claimant to an assignment of the respondent's debt under the head contract to the claimant to the extent of the amount shown in the debt certificate.[109] In Western Australia, the adjudicator's determination can either be enforced as judgment or order of the court with leave or the successful claimant can suspend performance of the contract until payment.[110] In the Western Australia Act, there is a limited provision[111] for the person who is aggrieved by the certain determinations of an adjudicator such as whether the contract is a construction contract or whether the adjudication application complied with the Act for review by the State Administrative Tribunal. In this regard, the State Administrative Tribunal may set aside the determination and remit the determination back to the original adjudicator. The successful party under the Queensland Act may seek enforcement of the adjudication determination as court judgment.[112] In regard to the Northern Territory Act, the successful party in the adjudication may suspend work[113] until the adjudicated payment is received or seek enforcement of the adjudication determination as a court judgment.[114]

3.4.3 Law Reform and the Post Security of Payment Legislations

Notwithstanding the above state legislation, the Australian government in the new millennium set up the Australian Royal Commission to look into the Building and Construction Industry. The Royal Commission was chaired by Royal

[109] Sections 27(1), 27(2) and 31 to 33.
[110] Sections 42(3) and 43(2) of the Western Australia Act.
[111] Section 31(2).
[112] Section 31 of the Queensland Act.
[113] Section 44 of the Northern Territory Act.
[114] Section 45 *ibid.*

Commissioner the Hon T.R.H. Cole. The Royal Commission,[115] amongst others, analyzed issues relating to security of payment in the construction industry. As a result, the Royal Commission released Discussion Paper Twelve: Security of Payments in the Building and Construction industry. The proposed reform options include:

a) pre qualification;

b) licensing;

c) codes of practice;

d) trust funds;

e) compulsory insurance;

f) unfair contract clauses and rapid adjudication.

The reform proposals recommended pre-qualification and licensing procedures to ensure that construction work is undertaken by financially competent contractors. As a result problems with cash flow should lessen. The creation of trust fund is principally to secure construction payment akin to the trust recommended in "Constructing the Team" report of the United Kingdom. Adjudication is recognized as the way to swiftly address construction payment disputes.

The reform proposal also emphasized the enactment of a new national security of payments legislation but this has not yet materialized to-date. The rationale is to have a uniform code throughout the country.

[115] (2003) 19 BCL 133.

It has been stated[116] that the problem with security for payment legislation in Australia, particularly under the NSW Act, laid with the courts. The courts have regularly refused to enter summary judgment for the statutory debt created by the legislation. They could not conceive of a judgment for payment on account and allow cross claims to be raised in response to a claim for summary judgment for the statutory debt. The wealth of judicial authority in the United Kingdom has not been recognized in New South Wales and the resultant cases in New South Wales on security of payment legislation have produced wrong and conflicting decisions. Thus in this respect, it is seen in *Brody v Davenport*[117] that the Supreme Court of New South Wales assumed unto itself the power to review and set aside the adjudicator's determination even though the NSW Act provides that the respondent cannot challenge the determination of the adjudicator in any proceedings brought by the respondent to set aside the judgment. The judicial attitude was probably due to the lack of appreciation of the intent of the new legislation to provide for rough, swift but enforceable adjudication decisions correctable by rehearing of the dispute through traditional arbitration or litigation but not by appeal or review of that decision.

That notwithstanding, it is also commented[118] that the NSW Act represented a significant step forward particularly for sub contractors in alleviating the problems associated with poor payment practices by those higher up in the contractual chain.

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[116] Bob Gaussen, *Construction Industry Payment and Adjudication – An Australian Perspective* (CIDB International Forum 2005).

[117] [2004] NSWSC 394.

[118] Dr Thomas E. Uher and Michael Brand, *The First Five Years of Adjudication in New South Wales* (CIDB International Forum 2005).

However, there is still under utilization of the NSW Act because of lack of pervasive awareness.

3.5 New Zealand

3.5.1 Introduction

Construction industry payment particularly security of payment has been of paramount concern in New Zealand even since the nineteenth century. As far back as 1892, New Zealand had legislation that protected contractors, sub contractors and workmen for the payments due to them in the form of the Contractor's and Workmen's Liens Act which was based on an Ontario statute and several other statutes in force in different American states at that time. The 1892 Act utilized the concept of liens for master builders that were enacted in the American State of Maryland. The 1892 Act was consolidated in 1908 through the merger of the Treshing–machine Owners Lien Act 1895, the Truck Act 1891, the Workmen Wages Act 1893, the Wages Attachment Act 1895 and the Wages Protection Act 1899 to become the Wages Protection and Contractor's Liens Act 1908. The problems that arose in the 1908 Act were remedied by the introduction of the Wages Protection and Contractor's Liens Act 1939. The way in which payment protection operated in New Zealand was to provide the right of payment to any contractor, sub contractor, supplier of materials, or workmen by way of security

given over the owner's money known as the charge or over the owner's interest in land or chattels known as the lien.[119]

The Wages Protection and Contractor's Liens Act 1939 was however repealed in 1987 because of the conflicting and competing interests between the players of the construction industry. It was stated[120] by the Minister of Justice that:

> "I am completely satisfied that it is not possible to reach agreement with the industry on the reform of the revised Liens Act and the reason is that the interests of contractors and sub contractors are diametrically opposed to each other. Contractors prefer to hang on to retention money for as long as possible. The time has arrived for the building industry work to out its own solutions – a task which I believe has commenced … There is no reason to assume that the building industry is incapable of looking after itself in the same way as its overseas counterparts."

As a result, the Wages Protection and Contractor's Liens Act 1939 was repealed. The repeal caused many problems that confronted the construction industry. Monetary retentions that were originally deducted by the payer from payments due to and for the protection of contractors and subcontractors prior to the repeal of the Act continued to be deducted by owners after the repeal of the Act to an equal or even greater extent. This is done under the pretext of performance, completion or maintenance retention requirements. Furthermore, the monetary protections provided by the 1939 Act were reversed after the Act's repeal in 1987. In consequence, it protected those who made payment rather than those who had

[119] Geoff Bayley & Tomas Kennedy Grant, *A Guide to the Construction Contracts Act* (Rawlinsons Media, 2003) at 12 -13.

[120] New Zealand Law Commission Report 1987 - *Protecting Construction Contractors* at 5 para 12.

carried out the work. The repeal of the 1939 Act also resulted in the use of "pay when paid" by main contractors against sub contractors becoming far more prevalent. The use of "pay when paid" clauses was seen by some main contractors as an effective way of using retained subcontractor's moneys to finance their work.

By reason of the lack of statutory protection after the repeal of the 1939 Act, many dispute values rose quickly into millions of dollars. Under the 1939 Act, the claimant will notify the owner of the land specifying the amount and particulars of the claim requiring the owner to take the necessary steps to pay or secure to the claimant. This notification resulted in securing the monies allegedly owed prior to the commencement of any dispute resolution process. The speed of the dispute resolution process was not a priority prior to the repeal of the Act because the monies were secured. After the repeal of the Act, there was no simple way of securing monies allegedly owed prior to the issue of payment or dispute being resolved. Consequently, those who retained disputed monies benefited from the interest for as long as the resolution of the dispute was delayed so as to cause the insolvency of the claimant. Beginning from the late 1980's, there were consequently a number of major insolvencies in the construction industry including Mcmillan & Lockwood Ltd and Augus Construction. Many of the failures of head contractors resulted in the consequential failures of large numbers of sub contractors.[121] The construction industry payment problems in New Zealand again appear to be similar to that in the United Kingdom, Australia and the Malaysian Construction Payment Problems discussed in Chapter 2.

[121] Supra n. 119. at 17-18.

Thus, in the course of the New Zealand government's review[122] of the insolvency laws in 1999, the Law Commission formed the view that it was timely to consider the re-enactment of the Wages Protection and Contractor's Liens Act in a modified form. As a result, the Law Commission in November 1999 published a further report[123] recommending the enactment of a Construction Contractors Protection Act modeled on the recent NSW Act in Australia.

3.5.2 The Construction Contracts Act 2002

The Construction Contracts Act 2002 (hereinafter referred to as the CCA) was accordingly enacted in New Zealand to reform the law relating to construction contracting and payment. The purpose of the CCA is stated to be as follows:

> "a) to facilitate regular and timely payment between the parties to a construction contract;
> b) to provide for the speedy resolution of disputes arising under a construction contract; and
> c) to provide remedies for the recovery of payments under a construction contract.[124]"

The scope of coverage of the CCA is wide but to some extent different from its counterparts in the United Kingdom and the states of Australia. The CCA applies to

[122] New Zealand Law Commission Report 1999 - *Priority Debts* at para 206.
[123] New Zealand Law Commission Report 1999 - *Protecting Construction Contractors; An Advisory Report to the Ministry of Commerce.*
[124] Section 3.

all construction contracts, to wit, any contract for the carrying out of construction work.[125] It includes residential construction contracts.[126] It binds the Crown as well.[127] Nevertheless, the CCA does not extend to construction work by employees[128] and loan and indemnity agreements.[129] It is thought that by the definition of construction work in the CCA, consultancy services and supply of materials in relation to the work are excluded.[130] The CCA applies whether the construction contract is written, oral or partly written and partly oral and whether or not the construction contract is governed by New Zealand law.[131] There is also a provision prohibiting contracting out from the CCA.[132]

As with its counterpart in the states of Australia, the CCA has detailed provisions on payments, adjudication of disputes and post adjudication remedies. In gist, the CCA preserves the rights of the parties to agree on progress payment provision in the construction contract but provides for progress payment in the absence of express terms on it.[133] Conditional "pay when paid" payment provision has been prohibited.[134] In addition, there is the scheme of enforcement of payment provided in the CCA whereby if a payer fails to pay the claimed amount in a case where the payer has not provided a payment schedule to the payee in consequence of a demand by the payee under the CCA, then the payer is liable for the unpaid claim

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[125] Section 6.
[126] Section 10.
[127] Section 8.
[128] Section 11(a).
[129] Section 11(b).
[130] *Supra* n. 119. at 40.
[131] Section 9.
[132] Section 12.
[133] Sections 14 to18.
[134] Section 13.

as an enforceable debt in court or the payee may opt to suspend the carrying out of the construction work after due notification or both.[135]

As to adjudication[136] under the CCA, it is similarly a fast track process designed to provide an interim determination of the dispute between the parties to a construction contract. The provision on adjudication is wide in that any party to a construction contract has a right to refer the dispute (which can concern payment or determination of the rights and obligations of the parties) to adjudication.[137] Further it is possible for a sub contractor to seek relief in adjudication against the owner of the construction site by applying to make the owner jointly and severally liable with the main contractor. In this regard, approval may be sought to issue a charging order over the site.[138]

The time limits for adjudication under the CCA is that the adjudicator must determine the dispute within 20 working days (extendable by 10 days at the adjudicator's own volition) after the service of the written response to the adjudication claim or such further time as the parties may agree.[139]

The adjudication determination on payment may be enforced as a debt or as a judgment in court. In addition, the unpaid party may suspend the carrying out of the work after due notification.[140] As to non payment determination, the

[135] Sections 19 to 24.
[136] Sections 25 to 71.
[137] Section 25(1)(a).
[138] Sections 29 to 30.
[139] Section 46(2).
[140] Sections 58(1) and 59.

adjudication determination is not enforceable but the court may be moved to make a determination of the rights and obligations of the parties and the court is obliged to have regard to the adjudication determination.[141] Where the adjudication determination is made which requires the owner to be jointly and severally liable and, at the same time, a charging order over the site is approved, the owner is entitled to apply to the District court to review the determination.[142]

3.5.3 The Post CCA Position

The CCA provided a balanced and fair protection of all parties to the construction contract. There has been a marked effect on the attitudes within the New Zealand construction industry and payment practices have changed overnight. By the introduction of the CCA there had been a significant decrease in the number of construction insolvencies and liquidation. In addition, there has been little intervention by the courts and most adjudication determinations have been enforced without difficulty.[143]

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[141] Section 58(2).

[142] Sections 52 to 53.

[143] Geoff Bayley, *A Small Step Towards Zero Payment Default but a Giant Leap Towards Greater Efficiency* (CIDB International Forum 2005) as well as interview with Geoff Bayley in London in May 2006.

3.6 Singapore

3.6.1 Introduction

The norms of the property and construction industry in Singapore are closest to Malaysia, as both countries have English origins and very similar local conditions. For instance, for a long time, both countries shared similar contracting arrangements based on standard forms of construction contracts which originated from the JCT in the United Kingdom. The Singapore Institute of Architects (SIA) private sector form has however been completely rewritten solely by the late Ian Duncan Wallace Q.C. in the late 1970s and had since undergone six revisions. The public sector PWD form of Singapore has also been revised significantly in the 1990s and again in 2004 and was modeled after the SIA form. The Housing Development Board did likewise to its standard form.[144] The structure of the construction industry is also very similar as that in Malaysia but the Singapore business environment is more competitive. The Singaporean players at the owner level are big and financially sound and real properties are often sold to the public on a "build and then sell" basis.[145] The financing of projects are usually through internally raised capital.

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[144] Chow Kok Fong, *Law and Practice of Construction Contracts* (Thomson Sweet & Maxwell Asia, 3rd ed., 2004) at 85.

[145] Interviews with Mr. Chew Boon Yeow, a director of development company, Ms Eugenie Lip, a practising quantity surveyor, Mr Ng Cheng Huat, a director of a construction company and Mr Michael Chia Peng Chuang, a practicing construction lawyer in Singapore between 2006 and 2007.

Nevertheless, the Hon. Lee Sieu Kin, Second Solicitor General of Singapore[146] remarked:

> "From its peak in 1997, the construction industry has been in a long term decline as Singapore approached maturity in infrastructural development. However the industry remains an important segment of the economy constituting 5% of the Gross Domestic Product annually. The decline has brought about many problems in the construction industry, the most important of which is in terms of cash flow. Although this has always been an important issue, in the heady days of high growth it was ameliorated by the proliferation of projects that enabled contractors to finance one project from funds obtained from a previous one. Those days are now gone. The construction industry relies on a chain of payments down the line of sub contractors and requires a delicate balancing act to ensure that the funds trickle down smoothly and in a timely fashion so that essential players remain solvent. A failure in any link in that chain could trigger a collapse of a part or the whole of that chain, and more importantly, cause a severe delay in the progress of the project and the injection of funds into the economy. This was manifested in a number of well publicized collapses of large building contractors in the past few years."

The Singapore forms of contract placed express emphasis on temporary finality of certificates.[147] In other words, certificates in construction contracts are meant to be cashable to provide cash flow. Nevertheless, it is stated[148] that this has not been the position in reality. Many construction payment problems were due to one party making unwarranted deductions from sums otherwise due to the party who performed the work. An owner might deduct sums against payments otherwise due

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[146] Chow Kok Fong, *Security of Payments and Construction Adjudication* (LexisNexis, 2005) at Foreward.
[147] See for example, Clause 31(11) SIA Conditions of Contract 2004; see also *Tropicon Contractors Pte Ltd v Lojan Properties Pte Ltd* [1991] 2 MLJ 70 and *S.A. Shee & Co (Pte) Ltd v Kaki Bukit Industrial Park Pte Ltd* [2002] 2 SLR12.
[148] *Supra* n. 146. at 2 to 3.

to the main contractor for alleged defects without attempting to particularize or identify the defects as part of a deliberate scheme to improve its cash-flow position in the project. Similarly, a main contractor may set off amounts and counterclaim against payments to sub contractors or suppliers on unproven contentions of incomplete work or liability for delay to the works. There is unevenness in the capacity of different players in relation to the absorption of credit and cash-flow risks. Resolution of these payment problems through arbitration or the courts is normally considered only when the accumulated progress payment claim has reached a substantial level, typically in excess of S$500,000. The effort, time and cost needed for these processes may not justify their recourse for the recovery of smaller claims.

Thus, save for the Project Finance problem and to a much lesser extent the Dispute Resolution problem due to the efficiency of the Singapore court system, the other Malaysian Construction Payment Problems discussed in Chapter 2 exist in Singapore as well.

3.6.2 Building and Construction Industry Security of Payment Act 2004

As a result of the abovementioned prevailing problems in the Singapore construction industry, the Building and Construction Authority of Singapore was tasked to carry out an extensive industry wide consultation in 2003 to explore a new payment regime in construction contracting. As a result of the consultation, the Building and Construction Industry Security of Payment Act 2004 (hereinafter

referred to as the SOPA) was enacted. In the reading[149] of the SOPA bill in the Singapore Parliament, the Minister observed:

> "Progress payments are made periodically throughout the project's duration. Parties lower down the value chain usually fund their work in advance and collect payments thereafter. These downstream players will therefore be adversely affected if those upstream fail to make prompt payment for work done or materials supplied. Contractual terms also tend to favour those higher up the chain."

The SOPA is modeled on the Australian NSW Act. The object of the SOPA is to provide a statutory right to payment with the aim of improving cash flow by expediting payment in the building and construction industry.[150] There are two central pillars in the SOPA, the first deals with the right to progress payment and the second is the adjudication machinery.[151]

As to coverage, the SOPA covers any person who has carried out construction work or supplied goods or services under a construction contract or supply contract.[152] There are nevertheless exceptions in respect of contract relating to certain types of residential property, employment contract and work, goods or services carried out or supplied outside Singapore. The contract has to be in

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[149] Cedric Foo, Minister of State for National Development – The Straits Times, 17th November 2004 - public speech on 16th November 2004.
[150] Explanatory Statement of the Building and Construction Industry Security of Payment Bill 2004.
[151] *Supra* n. 146. at 5 to 60.
[152] Sections 2, 3 and 4(1) to (2).

writing.[153] As with the New Zealand CCA, the SOPA prohibits contracting out of the Act or its provisions.[154]

The first pillar of the SOPA on progress payment follows the elaborate NSW Act payment machinery provision and procedure of payment claims as well as payment responses.[155] It is mandatory that the procedure is complied with before a dispute can be referred to adjudication under the SOPA.[156] In other words, the dispute must necessarily have emanated from a payment claim in the first instance. In addition, as with its counterpart in Australia and New Zealand, conditional "pay when paid" payment arrangements are outlawed.[157]

The adjudication mechanism which is the second pillar of the SOPA is the swiftest amongst all its counterparts in the United Kingdom, states in Australia and New Zealand. The adjudicator must make the determination within 14 days (7 days if there is no payment response and adjudication response) after the commencement of the adjudication unless the adjudicator has requested for a longer period and agreed to by both parties.[158] As per the schemes under the various other countries, the adjudication determination under the SOPA is binding unless and until finally determined in court or other dispute resolution proceedings or by settlement between the parties.[159] There is however a short 14 days adjudication review

[153] Sections 4(1) and (3).
[154] Section 36.
[155] Sections 10 and 11.
[156] Section 12.
[157] Section 9.
[158] Section 17.
[159] Section 21.

procedure available to a dissatisfied party but that party is required to pay the adjudicated amount before lodging the application.[160]

The post adjudication remedies provided in the SOPA include:

i) enforcement of the adjudication determination as a judgment debt,[161]

ii) seeking direct payment from the principal,[162]

iii) exercise lien on goods supplied,[163] and

iv) suspension of work or supply.[164]

3.6.3 The Post SOPA Position

The SOPA has imposed a mindset change in the processing of and compliance with a protocol for construction progress payments. Strict adherence is mandatory and cuts across the whole construction industry. Since the inception of the SOPA, there has been less than a hundred adjudication determinations to-date with very limited court challenges on enforcement. The first challenge that was made to the High Court was unsuccessful.[165] In that case the court held that as the SOPA is primarily directed to continually safeguard the financial viability of contractors who are victims of payment delay made in bad faith and perpetuated by upstream

[160] Sections 18 and 19.
[161] Sections 23(2) and 27.
[162] Section 24.
[163] Section 25.
[164] Section 26.
[165] *Tiong Seng Contractors (Pte) Ltd v Chuan Lim Construction (Pte) Ltd* [2007] 4 SLR 364.

contracting parties, it makes no sense to draw an artificially narrow interpretation that the scope of the SOPA was limited to interim but not final payment disputes.

The scheme has been successful, especially as a deterrent against those who unjustifiably wish to withhold construction payment.[166] It has inculcated a "payment conscious" culture in Singapore.

3.7 Summary

The construction industry in the United Kingdom and the various developed Commonwealth countries examined share similar norms and face payment problems which have led to the insolvency and collapse of construction players. The forms of construction contract (including standard forms) used are inadequate to protect players who have executed work or provided services. The common law position is also unsatisfactory especially in regard to remedies against non payment. The dispute resolution procedure via litigation and arbitration has similarly not been effective or efficient to deal with the problems. These problems are similar to the Malaysian Construction Payment Problems identified and discussed in Chapter 2.

It can be seen that all these countries have in recent years enacted statutory solution and safeguards pertaining to construction payment. In gist, there is the emphasis on the right to regular progress payment as well as the prohibition of conditional

[166] Interviews with Michael Chia Peng Chuang, a practising construction lawyer in Singapore on 31st July 2008 and Chow Kok Fong, a practising arbitrator and adjudicator in Singapore on 7th August 2009.

payment. There is also the creation of a rapid dispute resolution procedure known as adjudication. This procedure is swift and the determination is temporarily binding unless and until re-determined in arbitration or court. The adjudication determination also attracts various post adjudication remedies provided in the statute, typically enforcement as a court judgment.

The experiences of these countries reveal that the aforediscussed statutory solution is positive and the way forward for the construction industry.

CHAPTER 4

THE NORTH AMERICAN CONSTRUCTION INDUSTRY PAYMENT - EXPERIENCE AND SOLUTIONS

4.1 Introduction

This Chapter deals with the construction industry payment position in the Northern American continent, to wit, the United States of America (USA) and Canada respectively.

As in the previous Chapters, each part is devoted to an examination of the construction norms and contracting arrangements. Just as in Chapter 3, this Chapter will examine whether the problems encountered are similar with the Malaysian Construction Payment Problems set out in Chapter 2. The norms, in particular the funding and payment security arrangements are treated in greater detail because they are quite dissimilar to that in Malaysia and the Commonwealth countries discussed in the previous Chapter 3. This is followed by the examination of the payment problems and discussion of the common law as well as statutory provisions that have been enacted to cope with the problems. In so far as legal solutions are concerned, particular emphasis is given to mechanic's lien which is unique to these countries.

The discussion of the construction industry payment position in the USA will focus on the state of Hawaii. This is because USA is a very big country and Hawaii has a

construction industry of comparable size and dynamism with the Malaysian construction industry. As for Canada, the position in the state of Ontario is examined. Ontario is the most active and dynamic as far as the construction sector is concerned.

4.2 The Position in the United States of America

4.2.1 Generally

The construction industry in the USA has always been a significant contributor to her economic well being and gross domestic product. In the reported nationwide census carried out in 1997, the construction industry recorded the value of construction work done amounting to USD845,543,552,000.00. In the state of Hawaii, it is recorded at USD4,441,264,000.00.[1] By 2007, the value of construction work in the USA has grown to USD1,781,778,684,000.00.[2] In Hawaii, the value has however shrunk to USD3,585,447,000.00.[3] The Hawaiian construction industry is primarily sustained by housing and government construction. As for governmental construction, various branches of the U.S. military have spent several billions of dollars in home construction and base renovations, largely on the island of Oahu.

The owner in the USA is typically also the entity that provides the site, the design, the organizational process, and the money for the project. With some exceptions,

[1] US 1997 Economic Census, issued January 2000.
[2] US 2007 Economic Census, released 17 March 2009.
[3] State of Hawaii Databook 2007, Section 21- Construction & Housing.

such as real estate developers, owners tend to be "one-off" players and not the repeat players found in the contractor and professional segments of the industry.

The most important owner differentiation is between public and private entities. The private owner can select its design professional (by competitive bid or negotiation), its contractor (by competitive bid or by negotiation) and its contracting system (single contract or multiple, separate prime contracts) in any manner it chooses. In other words, the private owner is able to conduct its business as the owner sees fit.

In contrast, public agencies are limited by statute or regulation. As a rule, they must hire their designers principally on the basis of design skill and design reputation rather than merely fee competition. However, as to the construction work, the construction contract must generally be awarded to the lowest responsible bidders, often to separate specialty trade contractors.[4] In Hawaii, the public agencies are subject to the Public Procurement Code which applies to the procurement of goods, services and construction.[5]

Condominium housing projects are the most prevalent private sector development and construction in Hawaii. The developers of condominium apartment projects in Hawaii must comply with the statutory provisions in Hawaii Revised Statutes Chapter 514A on Condominium Property Regimes. The definition of condominium apartment is very wide and it includes property intended for any type of use or uses

[4] Justin Sweet, *Legal Aspects of Architecture, Engineering and the Construction Process* (Brooks/Cole Publishing Company 6th ed., 2000) at 81.
[5] Hawaii Revised Statutes (HRS) § 103D-11.

having common elements with other apartments.[6] The application of the statute is attracted whenever the developer or owner(s) declare through the execution and recordation of a master deed its desire to submit the property to the condominium property regime.[7] Thus, except residential houses, most private development projects come within this regime.

The statutory provisions regulating the sale and construction of the project are strict and elaborate. These include the developer having to register the project with the State Real Estate Commission and that the project cannot be offered for sale unless and until the project is registered and the Commission has issued the effective date for the project's preliminary, contingent final or final public report.[8] The preliminary report and contingent final report must disclose and submit all material facts pertinent to the project to the Commission[9] which would invariably include funding proposals of the project. The final report must include satisfactory evidence of sufficient funds to cover the total project cost from purchasers' funds, equity funds, interim or permanent loan commitments and satisfactory performance bond or other instrument of security issued by a surety licensed in the State of not less than one hundred percent of the cost of construction.[10] The aforesaid statutory provision sufficiently deals with and avoids the Project Finance problem aspect of the Construction Payment Problems encountered in Malaysia.

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[6] HRS § 514A-3.
[7] HRS § 514A-20.
[8] HRS § 514A-31.
[9] HRS § 514A-37 and 39.5(3).
[10] HRS § 514A-40(3) and (5).

The penalty for not complying with the abovementioned provisions is a misdemeanor punishable by a fine not exceeding USD10,000.00 or an imprisonment not exceeding one year or both.[11]

Again just like in the other countries examined in Chapter 3, the contractor is the entity which contracts with the owner to construct the project. In the USA, construction is largely local with contractors serving a single metropolitan area. However, few construction companies are even regional, let alone national or international.[12] In Hawaii,[13] the average contractor company is family owned, with a small number of employees. They operate usually as main contractors and they also operate as sub contractors to bigger main contractors for complex projects. Most workers are hired from a union or otherwise. There are however recent influx of bigger foreign contractors.[14]

Main contractors obtain their work by competitive bidding. Profit margins are low. Many contractors are specialty contractors, and one out of two of workers plies a specialized trade, such as plumbing, electrical work, masonry, carpentry, plastering and excavation. Thus in many construction projects, the contractor acts principally as a coordinator rather than as a builder. The principal function of the main contractor is to select a group of specialty contractors who will do the job, schedule

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[11] HRS § 514A-49.

[12] *Supra* n. 4. at 84.

[13] Website of the General Contractor's Association of Hawaii – www.gcahawaii.org/ (last accessed in June 2007).

[14] Interview with Lou Chang, Attorney at Law of The Accord Group LLC at University of Hawaii on 19th November 2003.

the work, supervise specialty trades for compliance with schedule and quality requirements and act as a conduit for the money flow.

The main contractors are also often underfinanced. They may not have adequate financial capability or equipment when they enter into a project. They often spread their money over a number of projects. They expect to construct a project with finances furnished by the owner through progress payments and with loans obtained from lending institutions. The construction industry has as a result attracted contractors of questionable integrity and honesty. These contractors will try to avoid their contractual obligations and conceal inefficient or defective performance. Such contractors are skillful at diverting funds intended for one project to a different project.[15]

Besides the main contractor, there will invariably be the involvement of a large number of sub contractors and possibly sub-sub contractors in large projects. Each one of these, as well as the contractor itself, purchases supplies and rents equipment. The material and equipment suppliers therefore also have a substantial stake in the construction project.[16]

In Hawaii, the main contractor and the sub contractors are required to be licensed to operate and/or advertise as general engineering or building contractor or specialty contractor.[17] This includes material suppliers too whose materials or goods

[15] *Supra* n. 4. at 84 and 85.
[16] *Id,* at 86.
[17] HRS § 444-9 and interview with Lou Chang at *Supra* n. 14.

supplied will become incorporated into the permanent fixed part of the structure.[18] The object of licensing includes ensuring the person possesses a history of honesty, truthfulness, financial integrity and fair dealing. In this regard, it is provided that a person who during the six years prior to application has failed to satisfy an undisputed debt or a judgment relating to services or materials rendered in connection with operations as a contractor shall be presumed not to possess a history of financial integrity.[19] All contractors must be licensed by the Contractors License Board of the Department of Commerce and Consumer affairs in order to enforce a contract to be paid for the construction work done.[20]

In the Hawaiian Supreme Court case of *Butler v Obayashi*,[21] it was held that the statutory provision in the Hawaii Revised Statutes prevented the main contractor from seeking payment for the work carried out (notwithstanding the unlicensed contractor's attempt to challenge the validity of the statutory restriction) where the owner knew that the main contractor was unlicensed at the time the contract was made. The Supreme Court unanimously wrote that:

> "*HRS Chapter 44*, providing for the licensing of contractors expresses a very strong public policy that contractors in this state should apply for, and receive licenses, and the provisions of *HRS §444-22* which are sweeping in their terms, are obviously intended to produce harsh results in furtherance of that policy."

[18] HRS § 444-2(4).
[19] HRS § 444-11(3).
[20] HRS § 444-22.
[21] 71 Haw. 175 (1990).

In addition, unlicensed contractors are prevented by statute from obtaining a mechanic's lien,[22] which is the predominant measure of security for payment. It is also a misdemeanor on the part of the contractor to operate without a license.[23] The licensing requirements are vigilantly enforced to make sure that contractors are sufficiently financed to undertake construction work so that their sub contractors and suppliers will be paid.[24] Thus the Project Finance Problem is again curtailed.

Besides the contractors in the construction industry, there are the design professionals who usually comprise architects and engineers. They are normally appointed by the owner to provide the design and supervision of the construction of the project. In Hawaii, these professionals must likewise be licensed.[25] It is said that the professionals often find themselves in the uncomfortable position of working for the owner yet being expected to make impartial decisions during the construction. The professionals, like the contractors also face tough competition, because there is usually not enough work to go around.[26]

The owner, contractor and design professional are described as the principal players in the construction industry. There are also usually secondary players such as professional bonding company and insurer.

The professional bonding company is involved as surety to perform or to pay a specified sum of money on the default of the principal debtor to the beneficiary. It

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[22] HRS § 507-49(b).
[23] HRS §444-9.3.
[24] *Supra* n. 14.
[25] HRS § 464-2.
[26] *Supra* n. 4. at 85.

is a common requirement for the main contractor as principal debtor to furnish performance bond to the owner as beneficiary. Likewise, the sub contractors are required as principal debtors to furnish performance bond to the main contractor as beneficiary. In public construction projects in the USA including the state of Hawaii, the contractor is also statutorily required as principal debtor to furnish payment bond to secure in a manner satisfactory to the public agency the protection of all persons supplying labour and material to the main contractor for the performance of the work.[27] The surety's function is to assure one party that the entity with whom it is dealing with will be backed by a financially responsible body.[28]

The insurer is commonly concerned with providing indemnification to the contractor and sub contractors on the occurrence of unusual and unexpected events in exchange usually for the main contractor paying a premium. In a way the insurer also provides financial security.

4.2.2 Project Funding

a) Sources of Funds

Few construction projects are paid for solely out of the developer or owner's own fund. Residential house construction may be an exception. There are two reasons for this, to wit, most developers have insufficient ready capital and, in any event, it

[27] HRS §103D-324(Supp.1998).
[28] *Supra* n. 4. at 633.

is often advantageous to leverage real estate projects through loan financing.[29] Construction lenders provide interim financing for the construction of most private and some public construction projects in the USA. Construction lenders include not only private financial institutions but agencies of the US Government, such as the Federal Housing Administration and the Farmers Home Administration, which finance public-purpose projects through loans to non profit corporate borrowers.[30] The other public projects are usually funded from the budget allocations made to the respective agencies.

The greater portion of the cost of a private construction project is always funded initially by means of a short-term loan from an institutional lender known as a construction loan. When construction is complete, a permanent loan replaces the construction loan. Generally two different lenders are involved in the private real estate construction projects. Firstly, there is the construction lender who provides funds to finance the project while construction is underway. Construction lending is ordinarily the province of commercial banks. Secondly, there is the permanent or "take-out" lender who provides permanent financing, often to pay off the loan given by the construction lender. Financial institutions, insurance companies and pension funds are often the permanent lenders. Occasionally the construction and permanent loans will be underwritten by a single lender.

The construction loan is secured by a mortgage on the project. A typical construction loan does not require amortization of principal, but periodic payment

[29] John G. Cameron Jr., *A Practitioner's Guide to Construction Law* (ALI – ABA, 2009) at 1-1.
[30] Bruner & O'Connor, *Construction Law Vol. 3* (Thomson West, 2002) at 243.

of interest only. The entire principal amount of the loan is payable in a lump sum on a prescribed date. This is usually within a stated time after completion of the project. The construction loan is repaid by the takeout or permanent loan which typically has a longer term. The repayment is ordinarily regular payment of installments of principal and interest with a "balloon" payment at the end of the term of the loan if it is not self amortizing.[31]

The construction loan documentation is usually designed to minimize the lender's risk and to maximize the lender's rights and remedies against default on the part of the owner. The common defaults include diversion of funds or failure to properly disburse funds by the lender, failure to keep the project free of liens or other encumbrances and/or project costs exceeding approved levels.[32]

The construction loan is disbursed to the owner in periodic installments as construction progresses pursuant to the terms of the loan agreement. The lender will advance funds not exceeding the value of the work performed less the amount of equity the owner is required to have in the project. The project architect would attest to the progress and quality of construction. In this respect, the architect certifies the work for payment when a request for payment is made by the main contractor.[33]

That notwithstanding, the lender will always require a mortgagee's policy of title insurance to be furnished by the owner or developer. This insurance policy is

[31] *Supra* n. 29. at 1-1 and 1-2.
[32] *Supra* n. 30. at 244 to 245.
[33] *Supra* n. 29. at 1-5.

primarily to protect the lender in the event the title becomes encumbered by claims arising from mechanic's liens. The title insurer accordingly acts as the lender's disbursing agent with instructions from the lender that each disbursement must only be made to the owner when the title insurer is prepared to endorse on the lender's policy after having checked for intervening lien claims which may have priority over the mortgage.[34] The lender will not make any disbursement on the construction loan until the title insurance company authorizes them. The title insurance policy must be endorsed each time a disbursement is made so that its coverage limits are increased to reflect the aggregate amount disbursed since the loan was originated. At the time of each disbursement, inquiries and searches on real estate titles will be done by the title insurer to review payment requests, lien waivers and other construction documents to determine whether a payment request should be honored.

In Hawaii, if the project is a condominium property regime and partly financed from the proceeds of the sale, it is statutorily[35] provided to create an escrow arrangement if the apartments are conveyed prior to the completion of construction of the building or buildings for the purpose of financing such construction. All moneys from the conveyance of such apartments, including any payments made on loan commitments from lending institutions must be deposited by the developer in a trust fund with a bank, savings and loan association or a trust company under the escrow arrangement.

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[34] *Supra* n. 29. at 1-6 and interview with Mike Freed and Earl T. Sato, Attorneys at Law of Rush Moore Craven Sutton Morry & Beh at their premises on 13th November 2003.

[35] HRS § 514A- 67.

It can therefore be discerned that the project funding at the apex owner or developer level is as a matter of norm tightly controlled and administered. The construction lenders must be comforted that the project is viable besides the fund financing being adequate and properly securitized.[36] The Project Finance problem in Chapter 2 is therefore comprehensively dealt with and avoided in the USA.

b) Fund Flow

The disbursement of fund is made, from time to time to pay for the construction costs of the building in proportion to the valuation of the work completed and for architectural, engineering, finance and legal fees and for other incidental expenses of the project as approved by the lender mortgagee. The final balance of the moneys loaned would be disbursed only upon completion of the building free and clear of all mechanic's liens. This provision is designed to prevent the diversion of the project funds by the owner or developer.

Typically, the main contractor on any substantial project is paid by the owner monthly as the work progresses with a customary withhholding of retainage of 5 to 10 percent. This retainage delays cash flow from the main contractor to those sub contractors and suppliers to whom it owes payment. Nevertheless, the main contractor often faces cash flow problems caused by the lag between payments to the main contractor and its corresponding obligations to the sub contractors. When there are retainages, the cash flow problem is more serious.

[36] *Supra* n. 14.

In the USA, it is also common that main contractors generally use sub contract payment provisions to minimize cash flow problems. These provisions frequently permit the main contractor to delay paying the sub contractor until the main contractor has been paid by the owner. As a result, the sub contractor with credit faces financial hardship when the credit is withdrawn or limited. By increased usage of sub contracting, there is more likelihood that non performance by a sub contractor will delay payment to other sub contractors in the tiers below who have performed properly. The sub contracting system therefore heightens the financial stress inherent in the fund flow through process because it increases the distance of the money flow.[37]

Notwithstanding the aforementioned problems with cash flow and construction disputes that have arisen therefrom, there have however not been any major construction insolvencies and collapses of construction players in Hawaii.[38] This is because there is adequacy of the funding at the owner or developer level and the availability and enforcement of security for payment by way of mechanic's lien action.

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[37] *Supra* n. 4. at 549.

[38] Interview with Earl T. Sato and Walter Beh, Attorneys at Law of Rush Moore Craven Sutton Morry & Beh at their premises on 13th November 2003.

4.2.3 Construction Contracts

a) Generally

In the USA, design and construction work frequently are performed after parties have assented to a standard prepared contract form created by associations such as the American Institute of Architects (AIA) or the group of engineering associations who created the Engineers Joint Contract Documents Committee (EJCDC).[39]

The AIA form of contract documents are most useful for small or middle priced projects as well as large scale residential or commercial projects in which design and construction are separated and in which the architect plays a central administrative role.[40]

The AIA form of contract is the most commonly used between the private owner and the main contractor for building construction in Hawaii.[41] The AIA forms of contract often comprise the A101-1997 Document which is the standard form of agreement between owner and contractor where the basis of main contracting payment is a stipulated sum under the traditional method of procurement. It is used together with the A201-1997 Document which is the general conditions of the contract for construction. The owner will then usually enter into a separate

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[39] *Supra* n. 4. at 379.
[40] Justin Sweet & Jonathan Sweet, *Sweet on Construction Industry Contracts: Major AIA Documents* (Aspen Publishers 4th ed., 2003) at 18.
[41] *Id.* at 14.

agreement with the architect using the B141-1997 Document which is the standard form of agreement between owner and architect with standard form of architect's services.[42] If however the design and build method of procurement is used, the A191-1996 Document which is the standard form of agreement between owner and design/builder is used.

Generally the owner does not dictate the use of an AIA document for construction services. The AIA document is often selected by the parties to the contract because of the document's reputation for fairness and familiarity. Nevertheless, changes are frequently made in AIA documents, principally in the areas of payment, changes, indemnification, arbitration and the responsibilities of the design professional.[43]

As for public construction projects in the State of Hawaii, the form of contract adopted for use between the Government and the contractor is the Interim General Conditions 1999 Edition.[44]

At the sub contracting level, where the A101-1997 Document is used, it is likely that the contractor will enter into sub contracts at least with first tier sub contractors using the A401-1997 standard form of agreement between the main contractor and sub contractor. The most widely used forms of sub contracts in Hawaii are those drafted by the American Institute of Architects (AIA) and the Associated General

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[42] *Ibid.*

[43] *Supra* n. 4. at 380 and interview with Karin L. Holma of Bays Deaver Lung Rose & Baba at their premises on 20th November 2003.

[44] *Supra* n. 14.

Contractors of America (AGC).[45] They are nevertheless also usually subject to changes especially on the payment provision.[46] In other cases of sub contracts, they are usually simple contracts often drafted by the main contractor. For supply contracts, they are often based on simple purchase orders.[47]

In a typical construction project, the sub contractor in the lowest tier is the one with the weakest bargaining power. In addition to strong bargaining pressures from main contractors or higher tier sub contractors, lower tier sub contractors also face the strong bargaining power of large suppliers and construction trade unions. Sub contractors, especially those at the lowest tier, often find themselves squeezed on all sides because of their poor bargaining position. Just as main contractors prefer an AIA document over a bespoke construction contract drafted by the owner, the sub contractors are likely to prefer a sub contract drafted by the AIA to one prepared by the main contractor.[48]

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[45] Gerald Clay, Karin Holma & David Schulmeister, *Hawaii Construction Law and Mechanic's Liens* (PESI, 2003) at IV-1.

[46] Interview with Karin L. Holma, Attorney at Law of Bays Deaver Lung Rose & Baba at their premises on 20th November 2003.

[47] *Supra* n. 14.

[48] *Supra* n. 4. at 551.

b) Main Contracts

1) Progress Payment

All the major standard forms of contract provide for progress payments by the owner to the main contractor.[49] The main contractor's entitlement to progress payment in all the major forms of contract is subject to the determination of a professional third party such as the licensed architect or engineer. The determination is labeled as certificate or recommendation as the case may be.

The main contractor is obliged in the A101-1997 read together with the A201-1997 Documents[50] to submit an application for progress payment to the professional third party with substantiating information and documents in order for the third party to make his determination. Upon the receipt of the main contractor's application for payment, the professional third party must make his determination of the entitlement of the contractor taking into account various provisions set out in the payment clause of the contract.

The determination is based on the professional third party's evaluation of the work and amount properly due to the main contractor. The professional third party is entitled to withhold the certification for non conformance with the contract on the part of the main contractor. The review by the professional third party of the main contractor's applications for payment is to fulfill the contractual responsibility to

[49] Article 5 of the A101-1997 Document and Article 8.4 of the Interim General Conditions.
[50] Articles 5 and 9.

ensure that the work has been performed adequately and to the level of progress represented by the contractor. The review is also necessary to avoid exposure of government entities under false claim statutes.[51] Under the AIA form of contract, the evaluation represents the architect's belief that the quality of the work is in accordance with the contract documents and that the work has progressed to a point indicated in the main contractor's application for payment.[52]

The preparation of the certificate for payment is the responsibility of the architect.[53] The power available to the architect to withhold progress payment certification is wide and may be harsh to the main contractor, particularly if the architect is strict and stringent on the work quality standard achieved. Without receiving the funds due and owing for work properly completed, the main contractor may have no other option but to default.[54] The power of certification is discretionary and the exercise of it will be left to the good sense of the architect but not the arbitrary whims of the owner.

The owner does not want its payments to run ahead of the work. Furthermore the owner would not want to pay on the basis of the main contractor's expenditure if that would shrink the retainage. This may occur if the architect certifies solely on the basis of the contractor's cost rather than the proportion of the contract price earned. On the other hand, because the main contractor needs money as it performs, an overzealous withholding of funds can be devastating. Like many

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[51] *Supra* n. 4. at 477.
[52] *Supra* n. 30. at 44.
[53] *Supra* n. 29. at 10-44.
[54] *Id.* at 10-44 to 10-45.

other problems, this situation involves a delicate balancing of the rights of the parties by the architect.[55]

2) Retainage

Retainage is the American equivalent of retention in Malaysia. In the major standard forms, retainage provides security to the owner against non performance of the main contractor. In the Interim General Conditions,[56] the retainage provision is applicable against all progress payment but the third party professional has the discretion to elect not to require further retainage beyond 50% completion if the work is progressing satisfactorily. Retainage is however only an optional provision under the A101-1997 Document[57] though it is often used.[58]

As to retainage, the owner usually retains a certain portion from progress payments to secure itself in the event of either the main contractor's breach or the filing of liens or other claims. The retainage can also be an incentive for the main contractor to finish. The AIA supports retainage but prefers that retainage be reduced as the work progresses.[59] The common contracting scheme is however to pass down through the contracting tiers the owner's right to withhold retainage. In this way the parties that really bear the brunt of the retainage are the sub contractors. In essence, sub contractors thus partially finance the owner's project by permitting the

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[55] *Supra* n. 4. at 488.
[56] Article 8.6 of the Interim General Conditions.
[57] Article 5.1.8.
[58] *Supra* n. 14.
[59] *Supra* n. 4. at 478.

owner to withhold a percentage of their contract price until the project is substantially completed.[60]

3) Final Payment

Aside from the progress payments, there are also provisions[61] in all the major standard forms dealing with the final payment to be made by the owner to the main contractor upon or post completion of the construction work. This payment is again subject to the determination of a professional third party. The final payment provisions contain elaborate mechanisms requiring numerous submissions from the main contractor including obtaining from sub contractors releases and waiver of liens, claims and encumbrances arising out of the carrying out of the construction work.

It is the norm in Hawaii that the main contractor is required to furnish to the owner waivers and releases from sub contractors and suppliers for each and every progress payment. Alternatively, payments are made jointly by the owner to the main contractor and sub contractors who actually performed the work by way of joint cheques.[62] At final payment, the main contractor must submit to the owner an affidavit verifying that its indebtedness to various sub contractors and suppliers has been satisfied. The owner may require further verification documents to this effect including releases and waiver of liens.

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[60] *Supra* n. 29. at 40-41.

[61] Articles 5.2.1-5.2.2 of the A101-1997 Document read together with Articles 9.10.1-9.10.2 of the A201-1997 Document and Articles 7.25.6, 7.25.7, 7.25.9, 8.8.1 and 8.8.2 of the Interim General Conditions.

[62] Interview with Mike Freed, Attorney at Law of Mike Freed & Associates at their premises on 13th November 2003.

4) Remedies for Non Certification and Non Payment

There are several contractual remedies provided in the AIA form of contract for non certification or payment:

i) suspension of work after due notification to the owner by the main contractor;[63]

ii) termination of the contract; [64]

iii) payment of interest.[65]

The AIA form of contract also provides[66] that all claims and disputes arising under the contract including the allegation of error or omission by the architect must be initially referred to the architect for a decision as a condition precedent to mediation and arbitration. Further, there is the provision for mediation and arbitration[67] if either party does not accept the decision of the architect or 30 days after the submission to the architect if no decision is made.

In respect of the Interim General Conditions for public construction projects, the remedy provided against non certification and/or dispute over the certification by the Engineer is to appeal to a designated Comptroller under the contract.[68] There is also a provision[69] for the payment of interest at the rate of 4% per year.[70]

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[63] Article 9.7.1 of the A201-1997 Document.
[64] Article 14.1.1.3 of the A201-1997 Document.
[65] Article 13.6.1.
[66] Article 4.4.1.
[67] Article 4.6.
[68] Articles 8.9 and 72.5.10 of the Interim General Conditions.
[69] Article 7.25.11.
[70] HRS § 662-8.

The construction payment problem seen in the USA especially in Hawaii is seldom that the owner simply refuses to pay the main contractor. There are often contentions by the owner that the architect's certificate was wrong or that there are cross claims that will extinguish or reduce the certified sum. In this regard and in the context of the AIA Document, the owner's refusal to pay is justified if there is a dispute. Accordingly in the light of the dispute, suspension of work by the main contractor under the contract has its risks. If the owner submits the dispute to the architect's decision pursuant to the contract or ultimately to arbitration or litigation, and prevails, the main contractor is exposed to a large damages claim.[71]

As to the certified final payment, if the owner does not make the final payment, the main contractor can claim interest pursuant to the AIA form of contract. Technically, the main contractor can also suspend the work or terminate the contract, but neither action will have practical value, because the main contractor has fully performed. The more frequent problem is whether failure to pay would justify the main contractor's refusing to rectify the defective work. The main contractor would not rectify the defects if it is not paid. If the main contractor is not entitled to payment, the main contractor's refusal to rectify could be considered a repudiation of the contract.[72]

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[71] *Supra* n. 4. at 514.
[72] *Ibid.*

c) Sub Contracts

1) Progress Payment

It is the norm that sub contractors are also paid progressively as they carry out the construction work.[73] The prevalent standard form of contract used is the A401-1997 Document when the A101 and 201-1997 Documents have been used in the main contract. The A401-1997 Document similarly provides for progress payment.[74] However it is administered by the main contractor and not the architect of the project under the main contract. There is similarly the requirement for payment application by the sub contractor which will then be processed by the main contractor for the main contractor's onward inclusion of the main contractor's payment claim to the owner. Payment to the sub contractor by the main contractor is conditioned upon the main contractor receiving payment from the owner. In other words, it is on a "pay when paid' basis.

2) Final Payment

The provision on final payment under the A401-1997 Document requires the sub contractor to satisfy the main contractor that the sub contract work is fully preformed and that the architect has certified the corresponding sub contract work under the main contract.[75] The final payment is also on the "pay when paid" basis

[73] *Supra* n. 14.
[74] Articles 11.1 -11.3 and 11.7-11.9.
[75] Articles 12.1-12.2.

provided that the sub contractor submits proof of payment of all indebtedness connected with the sub contract work.

The contractual payment provisions to the sub contractor which are linked to payment to the main contractor by the owner creates a payment condition vis a vis the main contractor and the sub contractor. Unless the condition is excused, for instance by waiver, if the main contractor is not paid by the owner, then the main contractor need not pay the sub contractor. It was held by the US Federal Court of Appeal that a payment condition cannot, like other conditions, be created by implication as the law requires a degree of explicitness for such a condition.[76] This requirement often avoids the creation of forfeiture, preserves cash flow, and ameliorates the weak bargaining position of sub contractors. The conditional payment type of clauses fall either into the "pay when paid" category or the "pay if paid" category. If the clause is judicially construed to fall into the "pay when paid" category, the clause permits the main contractor reasonable delay before the main contractor must actually pay the sub contractor.[77] If the clause is construed to be a "pay if paid clause", the obligation to pay does not arise until there has been payment by the owner.[78] Thus a "pay when paid" clause deals with time whereas a "pay if paid" clause deals with the risks of non payment.[79] It is ultimately a question of construction of the clause but the language in the AIA form of contract does not appear specific enough to create a "pay if paid" payment condition.[80]

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[76] *Thomas J. Dyer Co. v Bishop International Engineering Co.* 303 F.2d 655 (6th Cir.1962) at 661.
[77] *Id.* at 662.
[78] *Mascioni v I. B. Miller, Inc.*, 261 N.Y. 1, 184 N.E. 473 (1933).
[79] *Supra* n. 4. at 575.
[80] *Id.* at 582.

3) Remedies for Non Payment

The contractual remedies under the AIA form of contract[81] available to the sub contractor for non payment similarly images the remedies available to the main contractor for non payment under the main contract. The notable difference seen is that there is no requirement for the sub contractor to refer a claim or dispute to the architect for a decision before resorting to mediation and arbitration or litigation.

As aforestated, the A401-1997 Document is used only when the A101-1997 and A201-1997 Documents are used in the main contract. In 1998, the Associated General Contractors of America (AGC) withdrew from publication the standard sub contract document AGC 640 for sub contracting usage.[82] Thus, many sub contracts (including those where the Interim General Conditions are used in the main contract) are simple contracts in writing which are drafted by the main contractor. These are often drafted favorable to the main contractor particularly on the payment condition making payment on a "pay if paid" basis.[83] It is nevertheless also common that the A401-1997 form of sub contract is used, the payment provision has been amended accordingly.[84]

That notwithstanding, in the leading conditional payment case of *Thomas J. Dyer Co. v Bishop International Engineering Co,*[85] the Federal Court of Appeals held in favour of the sub contractor that performing parties usually expect to be paid for

[81] Articles 4.7.1 and 6 of the A401-1997 Document.
[82] *Supra* n. 4. at 579.
[83] *Supra* n. 14.
[84] *Ibid.*
[85] *Supra* n. 76.

their work. There is the requirement for very clear and specific language to support the interpretation which favours a party suffering forfeiture by having performed but yet not being paid. The court held that sub contractors (in addition to mechanic's lien protection) contract mainly in reliance on the solvency of the contractor. Hence if there is intention to change this normal credit risks, the contract should contain an express condition clearly showing that to be the intention of the parties.[86]

d) Supply Contracts

There is no standard form of supply contract in the construction industry of the USA. The supply contracts used range from simple written purchase orders issued by the contractor or sub contractor to very elabourate and thorough printed sale terms and conditions prepared by huge suppliers particularly of M&E equipment.[87] Consequently, every contract would differ and have to be construed individually as to the effect of its terms subject to the Uniform Commercial Code.[88]

e) Design Professional Agreements

The AIA has also produced the B141-1997 Document for design services to complement the other Documents used for construction as mentioned in the discussion above. The provisions on payment primarily provide for monthly fee

[86] *Ibid.*
[87] *Supra* n. 14.
[88] HRS Chapter 490.

and reimbursable payment to the architect on presentation of the statement of invoice.[89]

Architectural services often span a lengthy period of time. For that reason most architects cannot afford to wait until the end of performance of the services to be paid. Similarly, delaying payment or allowing the work to outrun payments increases the risk that the architect will not be paid for the services. The right to file a mechanic's lien is a poor substitute for collecting interim fee payments. It is thus essential to have interim fee payment provision and insistence on compliance with that provision for needed cash flow. Furthermore the regular receipt of payment gives an indication of the owner's financial resources and the owner's failure to make an interim payment may be a tip-off to a project disaster. The change in B141-1997 to allow for monthly payment reflects these needs.[90]

The B147-1997 Document also provides[91] remedies of suspension or termination for non payment available to the architect by the owner besides payment of interest.

The failure to pay by the owner may result in the architect exercising remedies of suspension or termination besides charging interest for late payment. The threat to cease work, either temporarily or permanently can be very effective against the defaulting owner but it can also be risky.[92] This is because if the suspension or termination is unjustified, the architect is in repudiatory breach of contract.

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[89] Articles 1.3.9.1 -1.3.9.4 of the B141-1997 Document.
[90] *Supra* n. 4. at 189-190.
[91] Articles 1.3.8.1, 1.3.8.4 and 1.5.8.
[92] *Supra* n. 4. at 192.

As a result, the common and safer way is to bring the claim or dispute to mediation followed by arbitration or litigation as provided in the B141-1997 Document.[93]

Consequently it can be discerned that there is to a limited extent the Unfair Contract Terms problem aspect of the Malaysian Construction Payment Problems in Chapter 2 that is encountered in the USA since there is wide usage of standard forms unaltered. Nevertheless the problem seen is also the "pay when paid" problem at the sub contract levels but the courts are hesitant to uphold the condition of payment that the sub contractor will only be paid by the main contractor when payment is received from the owner unless the term in the sub contract is explicitly and unambiguously drafted.

4.2.4 Construction Payment Problems

There are also frequent problems of withholding of payment at both the main contract and sub contract levels in Hawaii, particularly for defective work as well dispute over variation claims.[94] More often, the withholding is sanctioned by the architect through the exercise of the certification powers under the standard forms of contract. There are also occasions of set off against payment especially at the sub contract level by the main contractor where there is no involvement of the architect. The Withholding of Payment problem aspect of the Construction Payment problems in the context as defined in Chapter 2 thus exists in the USA.

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[93] Article 1.3.4.
[94] *Supra* n. 14.

However, this problem occurs to a limited extent and this is often addressed by the initiation of the mechanic's lien actions, which is discussed below.

4.2.5 Statutes Relating to Construction Payment

a) Liens and Bonds

1) Generally and Historical Perspective

The singlemost significant statute relating to construction payment is that on mechanic's lien. Mechanic's lien laws are complicated and vary considerably from state to state in the USA.[95] Participants in the construction process who can in various ways trace their labour and materials into property improvements of another are given lien rights against the property in the event they are not paid by the party who promised to pay them. The most important lien recipients are the main contractors, sub contractors, suppliers, labourers and design professionals. The remedy accorded a lien holder is the right to demand a judicial foreclosure or sale of the property and be paid out of the proceeds including the legal costs of perfecting the lien, such as attorney's fees.[96]

From a historical perspective, the first American mechanic's lien law entitled was enacted by the Maryland General Assembly in 1791 to facilitate the construction of the new capital city of Washington as part of the Md. Code Ann., Real Prop. All

[95] Robert F.Cushman & Stephen D. Butler, *Fifty State Construction Lien and Bond Law* (Aspen Publishers 2nd ed., 2000) at Vol 1 lxiii; see also *Supra* n. 4. at 565.

[96] *Supra* n. 4. at 566; see also *Lucas v Redward* 9 Haw. 23 (1893) and *Hopper v Lincoln* 12 Haw. 352 (1900).

50 states in the USA now have mechanic's lien statutes. The mechanic's lien may have grown out of maritime law, which granted a lien against a ship to those who furnished material or labour to the vessel. The early common law also granted a lien to mechanics that increased the value of personal property committed to their possession, while the European civil law has long recognized a lien right in a builder. The system of mechanic's lien was motivated by the desire to build up a new and rapidly growing country. At that time without a strong private banking system, the new nation relied upon labourers and material suppliers for credit. The mechanic's lien statutes therefore served to encourage workers and material suppliers to devote their assets to the construction of buildings and other structures.[97]

Mechanic's lien laws provide a quick and effective remedy for unpaid workers to collect their wages. It has been succinctly stated by Professor Justin Sweet[98] that:

> "Quick and certain remedies can induce workers to work on construction by assuring them they will be paid. Amplification of this inducement so vital to a developing country could and did lead to the expansion of lien beneficiaries to include not only labourers but all those who participate directly in the construction process. The state gives credit to prime contractors by granting sub contractors lien rights, which encourages people to furnish labour and materials for construction. This state credit was especially needed to bolster an unstable construction industry composed of many contractors unwilling or unable to pay sub contractors and suppliers. This support is probably the principal reason for giving lien rights today. Expansion of lien laws is undoubtedly traceable to the

[97] James Acret, *Construction & the Law* (Thelen Reid & Priest Construction Law Series) at 177.
[98] *Supra* n. 4. at 566.

realities of the political process. Once some participants in the construction process have received lien rights on frequently asserted unjust enrichment theory, it was relatively easy to expand the list of lien beneficiaries. Those who might oppose lien expansion, such as owners are often unrepresented as an organized group in the legislatures. This too may have accounted for expansion of lien beneficiaries and lien rights. **The desire by participants to expand mechanics' lien rights is understandable, because the mechanics' lien is a more effective remedy than a money award." (emphasis added).**

As with the other states in the USA, the state of Hawaii has statutorily enacted mechanic's lien law as a section of the Hawaii Revised Statutes.[99] The lien is an "in rem" action.[100] The lien is an important security of payment protection for sub contractors and suppliers whose contracts are with the main contractor rather than the owner. Without a mechanic's lien statute, under the common law, sub contractors and suppliers generally cannot assert a claim against the property owner for compensation because they are not in contractual privity with the owner, either directly or as a third party beneficiary of the main contract. The civil suit by the sub contractor or supplier against the main contractor may be a hollow victory if the main contractor has filed for bankruptcy or does not have assets to satisfy the judgment. Thus, a mechanic's lien statute which allows the sub contractor to look to the owner when the main contractor has failed to pay is a valuable remedy afforded by state law.[101]

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[99] HRS § 507 - 43 to 507 - 49.
[100] *Supra* n. 95. at Vol. 1 264.
[101] Albert Tiberi, Hazel Beh and Amarjit Singh, *Mechanic's Liens on Private Projects in Hawaii* (ASCE Publications, Journal of Professional Issues in Engineering Education and Practice Vol. 130 Issue 4, October 2004) at 2 to 3.

Since mechanic's liens are creatures of statute, the right to enforce them is dependent upon meeting the statutory requirements. Whilst statutes are generally liberally construed to effect their purpose, it is however a condition precedent to effectuating a lien that the statutory requirements are met.[102]

In Hawaii, the technical aspects of lien statutes are formidable and care must be taken to strictly comply with the statute.[103]

2) Enforcing the Mechanic's Lien

The process of lien enforcement is examined to have a better understanding of its operational and consequential problems. The benefits and drawbacks of mechanic's liens as construction payment security are thereafter discussed.

i) Entitlement to Lien

It is broadly defined in the Hawaiian statute that any person or association of persons furnishing labour or material in the improvement of real property is entitled to obtain a lien.[104] In *Nakashima Assocs. v Pacific Beach Corp.*,[105] the definition includes professional consultants who have provided services which were used in the project. The case concerns an engineer who had provided plans for the piling of

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[102] *Supra* n. 30. at 275; see also *State Sav. & Loan Ass'n v Kuai Dev. Co.* Inc 50 Haw. 540, 445 P.2d 109 (1968).
[103] *Supra* n. 101. at 3.
[104] HRS § 507-42.
[105] 3 Haw.App.58, 641 P.2d 337 (1982); see also *Haines v Maalaera Land Corp.* 62 Haw. 13, 608 P.2d 405 (1980).

the project. Union and trade organization trust funds have also been allowed to file mechanic's liens for delinquent payments on behalf of labourers.[106] In *H. Hackfeld & Co. v Hilo R.R.*[107] the court allowed the entering of a lien by a material supplier who contracted with a sub contractor but had no privity of contract with the owner or main contractor.

Nevertheless, it is a mandatory requirement that the contractor must be licensed to be entitled to file a lien action.[108] In this regard, even licensed sub contractors working under an unlicensed main contractor may not obtain a lien.[109]

ii) Attachment of the Lien

The statute permits liens upon the improvement and upon the interest of the owner of the improvement in the real property upon which the improvement is located or for the benefit of which the improvement was constructed.[110] In *Jack Endo Electric, Inc. v Lier Siegler, Inc.*,[111] the court held that the statutory provision allowed lienors to obtain a lien on the improvement itself and an interest in the real property of the owner or beneficiary of the improvements. Depending on the terms of the lease, it is also possible to have a lien on the interest of the lessors in the improvements and the real property. Thus the effect of the lien is pervasive.

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[106] *Hawai'i Labourers' Trust Funds v Maui Prince Hotel* 81 Haw. 487, 918 P.2d 337 (1982); see also
[107] *Hawai'i Carpenter's Trust Fund v Aloe Development Corp.* 63 Haw. 566, 633 P.2d 558.
[108] 14 Haw. 448 (1902).
[109] HRS § 444-22.
[110] HRS § 507-49(b).
[111] HRS § 507-42.
59 Haw. 612, 585 P.2d 1265 (Haw. 1978).

iii) Amount of the Lien

It is statutorily provided that the lien would be for the price agreed to be paid (but only if the agreed price does not exceed the fair and reasonable value of the labour and materials) or alternatively the fair and reasonable value of all labour and materials covered by their contract, express or implied (if the agreed price exceeds that value or if no price is agreed upon by the contracting parties).[112] General expenses such as home office overhead, insurance, taxes and profit are often, by themselves, not lienable. Profit is usually a lienable item as it is incorporated as part of the contract price. Failure to substantially complete the work will entitle the claimant only to the reasonable value of the labour and materials furnished rather than the contract price.[113]

In Hawaii, the lien statute is based on the Pennsylvannia model which enables the lienor to recover from the owner when the lienor has not been paid by the contractor, even if the owner has already paid the contractor for the services. This is unlike the statute in several other states which is based on the New York model which does not oblige the owner to pay twice and the lien awarded to the lienor is limited to an amount that remains due to the main contractor.[114]

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[112] HRS § 507-42.
[113] *Supra* n. 30. at 297-299.
[114] *Supra* n. 101. at 4; see also *Masten Lumber & Supply Co. v Brown* 405 A.2d 101 (Del.1979).

iv) Demand for Payment

The lienor must make a demand for payment in writing prior to the enforcement of the lien. The demand can be made before the application for the lien but usually the demand is included with the application and served on the owner at the same time.[115] In *Monji & Umeda v Sanko Contracting Co.*[116] it was held the application was defective where the contractor filed the lien application but failed to demand payment from the owner.

v) Filing the Lien Application

The lien application must be filed in the circuit court where the property is situated in the form of an Application for a Lien and accompanied by a written "Notice of Lien" setting forth the alleged facts by virtue of which the person claims the lien.[117] The contents of the application must include the amount of the claim, the labour or material furnished, a sufficiently detailed description of the property to identify the property, the names of the parties who contracted for the improvement, the name of the main contractor and the names of the owners of the property and any person with an interest therein including the surety of the main contractor.[118] The description of the work done and materials supplied need not be itemized but they

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[115] *Supra* n. 101. at 9.
[116] 32 Haw. 831 (1933).
[117] HRS § 507-43 (a); see also *Haas & Haynie Corp. v Pacific Millwork Supply, Inc.* 2 Haw. App. 132, 627 P.2d 291 (1981).
[118] HRS § 507-43 (a).

must be specific enough to give a clear understanding of the nature of the lien and amount of lien claim.[119]

vi) Filing Deadline

The deadline to file the application is statutorily provided to be no later than forty-five days after the date of the completion of the improvement against which it is filed.[120] In Hawaii, there are three potential dates that can constitute completion of the improvement. If the owner files a valid notice of completion, the date of completion means the date that the owner has satisfied the published notice of completion requirements. The lienor has forty five days thereafter to apply for the lien. If the owner does not file a notice of completion, then the date of completion means one year after the date of actual completion of the improvement or one year after the date the contractor has abandoned work on the improvement.[121]

Generally, substantial performance is sufficient to constitute completion. In *Lansing v Dondero,*[122] it was held that sub contractors, materialmen and labourers may file their mechanic's liens upon the main contractor's or owner's upon abandonment of the work. If however where the main contractor abandoned the work when the building is substantially but not entirely completed (and the owner having taken no steps to complete it), the work is deemed completed.

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[119] *City Mill Co. v Horita*, 21 Haw. 585 (1913), *Wong v Honolulu Skating Ring, Ltd* 24 Haw. 181 (1918).
[120] HRS § 507-43(b).
[121] *Supra* n. 101. at 10; see also HRS § 507-43(f) & (g).
[122] 21 Haw. 736 (1913).

It is the responsibility of the owner or main contractor to publish the notice of completion and the notice must be published twice seven days apart in a newspaper of general circulation. The record of these notices will be kept by the clerks of the various circuit courts.[123]

vii) Service of Lien Application

Subsequent to the filing of the lien application, the Hawaiian statute requires that the owner, main contractor and party who contracted for the improvement and other interested parties must be notified of the application by way of service of the "Application For a Lien" and court stamped "Notice of Lien". It is usually made by the court process server. If the parties cannot be personally served after diligent efforts had been put in, the notice may be given by posting the "Application for a Lien" and "Notice of Lien" on the improved property.[124]

If and where there is a construction loan taken by the owner, the lender would be vigilantly monitoring for the filing and service of these "Notices of Liens".[125] In this regard, it is statutorily provided that the clerks at the circuit courts will keep in their respective offices book on "Mechanic's liens" records.[126]

[123] HRS § 507-44.
[124] HRS § 507-43(a).
[125] *Supra* n. 14.
[126] HRS § 507- 44.

viii) Probable Cause Hearing

The court stamped and served "Application for a Lien" and the "Notice of Lien" will be endorsed with a return day not less than three nor more than ten days after service. On the return day, a hearing will be held by the court to determine whether probable cause exists to permit the lien to attach to the property.[127]

It is also specifically provided in the Hawaiian statute[128] that any person to whom notice is required to be given shall be permitted to offer testimony and documentary evidence on the issue of whether probable cause exists to permit the lien to attach. If the person who contracted for the improvement giving rise to lien claims a set off against the lienor or if any person to whom the notice is required to be given disputes the amount of the requested lien, the court shall hear and receive all admissible evidence offered and shall only permit the attachment of the lien in the net amount the court determines is the reasonable probable outcome of any such dispute.

At the hearing which is heard by the judge of the circuit court without a jury (the proceeding is a proceeding in equity[129]), the court will first determine whether probable cause exists for the attachment of the lien. This is established by the applicant showing that an improvement was made on the property.[130] The court will then receive testimony and review evidence concerning set-off to determine

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[127] HRS § 507-43(a).
[128] HRS § 507-43(a).
[129] Lawrence J. Culligan and Anthony V. Amodio, *Corpus Juris Secundum Vol. 56* (St Paul Minnesota, West Publishing Co.) at 443.
[130] *Haines, Jones Farrel, White, Gime, Architects Ltd. v. Maalaea Land Corp.* 62 Haw. 13 (1980).

whether and for how much the lien will attach. In *Quality Masons, Inc. v. Tomita,*[131] the Hawaii Supreme Court held that:

> "[I]f a lien applicant, in a probable cause hearing, shows that it is probable that it will be able to establish at trial a benefit to the real property by reason of its labour and/or materials, it is then incumbent upon the other parties claiming a set off against the amount of that benefit to show that it is probable that on trial of the mechanic's lien suit, that they will be able to establish a set-off of the given amount. If that set-off equals or exceeds the amount of the lien, then no lien would attach; otherwise, the lien should attach for the net amount of the benefit shown."

The applicant has the burden of establishing for the amount he is entitled to in the lien.[132] In order to recover on quantum meruit, the applicant has the burden of proving what materials were furnished and their reasonable value, and what labour was performed and its reasonable value.[133] Where the applicant proves the full value of his services and if there should be any deductions therefrom by way of mitigation of the amount of recovery, the burden is on the defendant to show the amount thereof.[134]

The evidence to enforce a mechanic's lien in the lien action must be sufficient to show performance of the contract to the extent required to support the lien.[135] It

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131 2 Haw.App. 90, 626 P2d. 204 (1981).
132 *Interstate Lumber Co. v. Rightman* 297 P.579, 112 C.A. 718.
133 *Hurwitz v. Dukas* 186 N.Y.S. 276.
134 *Central Dreging Co. v. F.G. Proudfoot Co.* 158 N.E. 229.
135 *Macknight Flintic Stone Co. v. New York* 79 N.Y.S.521, 78 A.D.641, affirmed 68 N.E. 1119.

has been held that an architect's certificate under the provisions of the building contract is conclusive as to the existence of indebtedness in the absence of fraud.[136]

At the probable cause hearing, the court reviews the pleadings in the same way as it evaluates a motion for summary judgment. In other words, only when evidence presents no conflict does the court enter a final order establishing the lien but, if the pleadings and affidavits indicate a dispute, the court would make an interlocutory order setting out the perimeters of the lien and setting the matter for trial of all issues necessary to final determination.[137]

In Hawaii, the norm is that if there is an arbitration clause in the contract between the relevant parties, the court may instead stay the lien action and order that that the dispute be arbitrated.[138] The lien action would subsequently be recalled up for disposal based on the award of the arbitrator.

If the court (or the arbitrator) ultimately finds that there is probable cause that a lien exists for more than the cumulative amounts of set off claimed, the lien would attach to the property and the lienor has 90 days to foreclose on the property. No lien binds any property for longer than 90 days after the recording of the claim of lien, unless within that time an action to foreclose the lien is commenced in a proper court.[139]

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[136] *Maddux v. Buchanan* 92 S.E. 830, 121 Va. 102.
[137] *Ocean Plaza Joint Venture v Crouse Const, Co. Inc.* 490 A.2d 252, 62 Md.App.435.
[138] *Supra* n. 14.; see also *Frederick Contractors, Inc. v. Bel Pre-Medical Centre, Inc.* 274 Md. 307, 334 A.2d 526 (1975).
[139] *Supra* n. 101. at 13.

ix) Foreclosure

If the owner does not pay off the lien upon demand, the lienor may apply to court to foreclose the property and force its sale in order to recover the lien. The foreclosure action is like a foreclosure on a mortgage or deed of trust.[140] The owner may avoid foreclosure by discharging the lien either by putting in cash or a bond twice the amount of claim for lien into the court.[141]

x) Priority

The legal position on priority of mechanic's lien protection varies from state to state in the USA. Generally, all mechanic's liens will be subordinate to the construction lender/ financier's interest. This is because the lender's security interest is perfected upon the recording of the mortgage, security deed, deed of trust or like instrument.[142] The mechanic's lien in Hawaii attaches on the property with effect from the time of visible commencement of operations for the improvement.[143] It is thus of paramount importance for the construction lender to perfect the security documents before the commencement of any construction operation. The lender vigilantly so monitor.[144] The lender takes priority if all or a portion of the money advanced under or secured by the mortgage is used for paying for the improvement and that the mortgage recites that it is for the purpose to

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[140] *Supra* n. 101. at 13.
[141] HRS § 504-45.
[142] *Supra* n. 30. at Vol. 3 334-335.
[143] HRS § 507-46.
[144] Dialogue with Professor Bruce Graham at University of Hawaii on 2nd January 2004.

secure the moneys advanced for the purpose of paying for the improvement in whole or in part. Payments in good faith to the main contractor for such purposes will be presumed to have been used for the paying for the improvement.[145]

Subject to the aforesaid lender's security interest as well as liens in favour of any branch of the government and liens or judgments filed and recorded prior to the time of visible commencement of operation, and liens for wages for labour performed in completion of the improvement not exceeding USD300.00 per claimant, which takes first in priority, the lien then ranks equally in priority with the other mechanic's liens.[146] This is regardless when each lienor actually commenced or completed their work on the real property.

On foreclosure of the property and after paying off the various interests which took priority, if there are insufficient proceeds to satisfy all equally ranked lienors, the funds would then be divided pro-rata.[147] Obviously the other unsecured creditors will only share out the remaining funds, if any, after the lienors have been paid.

xi) Releases

In view of the severity of lien attachment on the property, the owner would obviously as a norm in the US construction industry want to ensure the right to a lien is waived as payment is made. Although privity of contract is between the owner and the main contractor, the owner with the consent of the main contractor

[145] HRS § 507-46.
[146] HRS § 507-46.
[147] *Supra* n. 101. at 5.

can insure payment of a sub contractor or supplier by making a direct payment to the sub contractor and then subtract the amount of the payment from the earnings of the main contractor. Alternatively, the owner (with the consent of the main contractor[148]) may make payment both to the main and sub contractor by means of a joint cheque payable jointly to both of them. The owner would require a notation to the effect that endorsement of the cheque by both parties acknowledges payment of the full face amount of the cheque and each endorser releases all mechanic's lien rights against the project through the date of the cheque.[149] This norm to ensure payment is made in avoidance of lien attachment is commonly known as policing construction payment.[150]

There is no lien rights on public construction projects because the doctrine of sovereign immunity precludes liens against government property.[151] Thus, in Hawaii, in lieu of lien rights, there is the statutory provision requiring main contractors undertaking public construction work (exceeding USD25,000.00 and USD100,000.00 for state and federal projects respectively) to furnish joint performance and payment bond.[152] The payment bond affords protection to every person who has furnished labour or material to the main contractor for work provided in the contract who is the person having a contract with the state. If a sub contractor or supplier is not paid in full within ninety days from the date of the performance, a written notice of bond claim must be sent to both the main

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[148] This is necessary as it would be a breach of contract in the absence thereof, see *Piedmont Eng'g & Constr. Corp. v. Amps. Elec. Co.* 162 Ga.App. 564, 292 S.E. 2d. 411(1982).

[149] *Supra* n. 97. at 183-184.

[150] *Supra* n. 14.

[151] *F.D. Rich Co. v. United States ex rel. Indus. Lumber Co.* 417 U.S. 116, 121-122 (1974).

[152] HRS § 103D-324 (Supp. 1998).

contractor and the surety. The claim must state the amount claimed and the name of the party to whom the material was furnished or supplied or for whom the labour was done or performed.[153]

3) Benefits and Drawbacks of Mechanic's Liens

The principal attraction of mechanic's liens is to provide financial security to bolster an unstable construction industry composed of many main contractors who are unwilling or unable to pay sub contractors and suppliers. The lien thus benefits and encourages these sub contractors and suppliers to furnish labour and materials for construction with expectation of payment, if necessary, from the foreclosure of the owner's built property through the enforcement of lien rights. Besides, the unpaid main contractor and professional consultants also have similar financial security and enforcement of lien rights against the defaulting owner. In consequence, there is policing of payment by the owner or construction lender to ensure that especially sub and sub sub contractors are paid by the main contractor.

Nevertheless, there are many drawbacks. Whilst the lien operates in priority ahead of other unsecured creditors, the lien is subordinated to the perfected and secured loan rights of the owner's construction lender in the built property. Consequently lien claims become valueless if trouble develops and the construction lender forecloses on the property. In such situation, the lien claim is wiped-out as the leftover fund after foreclosure is usually non existent. In addition, though the

[153] HRS § 103D-324(e) (Supp.1998).

Hawaiian mechanic's lien statute is based on the Pennsylvania model many other states have mechanic's lien statute based on the New York model that limits the amount of the lien to only the unpaid balance owed by the owner to the main contractor. On the other hand, the Pennsylvania model puts the owner at risk of paying twice. Another frequent problem encountered is whether the work qualifies for a lien under the relevant mechanic's lien statute.[154] This is because generic terms such as improvements, building and structures are used in the statutes. The mechanic's lien statute requires stringent compliance, otherwise the lien is invalidated. Substantial compliance is not sufficient.[155] It is therefore vital for parties seeking to enforce lien security to be thoroughly well verse with the lien legislation and procedure such as the lien application and filing. This often requires the services of an attorney and is costly.[156] Finally, it is common practice of parties entering into "no-lien" construction contracts where the owner requires the main contractor to waive lien rights for it and its sub contractors.[157] As a result, the payment security protection of these contractors is lost. These waivers are effective unless prohibited by statute in some of the states.[158]

b) Uniform Commercial Code

In America, contracts for the sale of goods are governed by the uniform Commercial Code (U.C.C.). In Hawaii, the UCC has been enacted as the Hawaii

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[154] *South Bay Eng'g Corp. v Citizens Sav. & Loan Ass'n* 51 Cal.App. 3d 453, 124 Cal.Rptr.221(1975); see also *John F. Bushelman Co. v Troxell* 44 Ohio App. 2d 365, 338 N.E.2d 780(1975) and *Freeform Pools, Inc. v Strawbridge Homes for Boys, Inc.* 228 Md. 297, 179A 2d 683 (1962).

[155] *IGA Aluminum Products, Inc. v Mfg. Bank* 130 CalApp.3d 699, 181 Cal.Rptr. 859 (1982).

[156] *Supra* n. 14.

[157] *Supra* n. 4. at 568.

[158] For e.g. in Illinois and Wisconsin.

Revised Statutes Chapter 490. The U.C.C. does not apply to service contracts or those contracts that involve land.[159] Thus the U.C.C. is available to unpaid suppliers of materials and goods in the construction process only. The principal remedies available to the unpaid supplier are commencing an action for the price of the goods supplied or damages for non acceptance or repudiation.

c) Statutory Protection of Professional Fee

The fee payment to professional consultants is also statutorily protected in Hawaii. It is provided in the Hawaii Revised Statute Chapter 444 at §444-25 that:

> "A contractor shall pay the contractor's subcontractor for any goods and services rendered within sixty days after receipt of a proper statement by the subcontractor that the goods have been delivered or services have been performed. The subcontractor shall be entitled to receive interest on the unpaid principal amount at the rate of one percent per month commencing on the sixtieth day following receipt of the statement by the contractor, provided that this section shall not apply if the delay in payment is due to a bona fide dispute between the contractor and the subcontractor concerning the goods and services contracted for. If there is no bona fide dispute between the subcontractor and the contractor concerning the goods or services contracted for, the subcontractor shall be entitled to payment for goods and services under this section."

This statutory provision operates as a statutorily implied term in the contract. It is applicable in an owner /main contractor and professional consultant relationship or

[159] *Supra* n. 4. at 554; see also HRS § 490:2-102.

in a sub contractor and sub sub contractor relationship and so on as the definition of contractor in the statute is widely defined.[160]

4.2.6 The Common Law Relating to Construction Payment

The common law in the USA recognizes the importance of prompt construction payment.

Therefore, the owner's unexcused failure to pay the main contractor pursuant to a construction contract is almost always regarded as a material or fundamental breach which excuses the main contractor from further performance.[161] In *Guerini Stone Co. v P.J. Carlin Const. Co.*[162] the court held that;

> "In a building or construction contract ... calling for the performing of labour or furnishing of materials covering a long period of time and involving large expenditures, a stipulation on account to be made from time to time during the progress of the work must be deemed so material **that a substantial failure to pay would justify the contractor in declining to proceed." (emphasis added).**

The right of the contractor in declining to proceed and terminate its obligation to perform under the contract is fact sensitive and can thus only be exercised if the owner's failure to pay has grave consequences on the contractor's ability to perform. In addition, the court would also inquire into the likelihood of future non

[160] HRS § 444-1.
[161] *Drainage Dist. No 7 of Poinsett County, Ark. v. Sternberg* 15 F.2d 41 (C.C.A. 8th Cir.1926).
[162] 248 U.S. 334 (1919) at 344.

payment. If there is a clear statement that performance will not be carried out, there is then repudiation. This is a material or fundamental breach that affords the aggrieved party the right and probably the obligation to stop performance.[163] Besides, the persistent failure of the owner to pay together with other breaches committed by the owner may also justify the contractor in terminating the construction contract.[164]

Similarly the contractor's failure to pay its sub contractors and suppliers may constitute a material breach of contract. In *U.S. for Use of Endicott Enterprises Inc. v. Star Brite Const. Co. Inc.*,[165] it was held that the contractor's persistent underpayment in relation to the percentage of completion justified the subcontractor's abandonment of the work. The amount of the withholding is an important factor in determining whether a breach justifying abandonment has occurred. Thus in *Stewart v C& C Excavating & Const. Co.*,[166] it was found that a debt of USD2,385.00 was an insignificant portion of the contract price and did not justify abandonment. If the contractor abandons work and it is later proven that the owner was not in breach, the contractor would then be liable instead to the owner for damages.[167] The decision as to whether to terminate the construction contract and abandon work for non payment can therefore be precarious particularly if there are concurrent breaches of contract by the unpaid party. Thus, to avoid committing

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[163] *Supra* n. 14. at 417.
[164] *Integrated, Inc. v Alec Fergusson Elec. Contractors* 250 Cal App.2d, 287, 58 Cal.Rptr.503 (1967).
[165] 848 F.Supp. 1161 (D. Del. 1994).
[166] 877 F.2d 711 (8th Cir.1989).
[167] *Drew Brown Limited v. Joseph Rugo, Inc.* 436 F.2d 632 (1st Cir. 1971).

a wrongful abandonment of the work, most unpaid contractors instead resort to lien actions for recovery of payment.[168]

Apart from taking an action for breach of contract, there have been cases in various states outside Hawaii where unpaid contractors have sued on the basis of unjust enrichment. The claim is in restitution and it enables the contractor to recover for any net benefit that its performance has conferred on the other party. Thus in *Irwin Concrete, Inc. v. Sun Coast Properties, Inc.*,[169] five claimants mounted an unjust enrichment claim against a construction lender. During the course of construction, the lender informed one contractor that it would have to continue working in order to receive funds and notified another contractor that sufficient loan proceeds were available to pay for the contractor's work. However, at that time, the lender was foreclosing its own deed of trust on the project, thereby misleading the contractors to continue performing. Under those facts, the court held that it would be unjust for the lender to receive the benefit of the contractor's work and not pay for it.

Subsequently in *Twin City Const. Co. of Fargo N.D. v. ITT Industrial Credit Co.*,[170] Twin City contracted with a group of developers to construct a Holiday Inn. The developers defaulted on their progress payments and were forced to secure a rescue loan from ITT. As part of its agreement to provide the loan, ITT insisted that Twin City agreed to complete the project without any recourse against the Holiday Inn property. Subsequently, ITT refused to make the final payment. The court held

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[168] *Supra* n. 14. and interview with Robert Rubin, Attorney at Law of Postner & Rubin, New York Attorneys on 22nd December 2003.

[169] 33 Wash. App. 190, 653 P.2d. 1331 (Div.2 1981).

[170] 358 N.W. 2d 719 (Minn.Ct.App.1984).

that if ITT was permitted to benefit from the work performed by Twin City and also avoid paying out the complete funds relied on by Twin City for its performance, ITT would be unjustly enriched. The court accordingly ordered ITT to pay Twin City as it would be inequitable to permit a financier of a construction project to retain funds committed to a project after completion of the work by the contractor.

Unjust enrichment claims are also often made where the construction contract is an entire contract and the claimant has not sufficiently performed until substantial completion to justify the contractual right to payment.[171] Unjust enrichment claims are also fact sensitive and recovery may be precluded if the claimant has also been in willful breach of contract.[172] In *Blum v Dawkins,*[173] the sub contractor was unsuccessful in its claim for unjust enrichment against the owner when the lien claim failed as the owner had paid out the entire contract price. Sub contractors must use statutory remedies or bonds as otherwise they will be left only with whatever claim they may have with the party with whom they dealt with directly.[174]

4.2.7 Legal Enforcement of Payment Claims and Dispute Resolution

Disputes in the American construction industry are not uncommon. The disputes in Hawaii tend to centre on non payment by reason of alleged constructional defects

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[171] *R.J. Berke & Co. v J.P. Griffin, Inc.* 116 N.H. 760, 367 A.2d 583 (1976) and *Kreyer v Driscoll* 39 Wis.2d 540,159 N.W.2d 680 (1968).

[172] *Supra* n. 4. at 431.

[173] 683 So.2d 163 (Fla.Dist.Ct.App.1996) but see *American Sur. Co. of N.Y. v United States*, 368 F.2d 475 (9th Cir.1966) where the contractor succeeded despite its own breach.

[174] *Supra* n. 4. at 571.

and non agreement over change orders.[175] There are fewer cases on refusal to pay because of funding inadequacy. These claims for non payment are often launched by the main contractor or sub contractors or both. The design professionals on the other hand are seldom involved in claims for non payment against owners usually because their fees have been substantially paid prior to the commencement of construction. In addition, many of these design professionals forbear from making claims because they want to maintain a continuing relationship with the owner.[176]

The traditional forum to enforce a claim and resolve a dispute in the United States is by way of litigation in court. The litigation process of a construction dispute in court can be complex and would likely involve a jury if the case goes to trial as Professor John Barkai commented:[177]

> "Construction projects mean construction disputes and Americans frequently use the courts to resolve conflict. More and more Americans generally, and especially people in the construction industry are however turning away from the courts to resolve their disputes. The courts are seen as too expensive and too slow to resolve cases. In smaller cases, the costs for lawyers and pre-trial discovery may be more than the amount in issue. In really large cases, the legal expenses may be millions of dollars. However the legal costs are only part of the problem. It can take a long time to resolve these cases even if they eventually settle do not go to trial. In large cities in America, it might take up to 5 years between the time a case is filed in court until

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[175] *Supra* n. 14.
[176] *Supra* n. 43.
[177] Professor John Barkai, *Using Alternative Dispute Resolution Techniques in Construction Disputes* (unreported) at 1 and 3.

when the trial is completed. After that either side has a right to appeal the decision to an appellate court to review the decision for errors of law.

The first appeal can sometimes take 2 or more years. There is also the possibility of yet another appeal to a state Supreme Court or even the U.S. Supreme Court. With the appellate process, it might take 7 to 10 years before a decision is final. The cost, the delay, the time away from business, and the emotional toll on the business people are just some of the reason why court is not a favored way to resolve dispute. Arbitration and mediation are the two most common ADR (alternative dispute process) processes used these days."

In Hawaii, arbitration has been used for many decades in the construction industry and arbitration clauses have long been included in the standard form of construction contracts including those published by the American Institute of Architects (AIA).[178] Professor John Barkai further stated[179] that:

"The basic advantages of arbitration versus court litigation are : a) arbitration is usually a faster method to resolve disputes than court litigation; b) arbitration can be conducted privately without any publicity to the proceedings or the result; c) arbitration can be conducted more efficiently and for less money than court litigation; d) arbitration allows the parties to select decision makers who are expert in the areas under dispute; e) arbitration allows the parties to select a convenient forum for deciding their conflicts; f) arbitration can be more flexible than court litigation; and g) arbitration is more final than court litigation since the parties' abilities to seek appeal of the arbitration decision are usually very limited.

[178] *Supra* n. 45. at XV-1.
[179] *Supra* n. 177.

> The disadvantages of arbitration versus court litigation are : 1) it is perceived that arbitrators are less likely to decide matters on purely legal grounds and the ability for parties to challenge an arbitrator's decision on legal ground is usually very limited; 2) the parties have to pay the fees and costs of the arbitrator whereas they do not have to pay for judges and juries; 3) arbitration procedures that limit the discovery that a party can perform against his opponent may facilitate "ambush" tactics at the arbitration; 4) in some cases, arbitration can be more expensive than court litigation if the arbitrators do not control the tactics engaged by the parties; and 5) arbitrators have the reputation of deciding disputes by cutting the baby in half rather than rendering decisions which are one-sided."

The US Supreme Court in *Wilko v Swan*[180] has held that an arbitration award will not be vacated for errors of law unless the award demonstrates a "manifest disregard" of the law.[181]

In the USA, arbitration is governed by statute. In the past, the statutory provision in Hawaii was Chapter 658 of the Hawaii Revised Statutes. This Chapter has recently been wholly revised and replaced with Chapter 658A which adopted the US Uniform Arbitration Act. It takes effect from 1 July 2002.

The arbitration process under the revised statute substantially adopts the procedures and powers available in civil litigation.[182] These procedures and powers, especially those permitting the taking of depositions, discovery and subpoenas for production

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[180] 346 U.S. 427 (1953)

[181] *City of Milwaukee v. Milwaukee Police Ass'n* 97 Wis. 2d 15, 292 N.W.2d 841, *Botany Indus. Inc. v. New York J.B., Amalgamated Clothing Workers.* 375 F. Supp. 485 (S.D.N.Y. 1974).

[182] HRS § 658A-15 to 17.

of documents, would greatly slow down and increase the costs of arbitration.[183] That notwithstanding, arbitration is still the predominant procedure to resolve construction disputes. The main reason is because of the preference for speedier resolution.[184]

Pending the conclusion of the civil suit, the court in Hawaii has the power to order the attachment of the property of the defendant as security for the satisfaction of such judgment.[185] In *Vazquez v. Center Art Gallery*,[186] it was held that attachment is only available where the contract at issue also establishes a debtor-creditor relationship for payment of money.

Similarly in arbitration, the arbitrator is generally recognized to have the power to make orders to safeguard the subject matter of the arbitration.[187] In *re Astoria Medical Group*,[188] it was held that besides the arbitrator, the court may also grant an attachment order against property or an injunction when preservation of assets or the subject matter of a dispute is necessary. The court would grant the attachment order when the dispersion is imminent and the party requesting relief is not simply attempting to thwart the arbitration proceedings.[189] With respect to an injunctive relief, the court grants its assistance only when necessary to preserve the

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183 *Supra* n. 14. and interview with Professor John Barkai at University of Hawaii on 14th January 2004.
184 *Ibid.*
185 HRS § 651-2.
186 485 F.Supp.1015.
187 *Southern Seas Navigation, Ltd. of Monrovia v. Petroleos Mexicanos of Mexico City* 606 F.Supp. 692 (S.D.N.Y.) ; *Compania Chilena De. Nav. V. Norton, Lilly & Co. 652 F.*Supp. 1512 (S.D.N.Y.1987).
188 11 N.Y. 2d 128, 182N.E.2d 85 (1962).
189 *Compania Panamena v. International Union Lines* 188 N.Y.S. 2d 708 (1959).

status quo and prevent a clearly demonstrable and irreparable injury.[190] It is generally very difficult whether in the court or through the arbitrator to obtain an order for prejudgment/award attachment and/or injunction by reason of the high burden and evidentiary requirement placed upon the applicant.[191]

Thus, the provisional remedy most relevant and frequently resorted to in the construction industry is the filing of the mechanic's lien.[192] The filing of a mechanic's lien or the commencement of the foreclosure action does not constitute a waiver of the right to arbitrate.[193]

It can be therefore be summarized that construction disputes including payment disputes are mostly resolved by way of lien actions which are tried mostly via arbitration. Although the resolution may still take time, there is nevertheless security of payment in the lien. Thus, there is no major concern over protracted legal proceedings[194] unlike that of the Dispute Resolution & Security of Payment problem in Malaysia as outlined in Chapter 2. Furthermore, in Hawaii, the mechanic's lien laws have resulted in strict policing of construction payment by the lenders and owners principally to ensure that sub contractors and suppliers are paid by main contractors.[195] This is often done by way of imposed contractual direct

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190 *American Eutectic Welding Alloy Sales Co. v. Flynn* 399 Pa. 617, 161 A.2d 364; *J Brooks Sec. Inc. v. Vanderbilt* 484 N.Y.S. 2d 472 (1984).

191 Interview with Michael K. Livingston, Attorney at Law of Davis Levin Livingston & Grande at their premises on 24th November 2003.

192 Michael T. Callahan, Barry B. Bramble & Paul M. Lurie, *Arbitration of Construction Disputes* (Wiley & Sons, 1991) at 142.

193 *A Burgart Inc. v. Foster-Lipkins Corp.* 30 N.Y.2d 901, 287 N.E. 2d 269, 335 N.Y.S. 2d 562 (1972); *Paul Mullins Constr. V Alspaugh* 628 P.2d 113 (Colo.App.1981).

194 *Supra* n. 14.

195 *Ibid.*

payment and waiver of lien terms in the main contract. This procedure ensures that the owner's real estate or the lenders security is not encumbered by lien actions.

4.3 The Position in Canada

4.3.1 Generally

The structure and norms of the Canadian construction industry are close to that of the United States of America.[196] The Canadian construction industry is multi-tier and multi-player in nature too. The contracting arrangement and legal relationship amongst the players are similar. The construction industry also uses standard forms of construction contract[197] with payment provisions tied into and operate in conjunction with their construction lien laws. The concept of construction liens in Canada is synonymous to mechanic's liens in the USA. There is particular emphasis on liens and trusts as far as security of construction payment is concerned.

Though not all of the provinces in Canada operate based on the common law system, legislation has been enacted in each of the provinces of Canada that gives those who supply services and materials to certain project rights over which other ordinary creditors do not have. The legislation[198] is intended to ensure that those who supply labour services and materials to a construction project are protected in

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[196] Howard M. Wise, *Manual of Construction Law* (Carswell 1994 with 2000 supplement) at 1-1 to 1-19.
[197] CCDC 2 Stipulated Price Contract issued by the Canadian Construction Documents Committee.
[198] For e.g. Ontario Construction Lien Act 1990.

the event that there has been a default in payment for those labour services and materials.[199]

4.3.2 Liens

The construction lien in Canada is a statutory creation just like the mechanic's lien in the USA. The predominant one is the Ontario Construction Lien Act 1990 which was the province that first enacted such payment security legislation. This Canadian statute is comparatively more comprehensive, extensive and elaborate than that in Hawaii. Since the lien creates rights giving preference over others, the courts are similarly hesitant to provide an overly liberal interpretation of the lien statutes and are cautious to apply the provisions just to ensure that the spirit and intent of the statute are met.[200]

The provision in the Ontario Construction Lien Act 1990 similarly provides that a person who supplies services or materials to an improvement for the owner, contractor or sub contractor has a lien upon the interests of the owner in the premises improved for the price of those services or materials.[201] The lien rights are also accorded to the professional consultant such as the architect through recent statutory amendment as it was unclear whether they were included as found *in H.H. Angus & Associates Ltd v. Carleton University*.[202] Unlike the USA, the improved

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199 *Supra* n. 196. at 5-1.
200 *Clarkson Co. v Ace Lumber Ltd* [1963] S.C.R. 100.
201 Section 14(1).
202 (1995), 23 O.R. (3d) 120 (Gen. Div.).

property of the Crown in Canada can be subjected to the construction lien filed by unpaid contractors .

It is also essential that the procedure prescribed by the statute be adhered to in every construction lien claim. The Ontario Construction Lien Act 1990 provides a two-step process in enforcing lien rights. The first step is to preserve the lien claim by registering the claim against the appropriate property which the labour services or materials were supplied or, alternatively, by serving a notice to the proper authorities.[203] The second step is to perfect the claim by instituting an action to enforce the claim.[204] There are strict time limits to be observed.[205] Moreover, the Ontario Construction Lien Act 1990 also provides for sheltering whereby when there are several lien claimants. Hence, when a claimant perfects the claim for lien within the prescribed time period in which other claims must be perfected, the other claimants are entitled to shelter under the perfected action and need not separately commence their own action.[206]

In an action to enforce the lien, the claimant must file a concise statement of claim against the defaulting party under the contract and the owner of the premises. However, the main contractor in an action brought by the sub contractor may post security by payment into court to vacate the lien of the sub contractor. The sub contractor may then discontinue the action against the owner whose interest in the land is no longer affected and the sub contractor may simply proceed and look

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[203] Section 34.
[204] Section 36.
[205] *Goldyear Construction Inc. v Oriental Ocean Seafood Restaurant Ltd.* (1988), 13 W.D.C.P. 93 (Ont. Master).
[206] Section 36.

towards the security paid into court.[207] The statement of claim must be filed in the area where the premises are situated.[208]

The defendant may defend the lien action by off setting against the claim for any outstanding debt.[209] There may be also a cross claim for breach of contract.[210] The Ontario Construction Lien Act 1990 also comprehensively provides for posting of security to vacate the lien claim.[211]

As with the USA, there is frequently arbitration clauses provided in construction contracts and the courts in Canada uphold them as well.[212] The Canadian courts have also held that arbitration and lien litigation can co-exist. As a result, in *Automatic Systems Inc. v Bracknell Corporation*,[213] the courts upheld arbitration agreements and stayed the lien action pending the outcome of the arbitration.

The major benefit of arbitration in Canada is that the parties can have their disputes resolved in a more expedient manner. While it could take two to four years to have a major construction case heard in court, an arbitration case could take place within months of the completion of construction.[214] Arbitration is not necessarily less expensive than litigation but arbitration often leads to a speedier resolution of the dispute.

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207 *Delange Asphalt Paving v W.G. Gallagher Construction* (Ont. Gen Div).
208 Section 53 *Ontario Construction Liens Act* 1990; see also *878104 Canada Inc. v Dupont Construction Inc.* (1992) 4 CLR (2d) 196 (Ont. Gen. Div.).
209 Section 17(3) Ontario Construction Lien Act 1990.
210 Section 55; see also *Delange Asphalt Paving supra.*
211 Section 44.
212 *Automatic Systems Inc. v E.S.Fox Ltd* (1995) 19 CLR (2d) 35 (Ont.Gen.Div.).
213 (1994) 12 CLR (2d) 132; see also *BWV Investments Ltd. v Saskferco* (1994) 17 CLR (2d) 165.
214 Supra n. 194. at 4-7.

In Canada, the Ontario Construction Lien Act 1990 provides[215] for holdback to subsist with the lien. There is no corresponding feature similar to that in the Hawaii Revised Statutes under mechanic's liens. The holdback is a fund created where lien claimants may resort to in the event the person with whom they have privity of contract defaults in payment. The holdback provision creates the fund to satisfy successful lien actions between non contracting parties. The statute provides that each payor under a lien which may arise is required to retain a holdback in the amount of up to 10% of the price of the services or materials actually supplied until all liens that may be claimed against the holdback have expired or disposed off.

Since most construction projects are also financed through building mortgage, the Ontario Construction Lien Act 1990 also deals[216] with priority between mortgagees and lien claimants. The priority provision as designed creates liability on behalf of mortgage lenders resulting from deficiencies in holdback required to be retained by the owner during construction of the project. If a sub contractor has liened the property, the owner and the main contractor will have to decide who is responsible for vacating the lien. The owner would argue that as the unpaid claimant is in a direct contractual relationship with the main contractor, the main contractor should be responsible for posting security to vacate the lien. However, if the lien is for a large amount then the main contractor may not have the financial capability or bonding capacity to post security. Thus, in *Northern Air Construction v York*

[215] Sections 22 to 30.
[216] Section 78.

(Municipality) Public Library Board[217] the bonding company on behalf of the main contractor posted various bonds to clear the lien from the title whilst the owner additionally posted its full holdback liability with the court. The court held that the successful lien claimant may claim against the security paid into court and further against the bonds if that is insufficient.

The Ontario Construction Lien Act 1990 is designed to provide an expedient method of resolving lien disputes. The various court applications that can be brought pursuant to the statute attempt to strike a balance between the speed in which a matter can be brought for trial (assuming if there is no arbitration clause) and ensuring that the rights of the various parties to the action are protected both substantively and procedurally in relation to the land upon which the work was built. It is also seen that in large and complex multi party construction lien litigation where numerous parties have registered lien claims, the courts have proceeded and treated the lien proceedings as a class action led by certain claimants on behalf of all the claimants.[218]

4.3.3 Trusts

The Ontario Construction Lien Act 1990 has also elabourate and comprehensive provisions[219] on trust to ensure that funds in the construction project flow from the

[217] (1985) 13 CLR 123.
[218] See for e.g. *Nor-Min Supplies Ltd. v Canadian National Railway Co.* (1980) 28 OR (2d) 663 (H.C.).
[219] Sections 7 to 13.

apex to the base of the pyramid. In *Bank of Montreal v* Sidney,[220] the court held that:

> "Another object of the Act ... is to prevent those entitled to protection from being victimized by unscrupulous or impecunious builders or contractors ... **As a further safeguard for the benefit of those the Act is designed to protect, all moneys received by the contractor from the person primarily liable are, by s.3 [now section 7] expressly said to be and to constitute a trust fund in the hands for the benefit of those other persons. Until those persons have been paid, he must not appropriate or convert any part of it to his own use or to any use not authorized by the trust." (emphasis added).**

The statute is widely couched. Pursuant to the statute, where amounts become payable under a contract by an owner to the main contractor in relation to a certificate, an amount equal to the amount certified that is in the owner's hands or received by him from a construction lender is a trust fund for the benefit of the main contractor. Further, any amount owing to sub contractors by the main contractor, whether or not due or payable or any amount received by the main contractor on account of the sub contracts is trust fund for the benefit of the sub contractors or others who supplied services or materials to the benefit of the owner. Thus, monies of the project must flow into the project and be used for purposes intended in accordance with the construction pyramid.

In *Edwards Stevens Associates Ltd v G.L. Trenching Ltd*,[221] it was held that the beneficiaries of the trust fund must be restricted to only those having privity of

[220] [1955] OWN 581 (H.C.) at 583.

contract to the trustee of the fund. The court thought the trust liability would otherwise be too far-reaching. If and when funds are received by the beneficiary of the trust, the obligations of the trustee are discharged.

The trust provisions in the Ontario Construction Lien Act 1990 exist independent of the lien and the trust actions cannot be joined with the lien action.[222] This is to avoid prejudicing the defendant.

If the trust fund is mal-administered, the Ontario Construction Lien Act 1990[223] provides that the trustee, the recipient of the trust monies who participated in breach of trust as well as non recipient of funds who participated in breach of trust may be sued. The statute stipulates that every director or officer of a corporation and any person including an employee or agent of the corporation who has effective control of the corporation or its relevant activities or who assents or acquiesces in conduct that he knows or ought to know amounts to breach of trust by the corporation is liable. In other words, the statute is very pervasive to secure construction payment.

The liability for breach of trust also extends to financiers who loaned money to owners[224] as well as contractors who had as collateral taken an assignment of the

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221 (1990) 73 OR (2d) 112 (H.C.).
222 Section 50(1).
223 Section 13.
224 *G.C. McDonald Supply Ltd. v. Preston Heights Estates Ltd.* (1992) 45 CLR 293 (Ont. Gen. Div.); see also *Arthur Andersen Inc. v. Tornto Dominion Bank* (1992) 4 CLR (2d) 207 (Ont. Gen.Rev.).

book debts.[225] The bank is therefore under a duty to make reasonable inquiries into the nature of the funds and appropriation of monies.

The Ontario Construction Lien Act 1990 nevertheless permits the trustee to set off debts, claims and damages against monies otherwise payable as part of the trust under the construction pyramid.[226] Though the trust provisions are wide and far reaching, it was held in *Steeplejack Services (Sarnia) Ltd. v. Stowe Nut & Bolt Co.*[227] that the defendant trustee corporation which mismanaged its operation and paid the trust monies for the supply of services and materials was not liable to the unpaid beneficiary claimant since there was no misuse of funds.

4.4 Summary

It is seen that the American and Canadian construction industry have evolved to ensure that the people who had properly contributed their labour, services or supplied materials and goods are paid.

The sufficiency of funds to carry out and complete a project is of concern particularly when the project is undertaken by a private owner or developer. Consequently the private owner or developer in most projects in Hawaii who is subject to the condominium regime is obliged to satisfy a statutory body that there is viability and evidence of sufficient funding for the construction of the project before it can put for sale or construction. It is therefore the norm that the project

[225] *T. McAvity & Sons Ltd. v. Canadian Bank of Commerce* [1959] SCR 148
[226] Section 12.
[227] (1988) 31 CLR 115 (Ont. Dist.Ct.).

owner or developer would procure a full construction loan to fund the completion of the project.

Furthermore and though there is availability of contractual remedies, there is extensive statutory safeguard of construction payment by way of mechanic's lien legislation. In America, the lien applies to all private work. This is similar in Canada though the lien is extended to public work and there is further trust legislation protection.

The lien attaches to whatever interest is held in the property itself by the party on whose behalf the work is done or material and goods supplied. The holder of the property where the lien attaches faces no personal liability for the lien itself by reason that any action brought to foreclose on the lien is brought "in rem" and not "in personam". The right to a lien action is therefore independent of privity of contract which results in the ability of many sub contractors and suppliers to look to the owner for payment if they are not paid by the main contractor. The procedure of enforcing the lien is very technical and strict compliance is required.

Very importantly, the lien also has the benefit of priority over many other unsecured creditors even in a bankruptcy scenario. In this regard, besides unpaid sub contractors and suppliers, the interest of the unpaid main contractor is also protected if the project owner becomes insolvent. The lien is generally only subordinate to the construction loan financier's interest only.

Besides affording the main contractor, sub contractors and suppliers with direct remedy "in rem", the mechanic's lien legislation has resulted in a system of policing of payments in the American construction industry. In this respect the private owner or developer or the construction loan financier on its behalf actively and vigilantly monitors the making of payments during and after construction is completed. Besides paying the main contractor, the owner wants to ensure that sub contractors and suppliers are also paid to avoid the property being encumbered by a lien application. This concern has also given rise to practices such as consensual direct payment and payment by way of joint cheques. In addition, the owner would frequently also require the release and waiver of lien to the extent of each and every payment made. The mechanic's lien legislation has therefore to a large extent indirectly ensured that there is no diversion of construction fund at all levels. In Canada, this is further ensured by virtue of the hold back and statutory trust. The hold back ensures that there is fund to satisfy the lien whilst the trust provides additional civil remedies and criminal penalties against trustees who commits breach of trust arising from construction payment.

The modes of construction payment dispute resolution (whether in court or arbitration) in the USA and Canada are slow and expensive. Lien actions in Hawaii are often stayed and determined via arbitration. Nevertheless this does not pose to be a serious problem because there is usually sufficient availability of funds from project inception and there is security of payment because of the mechanic's lien and trust legislation. It can therefore be concluded that the Malaysian Construction

Payment Problems set out in Chapter 2 exist in the USA and Canada to some limited extent but they are nevertheless overcome or addressed by the prevailing norms and laws.

CHAPTER 5

RECOMMENDATIONS AND CONCLUSION

5.1 Introduction

This Chapter analyses the findings made in the previous Chapters, co-relates them, considers the strategies to address the Malaysian Construction Industry Payment Problems set out in Chapter 2 and finally proposes a suitable solution for the Construction Industry in Malaysia.

This Chapter is divided into five parts. The first part summarizes the norms of the construction industry in Malaysia as discussed in Chapter 2 and the other countries as discussed in Chapters 3 and 4 on a comparative basis. The second part analyses the construction industry payment problems and the solutions adopted in the various countries examined in Chapters 3 and 4 in search of a suitable option for Malaysia. The third part discusses the available strategies to overcome the Malaysian Construction Payment Problems. The fourth part sets out the proposed solution and explains the rationale underlying the proposal. Finally, the fifth part deals with the verification of the hypotheses set out in Chapter 1 and ends with the conclusion.

5.2 Summary of Findings of Construction Norms

It is evident from the discussion in Chapters 2, 3 and 4 that the construction norms in the countries examined share many common features.

5.2.1 Structure and Project Funding

The structure of the construction industry in Malaysia as seen in Chapter 2 is similar to that in the other countries examined in Chapters 3 and 4. The construction industry is a complex one involving multiple players operating in a multi-layered manner.[1] The contractual relationships between the primary players are similar. Generally, the owner or developer contracts with the main contractor to carry out the work designed by the professional consultants who separately contract with the owner. The main contractor in the carrying out of the work often contracts with sub contractors and suppliers. However, there is no nominated sub contracting in the USA and all sub contractors are domestic sub contractors there.

The project must be funded by the owner or developer.[2] In every country examined, the funding by the government for public sector projects does not appear to be a problem since the governments of the countries examined are all stable and the country is thriving. The funding problem occurs in private sector projects mostly due to speculative projects undertaken. The private sector owner or developer at the apex layer in every country has to source for funds either from internal equity

[1] Chapter 2.2.1, Chapter 3.2.1 and Chapter 4.2.1.
[2] Chapter 2.2.2(a), Chapter 3.2.2 and Chapter 4.2.2(a)

capital or, more often, from external financial institution borrowings with the development land mortgaged as security. The private owner or developer in all the countries examined (with the exception of the USA) is not compulsorily required by law to have adequate capital or loan finance to complete the construction work.[3] The only exception is Hawaii where it is statutorily provided that the owner or developer must satisfy the Real Estate Commission of its funding capacity before it is permitted to sell or construct the project.

It may thus be seen that private sector development and construction is a free market enterprise rampant with speculative development undertaken by non-financially sound owners or developers. This situation is acknowledged in the United Kingdom, including Sir Michael Latham's "Constructing the Team" report discussed in Chapter 3. In Malaysia, there is limited control only on licensed housing developers. They are statutorily regulated but that notwithstanding, the required capital adequacy requirement of RM250,000.00 is grossly inadequate in comparison with the project costs undertaken. In this respect, the main contractor and others at the lower layers of the construction pyramid are most likely to be financially exposed if the project fails. It is also seen that contractors in Malaysia and in Hawaii are required to be registered or licensed to ensure, amongst others, financial integrity. The licensing requirement is comparatively more stringent in Hawaii, such as requiring the satisfaction of undisputed or judgment debts. Be that as it may, the contractors are never expected to finance the project.

[3] *Supra* n. 2.

Top down project funding is the norm in all the countries examined.[4] This fund flow is critical and most construction contracts accordingly provide for progress payment.

5.2.2 Contractual Arrangements

The contractual arrangements and principles contained in the contract commonly used in the countries examined in Chapters 3 and 4 are also largely similar to that used in Malaysia.

There is often the usage of construction industry drafted standard forms of construction contracts[5] particularly at the main contract layer and nominated sub contract layer (other than the USA and Canada but there are standard forms for their domestic sub contracts) of the construction pyramid. These standard forms often provide fair and balanced allocation of responsibility and financial risks under the contract. The clauses in the standard forms provide elaborate mechanisms on the assessment of progress and final payment, usually for work done and materials delivered to site based on the certification of a professional third party.[6] This is to ensure fair valuation of the work done. There are correspondingly also retention (or retainage) clauses to provide security against non performance of the contract[7] as well as clauses[8] for deduction or set off against payment or withholding of certification for performance not in compliance with the contract. The deduction or

[4] Chapter 2.2.2(b), Chapter 3.2.2 and Chapter 4.2.2(b).
[5] Chapter 2.2.3(a) to (c) and Chapter 3.2.3(a) to (c), c.f. Chapter 4.2.3(a).
[6] Chapter 2.2.3(b)(1) and (3), Chapter 2.2.3(c)(1) and (3), Chapter 3.2.3(b) and (c) and Chapter 4.2.3(b).
[7] Chapter 2.2.3(b)(2) and (c)(2), Chapter 3.2.3(b) and (c) and Chapter 4.2.3(b)(2).
[8] Chapter 2.2.3(b)(5), Chapter 3.2.3(b) and Chapter 4.2.3(b)(l).

set off is often on the certification of the professional third party at the main contract and nominated sub contract levels. There are clauses[9] conferring remedies for non payment such as payment of interest, suspension of work and/or termination of the contract.

At the sub contract layers of the construction pyramid, conditional payment types of clauses particularly "pay when paid" ones are widespread in all the countries examined.[10] Standard forms of nominated sub contract in Malaysia have even been amended to introduce such "pay when paid" conditional payment.[11] It is also rampant in Malaysia that construction contracts at the lower layers of the construction pyramid are often oral, or at most, rudimentary if in writing. This situation is quite unlike that which prevails in the other countries.[12] It is particularly seen in the nominated sub contract standard form used in the United Kingdom that the main contractor is required to give prior notice to the sub contractor with substantiation before any set off can be effected.[13] This is aimed to protect the sub contractor against unwarranted payment deductions. However, such a precautionary step is not found in the Malaysian equivalent standard form. Furthermore, as seen in Chapter 2, the notable problem in Malaysia is that balanced standard forms are often amended in favour of the paying parties.[14]

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[9] Chapter 2.2.3(b)(4) and (c)(4), Chapter 3.2.3(b) and (c) and Chapter 4.2.3(b)(4) and (c)(3).
[10] Chapter 2.2.3(c)(1) and (d), Chapter 3.2.4(d)(1) and Chapter 4.2.3(c)(1) and (2).
[11] Chapter 2.2.3(c)(1).
[12] Chapter 2.2.3(d).
[13] Chapter 3.2.3(c) and (d).
[14] Chapter 2.3.1.

As to supply contracts in the construction industry, there is no standard form of contract in all the countries examined other than the nominated supply contract for public sector construction in Malaysia.[15] The supply contracts are usually simple written contracts although they operate against the background of statutory laws such as the Sale of Goods Act 1957 in Malaysia, Sale of Goods Act 1979 in the United Kingdom and Uniform Commercial Code in the USA. Payment for material or goods supplied is often against delivery.[16]

The professional consultancy contracts in all the countries examined are also mostly based on standard forms issued by the governing statutory body or professional association.[17] Payment is usually made according to stages of services rendered.

Most construction projects are prone to go wrong due to their inherent nature, complexity and the prevailing norms of the industry. This is the common situation in all the countries examined in Chapters 2 to 4. It is therefore seen that set offs against payments are rampant.[18] The set off often involves overvaluation of work, defective construction work and delayed completion of work. The resultant effect is high incidents of disputed non and delayed payment. In such disputed circumstances, it is also difficult to exercise the contractual remedies unless and until the dispute is resolved. This is because incorrect exercise of the remedies would instead put that party in repudiatory breach of contract. The traditional

[15] Chapter 2.2.3(e).
[16] Chapter 2.4.4, Chapter 3.2.3(e) and Chapter 4.2.3(d) and Chapter 4.2.5(b).
[17] Chapter 2.2.3(f), Chapter 3.2.3(e) and Chapter 4.2.3(e).
[18] Chapter 2.3.1 and 2.5.4, Chapter 3.2.4(b) and (d)(1), 3.4.1, 3.5.1 and 3.6.1 and Chapter 4.2.4.

mode of dispute resolution by arbitration or court litigation in most of the countries examined is slow and increasingly expensive.[19] As a result, the contractual remedies provided in the standard forms of contract are practicably ineffective. It is thus acknowledged that there is a critical need to have security for payment pending the resolution of the dispute, if not from the onset of construction of the project. This is primarily because the completed work becomes a fixture of the developed land and the unpaid contractors are mere unsecured creditors.

5.3 The Construction Payment Problems and Solutions in the United Kingdom, Commonwealth and USA

As aforediscussed, the construction industry norms in the countries examined do not differ vastly. The principal difference is with regard to security of payment.

In "Constructing the Team", lack of trust in the United Kingdom construction industry was identified as one of the key drawbacks in the industry. Speculative private sector development without adequate project funding is rampant. In addition, there are high incidents of construction payment disputes and problems because of cross claims brought by the paying party against the unpaid party. These cross claims arise for a multitude of reasons ranging from bad contractual performance (such as defective construction or delayed completion) to inability to pay because of lack of cash flow. Protracted resolution of disputes makes the

[19] Chapter 2.3.1 and 2.5.5, Chapter 3.2.4(d)(2) and 3.4.1 and Chapter 4.2.7 and 4.3.1.

situation worse for the aggrieved unpaid party.[20] These problems appear to be similar in Australia[21], New Zealand[22] and Singapore[23]. The only notable difference seen in Singapore[24] is that the private sector developers are financially sound. Thus, problems in Singapore often appear at the main contract layer as a result of main contractors operating with weak financial standing. This is often due to tight profit margin in the project and repeated losses sustained from other projects.

On the other hand, construction industry payment problems do not appear to be serious in the USA.[25] There are nevertheless still incidents of construction disputes but mostly not due to the inability to pay.

As seen in all the countries examined, the construction industry requires that the players have certainty and assurance in getting paid for construction work done, material supplied or services rendered.[26]

The principal difference seen is that criticality of the construction industry payment problem has been recognized and addressed in these countries at different points in time. It is seen in Chapter 4 that the concern for security of payment in the USA has been long recognized since the 18th century. In this respect, every state in the USA has enacted mechanic's lien statutes.[27] Problems associated with construction

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[20] Chapter 3.2.4(d)(2).
[21] Chapter 3.4.1.
[22] Chapter 3.5.1.
[23] Chapter 3.6.1.
[24] *Ibid.*
[25] Chapter 4.2.4 and 4.2.7.
[26] Chapter 2.3.1, Chapter 3.2.4(d)(3), 3.4.2, 3.5.1 & 3.6.1 and Chapter 4.2.5(a)(l) and 4.3.2.
[27] Chapter 4.2.5.

payment particularly security of payment became controlled notwithstanding that the dispute resolution may be protracted. In fact, the mechanic's lien statute had in an indirect way resulted in the norm of "policing" of payment by players at the upper layers including their financiers to ensure that payment is made to those players at the lower layers of the construction pyramid. This is done to avoid the project being encumbered by the statutory lien. The neighbouring Canada[28] also enacted similar lien statutes in all the provinces with trust obligations added on to co-exist with lien rights to protect construction payment.

On the other hand, the construction industry in the Commonwealth countries examined in Chapter 3 particularly the United Kingdom and New Zealand face serious consequences of payment problems, particularly due to suffocation of cash flow and inadequate security of payment. These problems had resulted in the insolvency and collapse of many construction companies in the late 1980s and early 1990's in these countries. In the United Kingdom, there has never been the existence of mechanic's lien statutes whereas New Zealand has one until its repeal in the late 1980s. The severity of the United Kingdom situation prompted the government and the industry to set up a commission led by Sir Michael Latham to make recommendations to surmount the problems. The recommendations of the commission in "Constructing the Team" report led to the enactment of the HGCRA in 1996.[29] As seen in Chapter 3, the enactment of the HGCRA inspired and prompted the other Commonwealth countries such as Australia, New Zealand and

[28] Chapter 4.3.2.
[29] Chapter 3.2.5.

Singapore to enact similar type legislations.[30] The principal features of these statutes are the statutory prescription of certain rights and obligations pertaining to construction payment and the creation of a swift dispute resolution procedure described as adjudication.

It has been stated[31] that there are only three possible modes of security of payment. These are the lien, trust or bond. The security of payment solution adopted in the United States of America is the lien.[32] In Canada, both the lien and trust are adopted.[33] In fact, the solution adopted in the United Kingdom, Australia, New Zealand and Singapore does not in theory provide security of payment. In "Constructing the Team" report, a trust type solution was recommended[34] but it was not adopted in the UK HGCRA. The common solution that is finally statutorily adopted in all these Commonwealth countries is rapid adjudication.[35] The adjudication decision is summarily registrable and enforceable as a court judgment. The underlying rationale is that such swift process should be sufficient to ensure payment recovery and cash flow.

There is no Commonwealth country that has to-date adopted the bond, to wit payment bond as the solution to security of payment. In USA, the payment bond is required to be given by main contractors to sub contractors and suppliers for public projects which are not subjected to mechanic's liens.

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[30] Chapter 3.4.2, 3.5.2 & 3.6.2.
[31] Center for Construction Law & Management, Kings College London, *Contemporary Issues in Construction Law Vol. I - Security for Payment* (Construction Law Press London, 1996) at 13 to 15.
[32] Chapter 4.2.5.
[33] Chapters 4.3.2 and 4.3.3.
[34] Chapter 3.2.4(d)(3).
[35] Chapters 3.2.5, 3.4.2, 3.5.2 and 3.6.2.

Finally, it can also be seen that in all the countries examined in Chapters 3 and 4, it is insufficient merely to have contractual remedies which are often provided in the construction industry drafted standard forms of contract to deal with payment problems. The common law is also inadequate. Thus, all the countries enacted statutes which are designed according to their perceived needs and necessities.[36]

5.4 The Strategies and Choice of Construction Payment Solution for Malaysia

5.4.1 Generally

It is seen that that the Commonwealth countries examined in Chapter 3 have even as late as in early 1990s, continued to face nationwide construction industry payment problems. The problems were so serious such as to lead to the collapse of many construction players. The seriousness of the problems necessitated the creation of governmental commissions to review the problems and propose appropriate recommendations. The Malaysian position has fortunately not yet reached such an alarming state. It is anecdotally perceived that there are many players suffering in silence. The Construction Industry Development Board is spearheading reform initiative in line with the Construction Industry Master Plan Malaysia 2006-2015 as seen from the launch of its survey on late and non payment issues.

[36] Chapters 3.2.5, 3.4.2, 3.5.2 and 3.6.2 and Chapter 4.2.5, 4.3.2 and 4.3.3.

In the circumstances, it is open for Malaysia whether to accept the strategies underlying the solutions adopted in USA and Canada or those in the other Commonwealth countries. Although the structure and norms of the property and construction industry in all the countries examined are similar, none is identical to that in Malaysia. It is therefore necessary that their concepts and solutions adopted be critically examined if and to the extent they suit the Malaysian norms and realities.

5.4.2 Liens

The dominant solution in the USA and Canada is the mechanic's lien. However, the lien poses a unique problem in Malaysia. This is because of the prevalence and continuing mode of the "sell-then-build" method of private sector property development. Although the "sell-then-build" mode has been discouraged in favour of the "build-then-sell" mode by the government, it is seen that the "sell-then-build" mode has as of late not been outlawed.[37] It is more likely to perpetuate unless and until local banks and financial institutions are committed to fully and adequately fund projects under the "build-then-sell" concept.[38] The central feature of the lien is that it provides security of payment to the builders, suppliers and professional consultants. The lien encumbers the title and interest of the defaulting private developer's property under development. If the development is financed by

[37] The Star Newspaper on 13 Sept 2006 wherein the Minister for Housing and Local Government was reported at the National Property and Housing Summit 2006 that the build-then-sell concept would not take over the current concept of "sell-then-build" but would instead run parallel with it.

[38] Interview with Steven Shee of Sunway Construction Sdn Bhd and Khoo Cheong of Kemas Construction Sdn Bhd, members of the Master Builders Association Malaysia (MBAM) on 17th April 2007 at MBAM premises after Contract and Practices Committee Meeting.

a bank, the lien ranks only after the bank's secured interest but takes priority over other unsecured interests. By having this lien solution in Malaysia, it would however affect third party purchasers who have purchased the property from the defaulting developer under the "sell-then-build" mode. It would hence definitely be unjust to have the lien taking priority over these innocent third parties's interest. This unjust result ipso facto makes the lien solution unsuitable for Malaysia.

The lien process is also elaborate and cumbersome in its implementation. In addition, the enforcement of the lien would have to be launched via the court (or through arbitration if so ordered by the court in the lien action). This will invariably take time and is unlikely to help cash flow. The cash flow problem in USA and Canada is resolved through the norm in their construction industry of "policing of payment" which takes place separately and indirectly from the lien solution. This norm has been acquired over a very long period of time because mechanic's lien has been introduced since the 18th century.

The introduction of the lien solution can thus be considered too radical for Malaysia would take a considerable period of time to assimilate the required changes in norms before it would be fully effective.

5.4.3 Adjudication

Unlike the USA and Canadian solution, the thrust of the solution adopted in the other Commonwealth countries is to outlaw unfair contractual payment terms such

as the "pay when paid" basis of payment. Further and more importantly, there is the creation of a swift interim dispute resolution procedure known as adjudication together with numerous post adjudication statutory remedies for non payment thereafter. The adjudication process is an interim dispute resolution process which produces a temporarily binding decision. The same dispute can be finally re-determined either in arbitration or in court. Nevertheless, the distinctive feature is that there is a legally binding and enforceable decision that can be swiftly obtained to provide the much needed cash flow. In other words, there is rapid rough determination of the dispute on its merits which is superior to the present summary judgment or interim award procedure available in court or arbitration respectively. These existing procedures have been proven to be generally ineffective to deal with construction payment problems.

As to the recovery of the adjudicated amount, the successful party in adjudication in all these countries can apply to the court to enter judgment in terms. The decision is then enforceable as a judgment debt. The judgment does not however put the successful party in a better position than that of an unsecured creditor. Hence there is still no certainty of payment.

In New Zealand, there is the additional provision of empowering the adjudicator to make a charging order on the property. This is akin to but not identical with the lien in that the priority and effective date is not dealt with in the statute. It is more similar to the Malaysian writ of seizure and sale mode of enforcement of

judgment.[39] The difference is that the latter is only obtainable after judgment has been entered (which is a mere further step away if the unpaid adjudicated amount is entered as a court judgment). In Singapore, there is additional remedy provided at the sub contract layer in the form of discretionary direct payment by the principal to the sub contractor if the main contractor does not pay the adjudicated amount. It is sensible that the direct payment is only discretionary rather than obligatory because the principal might have a set off against the non paying party or may have already paid that party. The other way to seek mandatory direct payment is by the garnishee mode of enforcement of judgment[40] though it can also be subject to the aforesaid set off limitation. Consequently, there is still the problem of lack of certainty in payment despite the after having succeeded in the adjudication.

Besides recovery of the adjudicated amount being that of accrued payment debt, there is the right of suspension of work statutorily provided in these countries to limit further financial exposure of the successful party if payment is not forthcoming.

The aforesaid Commonwealth solution is generally more suitable for Malaysia as it is less radical and more consistent with the prevailing norms. However, there is no security of payment in that solution per se.

[39] See for e.g. Orders 45(1)(1)(a) and 47 of the Rules of the High Court 1980.
[40] Order 49 of the Rules of the High Court 1980.

5.4.4 Trusts

As discussed above, the "Constructing the Team" report had suggested the creation of trust as security of payment. However, this was inexplicably not incorporated in the UK HGCRA. The trust solution in the report requires the employer to set up a mandatory trust account and regularly pays into the account in advance at prescribed intervals for the benefit of the main contractor and its first line sub contractors. Otherwise, the aggrieved party may resort to adjudication to have that trust account enforced. This is different from the trust solution in Canada where it is statutorily prescribed and declared that all monies received by an employer for the financing of construction constitute a trust for the benefit of the main contractor. Similarly, all monies owing to the main contractor and sub contractors or any amounts received by the main contractor or sub contractor on account of a contract or sub contract are trust funds for the sub contractors or others who supplied services or materials to the employers. The remedies are civil and criminal breach of trust. This Canadian solution is further coupled with mandatory retainage to hold back a portion of progress payment as security in the event of breach. Cash flow is hence stifled to some extent.

The trust solution works on the assumption that there are sufficient monies at all material times particularly at the apex owner's level. This is not necessarily the case in Malaysia due to the prevalence of private sector speculative development where there is often inadequate funds to complete the project unless the project is substantially sold.

Moreover, the administration and enforcement of the trust is cumbersome. The tracing remedy of breach of trust is time consuming and pegged with practical difficulty by reason of strict Malaysian banking secrecy laws.[41] From the author's experience[42] in the case of *ESPL (M) Sdn Bhd* v *Radio & General Engineering Sdn Bhd,* the enforcement of the trust as found and ordered by the Court of Appeal[43] has been difficult, frustrating and of limited effectiveness notwithstanding that a receiver has been appointed to facilitate the process to trace and secure the trust.

Notwithstanding the lack of security of payment in the statutory solution adopted by the Commonwealth countries seen in Chapter 3, in view of closer similarity in construction norms and contractual arrangements, the feasible strategy and solution for Malaysia is to adopt their solution but reinforced with appropriate security of payment.

5.4.5 Bonds

Since the lien and trust modes of security of payment are unsuitable, the only other mode of security of payment is by way of payment bond.[44] Thus though yet untested in all the Commonwealth countries examined, it is submitted that the payment bond solution pegged onto adjudication is workable and best suited for Malaysia. Since private sector speculative development is prevalent, pervasive and

[41] Section 97(1) Banking and Financial Institutions Act 1989 (Act 372); see also Section 6 Bankers' Books Evidence Act 1949 (Rev.1971) (Act 33).
[42] The author is one of the counsel in that case.
[43] [2004] 4 CLJ 674.
[44] *Supra* n. 31.

is likely to continue to be so in order to develop this country, it is unrealistic for the Government to set up the equivalent Hawaiian Real Estate Commission to impose upon and ensure that there is 100% financing for each and every project undertaken.[45] The next best alternative is therefore to have security of payment by way of payment bond to be furnished throughout the Malaysian construction industry. This solution also overcomes the problem of widespread usage of single project purpose private limited company in the private sector[46] where the judgment creditor gets nothing if the company goes insolvent. The advantage of the payment bond as security is certainty of payment coupled with ease of procurement, administration and enforcement. The disadvantage is the likely resultant effect of increase in construction costs industry wide. This is probably theoretical as it is equally true that lower bid prices would be obtained if there is certainty and security of payment.

To be effective, every paying party in the construction contract must furnish a payment bond to the other party. The Government is exempted since there is practicably no risk of insolvency. With regard to the private sector, in order not to cause hardship to small and "one time" players such as house owners undertaking renovation works, payment bonds ought only to be furnished in respect of construction contracts above RM 50,000.00. This limit is also a realistic limit to prevent unscrupulous parties from attempting to divide the construction contract into smaller contracts to avoid furnishing the payment bond. The payment bond should be a simple "on-demand" bond issued by a licensed bank. The validity of

[45] Chapter 4.2.1.
[46] Chapter 2.2.1(a).

the payment bond should be from the award of the construction contract till the end of the defects liability or maintenance period. The value of the bond should be no less than 10% of the contract price which would be the realistic limit of exposure when an aggrieved party is likely to resort to dispute resolution.

The further attractiveness of the payment bond is that it is in law a third party guarantee.[47] The successful party does not therefore face the problem of priority of debts in the event the paying party becomes insolvent. In other words, the successful party may simply demand on the bond and be paid regardless of the financial health or asset availability of the defaulting paying party. Nevertheless, in order to prevent abuse, the demand against the payment bond should only be made after successful dispute resolution, at least after an adjudication decision.

5.5 The Malaysian Statutory Solution and its Rationale

5.5.1 Generally

As with all the countries examined in Chapters 3 and 4, the solution must necessarily be statutory to be pervasive and effective. It is inadequate to merely rely on common law judicial decisions because the decisions are based on the peculiar facts in dispute in each case and effectively only bind the litigants. The statutory solution on the other hand binds all, whatever the factual matrix in dispute.

[47] Sections 77 to 100 of the Contracts Act 1950.

The scope of the statute must in principle be very broad, encompassing the entire construction industry including those other related industries such as the petroleum, gas and telecommunication industries which involve construction work. The statute should however only be attracted in respect of or in connection with the construction work on an identified fixture[48] in the territory of Malaysia. Otherwise, the statute will be overly pervasive, say encompassing even suppliers of construction materials sold to the general public. The statute must also in principle apply to all sectors and players of the construction industry such as the Government, statutory corporations, private owners, professional consultants, main contractors, sub contractors and suppliers.

In Chapter 2, it has been identified that the Malaysian Construction Payment Problems are five-fold.[49] Thus, the statute must comprehensively and adequately deal with all of them, to wit, the Project Finance problem, Unfair Contract terms problem, Certification of Payment problem, Withholding of Payment problem and the Dispute Resolution and Security of Payment problem.

As to the Project Finance problem, it is possible but presently impracticable as aforediscussed to statutorily compel owners or developers to satisfy a public authority (such as the local authority that approves building plans pursuant to the Street Drainage and Building Act 1974) that there is adequate funding before the project is permitted to be built or sold just like in Hawaii, USA. The recommended

[48] Section 5 National Land Code 1965; see also *Goh Chong Hin & Anor v The Consolidated Malay Rubber Estates Ltd* 5 FMSLR 86.

[49] Chapter 2.3.1.

alternative solution is to have statutory prescription of security of payment by way of payment bond to a value of 10% of the contract price. The bond should be sufficient to secure the contractor's exposure as it is expected that commercially prudent contractors would not further allow accumulation of financial exposure beyond that value. As to financial adequacy of main and sub contractors, they too have to furnish equivalent payment bonds to those they have contracted down the construction pyramid. In addition, just as in Hawaii, all these contractors must be registered with the Construction Industry Development Board (CIDB) pursuant to the Akta Lembaga Pembangunan Industri Pembinaan Malaysia 1994.[50] The financial adequacy especially capital of contractors can be regulated through the renewal of their registration. The registration system is in place already pursuant to the CIDB Act but it requires continuing vigilant monitoring by the CIDB.

The Unfair Contract Terms problem is a problem that arises from the unequal bargaining position of the players, largely as a result of the scarcity of work and intense competition for work. The statute must therefore outlaw those unfair contract terms such as "pay when paid" clauses. As previously discussed, such conditional payment provision stifles cash flow and shifts the financial risk of non payment unfairly to players down the construction pyramid. In addition, the statute should provide statutory implied terms of right to progress payment and the method of determination of such payments in the absence of any express agreement to that effect in the construction contract. There must also be strict prohibition

[50] Act 520 (hereinafter referred to as the CIDB Act).

against contracting out of the statutory provisions which may otherwise be a common occurrence in the Malaysian environment.[51]

In respect of the Certification of Payment and Withholding of Payment problems, the statutory solution is to provide a mechanism where these problems can swiftly be resolved. In this respect, it is recommended that adjudication be mandated and hence used more widely. Such adjudication should also allow for the review of the certifier's certification (including failure to certify) and cross claims on their merits and not whether there are merely triable issues.

Finally, as to the Dispute Resolution & Security of Payment problem, the proposed solution is again statutory adjudication and prescription of payment bond. As in all the other Commonwealth countries examined in Chapter 3, the statutory adjudication should only be an interim but temporarily binding dispute resolution procedure. Thus, the same dispute can be finally determined by arbitration or the court. The central thrust of adjudication is speedy determination of the dispute to overcome the present acute problem of protracted decisions through the other available dispute resolution processes of arbitration or court litigation. Nevertheless arbitration and court litigation must co-exist to complement adjudication. This is to enable aggrieved parties to have the opportunity to re-argue the dispute fully and finally. In other words, rough justice administered through adjudication must be curable by traditional fine justice through the other processes, if necessary. These final processes are necessary to enable dissatisfied parties to

[51] See for example, *SEA Housing Corporation Sdn Bhd v Lee Poh Choo* [1982] 2 MLJ 31 FC which is an attempt to contract out from the contractual terms prescribed under Housing Developers (Control & Licensing) Act 1966 (Act 118).

fully ventilate their grievances including having the avenues of elaborate discovery processes, interrogatories and presentation of oral evidence.

Apart from the above, the statute should also provide a comprehensive range of remedies to the successful party after adjudication notwithstanding that the same dispute may be re-arbitrated or litigated in court.

5.5.2 The Statutory Framework

Based on the above discussion and evaluation of the strategies for a solution to the construction industry payment problem, it is recommended that the proposed statute provides the basic framework to address the payment problems. The administrative details can be provided through subsidiary legislation by way of Regulations made pursuant to the statute.

Consequently, in order to adequately deal with the Malaysian Construction Industry Payment Problems, the statute should contain the following:

i) The construction payment framework must:

   a) prohibit conditional "pay when paid" type of payment terms in construction contracts;

b) provide for default terms for progress payment and method of assessment by implication in the event of absence of express terms in the construction contract;

c) provide for service of payment claim and payment response.

ii) The adjudication framework should deal with the following:

a) statutory right to refer all disputes to adjudication;

b) effect of adjudication particularly its relationship with other dispute resolution processes;

c) formation of statutory body to regulate and administer adjudication;

d) initiation and selection of adjudicator;

e) eligibility criteria of the adjudicator;

f) jurisdiction, duties and powers of the adjudicator;

g) adjudication process, particularly the deadlines and decision; and

h) setting aside of improperly procured decision through fraud or bribery.

iii) The post adjudication and security of payment framework must provide for:

a) the range of remedies available; and

b) payment bond and other related matters.

iv) The creation of the specialist construction court, inter alia, to effectively deal with problems arising from the statute particularly enforcement of adjudication decisions.

5.5.3 The Proposed Construction Industry Adjudication and Security of Payment Act

In the premises, the proposed statute for Malaysia incorporating the aforementioned framework is set out below. The statute is divided into six parts being:

Part I - Preliminary

Part II - Payment

Part III - Adjudication of disputes

Part IV - Security of payment and remedies

Part V- Construction Court

Part VI - Miscellaneous

The body of the statute reads as follows:

THE CONSTRUCTION INDUSTRY ADJUDICATION AND SECURITY OF PAYMENT ACT 2009

An Act to facilitate regular and timely payment, provide mechanism for speedy dispute resolution through adjudication and provide security and remedies for recovery of payment in the construction industry.

ARRANGEMENT OF SECTIONS

PART I

PRELIMINARY

Short title and commencement

1.(1) This Act may be cited as the Construction Industry Adjudication and Security of Payment Act 2009.

(2) This Act comes into operation on a date to be appointed by the Minister by notification in the Gazette.

Interpretation

2.(1) In this Act, unless the context otherwise requires –

"construction consultancy services contract" means an agreement to carry out consultancy services in relation to construction work and includes architectural, engineering, surveying and project management services.

"construction work" means the construction, extension, installation, repair, maintenance, renewal, removal, renovation, alteration, dismantling, or demolition of –

(a) any building, erection, edifice, structure, wall fence or chimney, whether constructed wholly or partly above or below ground level;
(b) any road, harbour works, marine works, platform, rig, railway, cableway, canal or aerodrome;
(c) any drainage, irrigation or river control works;
(d) any electrical, mechanical, water, gas, petroleum, petrochemical, or telecommunication works; or
(e) any bridge, viaduct, dam, reservoir, earthworks, pipeline, sewer, aqueduct, culvert, drive, shaft, tunnel or reclamation works,

and includes any works which form an integral part of, or are preparatory to or temporary for the works described in paragraphs (a) to (e), including soil investigation and improvement, earth-moving, excavation, laying of foundation and landscaping.

"construction work contract" means an agreement to carry out construction work.

"contract administrator" means an architect, engineer, superintending officer or other person howsoever designated who is duty bound to manage and administer the construction work contract and includes issuance of certificate.

"court" means a court constituted under the Courts of Judicature Act 1964 or the Subordinate Courts Act 1948 and includes the Construction Court.

"cross claim" means a set off or counterclaim.

"day" unless otherwise stipulated in this Act means working day at the place of the site and excludes weekend and public holiday.

"Government" means the Federal Government and the Government of any component state of Malaysia.

"High Court" means the High Court in Malaya or the High Court in Sabah and Sarawak, as the case may be.

"Minister" means the Minister of Works or charged with the responsibility for the construction of public work.

"payment bond" means a guarantee to secure against non payment under the construction work contract and construction consultancy services contract which may be in the form of bank guarantee, insurance bond or security deposit.

"payment claim" means a claim for debt or damages.

"performance bond" means a guarantee to secure against non performance of the construction contract and may be in the form of bank guarantee, insurance bond or security deposit.

"principal" means a person who has contracted with and is liable to make payment to another person who has in turn contracted with and is liable to make payment to a further person in a chain of contracts.

"retention money" means money retained from progress payment under the construction contract to secure against defect rectification or otherwise.

"site" means the location whereby the construction work is affixed whether on-shore or off-shore.

"supply of construction materials and goods contract" means an agreement to supply and deliver construction materials, goods or equipment and includes hire of plant.

(2) The Minister may, by order published in the Gazette, modify the definition of construction work in sub section (1) by adding, varying or deleting any part of the definition.

Scope and application of the Act

3.(1) This Act shall apply to every construction contract (whether or not the contract is expressed to be governed by the law of Malaysia) that concerns construction work at an identified site within the territory of Malaysia.

(2) This Act shall apply to every construction contract whether made in writing or otherwise.

(3) The Minister may, by order published in the Gazette, exempt the application of this Act or any part thereof to any construction contract or any class of construction contract.

Government to be bound

4. This Act shall apply to construction contract to which the Federal Government or the Government of any component state of Malaysia is a party.

No contracting out of the Act

5.(1) This Act shall have effect notwithstanding any provision to the contrary in any construction contract.

(2) Any provision in a construction contract which excludes, modifies or restricts the operation of this Act is void.

(3) The Minister may, by order published in the Gazette, prescribe the type of provisions in any construction contract which is deemed to have the effect of excluding, modifying or restricting the operation of this Act.

PART II

PAYMENT

Prohibition of conditional payment

6.(1) Any provision in a construction contract making payment conditional as defined in sub section (2) is void.

(2) For the purposes of this section, it is a conditional payment provision when –

(a) the obligation of one party to make payment is conditional upon that party having received payment from a third party; or

(b) the obligation of one party to make payment is conditional upon the availability of funds or drawdown of financing facilities of that party.

Parties free to agree on progress payment

7. Subject to section 6 of this Act, the parties to a construction contract are free to agree between themselves on payment including the number of progress payments, the interval between those payments, the amount of each of those payments and the date when each of those payments become due.

Default provisions for progress payment in the absence of express provision

8. (1) If the parties to a construction contract fail to agree on a mechanism relating to payment, the provisions in sub sections (2) to (4) shall apply to the extent that those provisions relate to any matter for which a mechanism has not been agreed on between the parties.

(2) A party who has agreed to carry out construction work or provide consultancy services under a construction contract has the right to progress payment at a value calculated by reference to –

(a) the contract price for the work or services;

(b) any other rate specified in the contract;

(c) any variation agreed to by the parties to the contract by which the contract price or any other rate specified in the contract is to be adjusted;

or in the absence of any the abovementioned matters, then having regard to the prices or rates prevailing in the construction industry at the time the construction work was carried out or the materials or goods were supplied or consultancy services provided; and

(d) if any part of the construction work is defective or not in conformance with the contract, having regard to the estimated reasonable cost of rectifying the defect or correcting the non conformance.

(3) The frequency of progress payment for construction work contract is monthly for work done for each month commencing from the month on which construction work was carried out. For consultancy services contract, the frequency of progress payment is as and when the service provider sees fit.

(4) The due date for payment is thirty (30) calendar days from the receipt of the claim or invoice.

Payment claim under the Act

9. (1) For the purposes of this Act, an unpaid claimant must serve a payment claim in respect of any payment under a construction contract on one or more persons who under the contract is liable to make the payment as determined in accordance with the terms of the contract.

(2) The payment claim must –

(a) be made in writing;

(b) state the claimed amount and due date for payment;

(c) contain sufficient details to identify the provision in the construction contract to which the payment relates;

(d) identify the work, materials, goods or services to which the payment relates; and

(e) state that it is made under this Act.

Payment response under the Act

10.(1) A respondent named in a payment claim served in relation to a construction contract must respond to the payment claim by paying to the claimant the claimed amount or such part thereof and serve a payment response to the claimant.

(2) The payment response must -

(a) be made in writing;

(b) state the amount admitted (if any);

(c) state where the amount admitted is less than the claimed amount, the reason for the difference.

(3) The payment response may include a cross claim which must contain sufficient details to identify provisions in the construction contract to which the cross claim relates.

Consequences for failure to serve payment response

11. If a respondent fails to respond to the payment claim, it is deemed that the payment claim is disputed.

PART III

ADJUDICATION OF DISPUTES

Right to refer disputes to adjudication

12. (1) Any party to a construction contract has the right at any time to refer to adjudication any dispute with the other party arising under or in connection with the construction contract including for withholding of certificate and non payment of payment claim made under this Act. The claim in the adjudication must be based on a cause of action in law and subject to the laws of limitation in Malaysia.

(2) The right to refer any dispute to adjudication may be exercised even though the dispute is the subject of proceedings between the same parties or concerns the same subject matter in arbitration or in the court.

(3) Any party to a dispute that has been referred to adjudication may be represented by representatives that the party considers appropriate and includes an advocate & solicitor.

Relationship between and effect of adjudication and other dispute resolution process

13. (1) Notwithstanding the right to refer to adjudication, the parties to a construction contract are not prevented to submit the dispute to another dispute resolution process such as mediation, arbitration or court litigation whether or not the proceedings of the other dispute resolution process takes place concurrently with the adjudication.

(2) If a party to a construction contract submits a dispute to another dispute resolution process while the dispute is the subject of adjudication, the submission to that other dispute resolution process does not bring to end the adjudication proceedings or affect the adjudication in any way.

(3) The adjudication proceedings is terminated if before the adjudicator decides the dispute, that dispute is settled by agreement between the parties in writing or decided by arbitration or the court.

(4) The adjudication decision is binding unless or until –

(a) the adjudication decision is set aside by the Construction Court pursuant to Section 34 of this Act;

(b) the subject matter of the decision is otherwise settled by agreement between the parties in writing; or

(c) the dispute is finally decided by arbitration or the court.

(5) An adjudication review determination under section 28 shall have the same effect as if it is an adjudication decision for the purposes of this Act.

(6) The parties and contract administrator (if any) under the construction contract and an adjudicator appointed subsequently to adjudicate on other disputes between the parties must give effect to the adjudication decision.

Initiation of adjudication

14. (1) The party to the construction contract that makes the claim (the claimant) initiates adjudication by serving a notice of adjudication on the other party (the respondent).

(2) The notice of adjudication must –

(a) be made in writing;

(b) state the nature and a brief description of the dispute;

(c) state the relief or remedy sought; and

(d) nominate the adjudicator.

(3) The claimant may provide other supporting documents with the notice of adjudication.

Selection of adjudicator

15. (1) The claimant is free to nominate an adjudicator to be agreed by the respondent. If the adjudicator nominated by the claimant is agreed to by the respondent, the claimant must make a request in writing with a copy of the notice of adjudication to the nominated person to act as adjudicator. Provided that if the nominated person is not an accredited adjudicator as defined in section 16 (1) of this Act, the claimant must make a request in writing and obtain the authorization of the Adjudication Control Authority before making the request to the nominated person to act as adjudicator.

(2) If the respondent does not agree to the adjudicator nominated by the claimant or does not respond to the claimant within three (3) days from the

service of the notice of adjudication or the Adjudication Control Authority does not authorize the agreed nominated person to act as adjudicator, the claimant must make a request in writing with a copy of the notice of adjudication to the Adjudication Appointing Authority to nominate the adjudicator.

(3) The parties to a construction contract cannot pre-agree to an adjudicator if a dispute has not arisen.

Eligibility of adjudicator

16. (1) A person is eligible to act as adjudicator provided the person is an accredited adjudicator on the register of accredited adjudicators maintained by the Adjudication Control Authority or authorized pursuant to sub section (3).

(2) A person may be on the register of accredited adjudicators if the person is an individual with such qualifications, expertise and experience as prescribed by the Adjudication Control Authority.

(3) The Adjudication Control Authority may authorize a person agreed by the parties to act as adjudicator in that dispute between the parties notwithstanding that the person is not an accredited adjudicator on the register of accredited adjudicators.

(4) A person who is directly or otherwise conflicted by interest in any matter connected with the construction contract or subject matter in dispute is disqualified to act as adjudicator in the dispute.

(5) If the adjudicator at any time discovers that there is conflict of interest the adjudicator must immediately disclose the conflict of interest to the parties and the Adjudication Control Authority.

Appointment of adjudicator

17. (1) The nominated adjudicator must within three (3) days from the request of the claimant or nomination by the Adjudication Control Authority serve a notice in writing to the parties that the nominated adjudicator is willing and able to act as adjudicator. The notice must also –

(a) state the fees to be charged by the nominated adjudicator; and

(b) contain a declaration that there is no conflict of interest.

(2) The nominated adjudicator may hold a preliminary meeting with the parties after the service of the notice in sub section (1) to acquaint with the dispute and afford an opportunity to the parties to resolve the dispute amicably.

(3) The nominated adjudicator must within five (5) days from the service of the notice in sub section (1) serve on the parties a notice of acceptance of appointment of adjudicator in writing. The notice of acceptance of appointment of adjudicator is conclusive that the adjudicator is appointed and on the terms as set out in the notice served pursuant to sub section (1) subject to modification (if any) on the fees.

(4) If the parties do not receive a notice of acceptance of appointment of adjudicator, the claimant may make a request in writing to the Adjudication Control Authority to nominate another adjudicator.

Adjudication claim

18. (1) The claimant must serve on the adjudicator and the other party the adjudication claim within seven (7) days from the receipt of the notice of acceptance of appointment of adjudicator.

(2) The adjudication claim must –

(a) be made in writing;

(b) state the nature and description of the dispute in detail; and

(c) state the relief or remedy sought.

(3) The claimant must provide supporting documents (if any) with the adjudication claim.

Adjudication response

19. (1) The respondent must serve on the adjudicator and the other party the adjudication response within seven (7) days from the receipt of the adjudication claim or any further time the parties may agree or the adjudicator may allow as reasonably required.

(2) The adjudication response must be made in writing and answer the adjudication claim. The adjudication response may include a cross claim by the respondent provided the cross claim was included in the payment response where the claimant has previously served a payment claim under this Act. The cross claim must similarly comply with the requirements of section 18 (2) as if it is a claim.

(3) The respondent may provide supporting documents (if any) with the adjudication response but must do so to support the cross claim (if any).

(4) The claimant may serve on the adjudicator and the other party the reply to the adjudication response within three (3) days or within seven (7) days if there is cross claim included from the receipt of the adjudication response.

Jurisdiction of adjudicator

20. (1) The adjudicator's jurisdiction in relation to any dispute is limited to deciding any matter permitted by this Act that is referred to adjudication by the parties but may include matters that are of a consequential nature necessary to complete the exercise of the jurisdiction.

(2) The parties to adjudication may at any time by agreement in writing extend the jurisdiction of the adjudicator to decide any other matter not already referred to the adjudicator.

(3) The adjudicator may investigate and decide on its own jurisdiction, including any objection with respect to the existence or validity of the contract and the applicability of this Act.

Withdrawal and recommencement of adjudication proceedings

21. (1) The adjudication claim or cross claim may be withdrawn at any time if the claimant or respondent, as the case may be, serves on the adjudicator and the other party a notice of withdrawal in writing (unless the other party objects to the withdrawal and the adjudicator recognizes a legitimate interest on the part of the other party in obtaining a decision in respect of the dispute) or if the parties agree on the withdrawal.

(2) Any party who has withdrawn an adjudication claim or cross claim is free to recommence adjudication on the claim or cross claim by serving a new notice of adjudication in accordance with section 14 of this Act.

(3) If an adjudicator dies or becomes seriously ill or is otherwise incapacitated or resigns from the adjudication proceedings, the claimant may serve on the adjudicator and the other party a notice of withdrawal in writing and is free to recommence adjudication by serving a new notice of adjudication in accordance with Section 14 of this Act.

Consolidation of adjudication proceedings

22. If two or more adjudication proceedings are pending, the adjudicator may with consent of all the parties to those adjudication proceedings consolidate and decide those adjudication proceedings at the same time.

Duties of the adjudicator

23. (1) The adjudicator must act independently, impartially and in a timely manner and to avoid incurring unnecessary expense.

(2) The adjudicator must comply with the principles of natural justice.

Powers of the adjudicator

24. The adjudicator will conduct the adjudication proceedings in the manner as the adjudicator considers appropriate and includes having the power to –

(a) establish the procedure including limiting the submission of documents by the parties;

(b) require submissions or production of documents from the parties;

(c) set deadlines for submissions and production of documents;

(d) use own specialist knowledge;

(e) appoint independent experts to inquire and report on specific matters with the consent of the parties;

(f) call for meeting with the parties;

(g) conduct any hearing;

(h) carry out inspection of the site, work, material or goods relating to the dispute including opening up any work done;

(i) inquisitorially take the initiative in ascertaining the facts and the law required for the decision;

(j) issue such direction as may be necessary or expedient;

(k) open up, review and revise any certificate, decision, instruction, opinion or valuation of the parties or contract administrator relevant to the dispute;

(l) decide on matter notwithstanding no certificate issued in respect of the matter; and

(m) award financing costs or interest.

Powers of the adjudicator

24. The adjudicator will conduct the adjudication proceedings in the manner as the adjudicator considers appropriate and includes having the power to –

(a) establish the procedure including limiting the submission of documents by the parties;

(b) require submissions or production of documents from the parties;

(c) set deadlines for submissions and production of documents;

(d) use own specialist knowledge;

(e) appoint independent experts to inquire and report on specific matters with the consent of the parties;

(f) call for meeting with the parties;

(g) conduct any hearing;

(h) carry out inspection of the site, work, material or goods relating to the dispute including opening up any work done;

(i) inquisitorially take the initiative in ascertaining the facts and the law required for the decision;

(j) issue such direction as may be necessary or expedient;

(k) open up, review and revise any certificate, decision, instruction, opinion or valuation of the parties or contract administrator relevant to the dispute;

(l) decide on matter notwithstanding no certificate issued in respect of the matter; and

(m) award financing costs or interest.

Jurisdiction and power of adjudicator not affected by failure to respond

25. The jurisdiction and power of the adjudicator to decide the dispute is not affected by the failure of any of the party to respond and the adjudicator may proceed to draw inferences and decide the dispute based on available information.

Adjudication decision

26. (1) The adjudicator must decide the dispute within thirty (30) days after the service of the adjudication claim or such further time as agreed to by the parties.

(2) In making the adjudication decision, the adjudicator must take into consideration all matters found by and brought before the adjudicator in the course of the adjudication proceedings particularly submissions by the parties.

(3) The decision of the adjudicator must be made in writing and contain reasons unless the requirement for reasons is dispensed with by the parties.

(4) The decision must also determine the adjudicated amount (if any) to be paid by one party to the other and date on which the adjudicated amount is

payable and any other matters in dispute as to the rights and obligations of the parties under the contract.

(5) The adjudicator must serve a copy of the adjudication decision (including any corrected adjudication decision made under sub section (6)) on the parties and the Adjudication Control Authority.

(6) The adjudicator may correct any error in computation or clerical or typographical error or other error of a similar nature on its own initiative or at the request of any party.

(7) There shall be no stay of the enforcement or effect of the adjudication decision pending the resolution of the dispute in arbitration or the court.

Review of adjudication decision

27. (1) Any party which is aggrieved with the decision of the adjudicator may within seven (7) days after the receipt of the adjudication decision make an application to the Adjudication Control Authority with a copy served on the other party for review of the adjudication decision.

(2) The written application for review of the adjudication decision must-

(a) be made in writing;

(b) specify the grounds;

(c) be accompanied by the adjudication decision and other relevant documents; and

(d) be accompanied by such review fee as may be established by the Adjudication Control Authority.

(3) The party applying for review must also lodge with the Adjudication Control Authority the adjudicated amount (if any) payable to the other party ordered in the adjudication decision. The adjudicated amount will be held by the Adjudication Control Authority as stakeholder pending the determination of the adjudication review.

(4) On receipt of the application for review of the adjudication and the payment of the adjudicated amount (if applicable), then the Adjudication Control Authority shall appoint a panel of three (3) adjudicators from the register of accredited adjudicators to conduct the review and notify the parties accordingly in writing.

(5) The Adjudication Control Authority must not appoint as review adjudicator the adjudicator whose decision is the subject of the adjudication review or any person who is conflicted by interest.

Conduct of adjudication review

28. (1) The review adjudicators must undertake and determine the review within fourteen (14) days from the appointment by the Adjudication Control Authority or such further time as agreed to by the parties.

(2) The review adjudicators will have the same powers as provided in sections 24 and 26(6) of this Act and will conduct the review as they deem appropriate which includes having a hearing if necessary.

(3) The review adjudicators may confirm, vary or substitute the adjudication decision as they consider appropriate which includes directing the payment of the adjudicated amount (if any) lodged with the Adjudication Control Authority and the determination shall be decided in accordance with the opinion of the majority of the review adjudicators.

(4) The review adjudicators' determination must be made in writing and served on the parties and the Adjudication Control Authority.

(5) The applicant party may at any time withdraw the adjudication review by serving a notice of withdrawal in writing on the other party, the review adjudicators and the Adjudication Control Authority. On receipt of the notice of withdrawal, the Adjudication Control Authority must refund the

payment of the adjudicated amount lodged by the applicant (if any) but the review fee will be forfeited.

Cost of adjudication proceedings

29. (1) The adjudicator in making the adjudication decision must decide which party shall pay the adjudicator's fees and expenses including the proportion and amount of the fees and expenses.

(2) Each party must bear its own other costs in any event including the costs of representation.

Adjudication Control Authority

30. (1) The Minister shall by notification in the Gazette prescribe the body that shall be the Adjudication Control Authority for the purposes of this Act.

(2) The Adjudication Control Authority shall –

(a) establish and maintain a register of accredited adjudicators;

(b) establish and administer codes of conduct or practice of adjudication;

(c) provide training and conduct examinations for individuals to become accredited adjudicators;

(d) establish and maintain a scale of fees for the services of adjudicators acting by virtue of this Act;

(e) facilitate and provide administrative support for the conduct of adjudications under this Act; and

(f) undertake such other duties or functions as may be imposed by this Act or as may be directed by the Minister.

Adjudicator's fees and expenses

31. (1) An adjudicator is entitled to be paid by way of fees an amount that is agreed between the adjudicator and the parties to the adjudication or if there is no agreement, such fees as prescribed in the scale of fees established by the Adjudication Control Authority and reasonable expenses incurred by the adjudicator.

(2) The parties to the adjudication are jointly and severally liable to pay the adjudicators fees and expenses and the adjudicator may recover the fees and expenses due as a debt.

(3) The adjudicator may on appointment require the parties to contribute and deposit in equal share a reasonable proportion of the fees in advance as security to be lodged with the Adjudication Control Authority.

(4) The adjudicator may require payment of the fees and expenses before releasing the adjudication decision to the parties to the adjudication.

(5) If the adjudication proceeding is withdrawn, the adjudicator is entitled to be paid the fees and expenses incurred in relation to the adjudication up to and including the date on which the adjudication proceeding is terminated.

(6) An adjudicator is not entitled to any fees or expenses in connection with the adjudication if that adjudicator fails to decide the dispute with the time limits prescribed in this Act.

Immunity of adjudicator and Adjudication Control Authority

32. (1) No suit or other legal proceedings shall lie against an adjudicator with respect to anything done or omitted to be done in good faith in the discharge of the duties and functions of the adjudicator under this Act.

(2) No suit or other legal proceedings shall lie against the Adjudication Control Authority or any person acting under the direction of the Adjudication Control Authority with respect to anything done or omitted to be done in the discharge of the duties and functions of the Adjudication Control Authority under this Act.

(3) An adjudicator cannot be compelled or required to give evidence in any arbitration or the court in connection with the same dispute where the adjudicator has acted or decided.

Confidentiality of adjudication

33. The adjudicator and any party to the dispute must not disclose to another person any statement, admission or document made or produced for the purposes of adjudication except –

(a) with the consent of the relevant party;

(b) to the extent that the information is already in the public domain;

(c) to the extent that disclosure is necessary for the purposes of or in connection with the enforcement of the adjudication decision or any proceeding in arbitration or the court; or

(d) to the extent that disclosure is required for any purpose under this Act or the regulations made hereunder.

Improperly procured adjudication decision

34. (1) If an adjudication decision has been improperly procured through fraud or bribery, the aggrieved party may at any time apply to the Construction Court to set aside the adjudication decision.

(2) The application must be made by originating summons (where appearance not required) accompanied by an affidavit of the plaintiff stating the grounds and particulars.

PART IV

SECURITY FOR PAYMENT & REMEDIES

Payment and performance bonds

35. (1) For any construction work contract or construction consultancy services contract having a contract price of more than fifty thousand Ringgit (RM50,000) the party (with the exception of the Government and any other person as may be designated by the Minister) awarding the contract must furnish to the other party as beneficiary a payment bond issued by a bank licensed under the Banking and Financial Institutions Act 1989 for the financial protection of that other party carrying out construction work or consultancy services.

(2) The payment bond value shall be of minimum ten (10) percent of the contract sum (if the contract sum is not stipulated, the estimated value of the construction work undertaken) shall be valid up to the expiry of three (3) months after the final payment under the construction work contract or construction consultancy services contract.

(3) The payment bond must be made in accordance with the prescribed form as set out in the regulations.

(4) The beneficial party to the payment bond is not obliged to commence any work under the construction work contract or construction consultancy services contract unless and until that party receives the payment bond for the value and in the form as prescribed by this Act.

(5) Notwithstanding any provision to the contrary in the construction work contract, construction consultancy services contract or performance bond, neither party can make a demand for payment against the payment bond or performance bond or utilize the retention money, as the case may be, unless that party is found entitled to do pursuant to an adjudication decision, arbitration award or judgment of court whichever is the earlier.

Enforcement of adjudication decision as judgment

36. (1) An adjudication decision may with leave of the Construction Court be enforced in the same manner as a judgment or an order of the High Court to the same effect.

(2) Where leave of the Construction Court is so granted, judgment may be entered in the terms of the adjudication decision.

(3) The application for leave to enforce an adjudication decision must be made by originating summons (where appearance not required) accompanied by an affidavit of the plaintiff and where applicable stating that the whole or part of the adjudicated amount has not been paid at the time the application is filed.

(4) If the affidavit referred to in sub section (3) indicates that part of the adjudicated amount has been paid, the judgment shall be for the unpaid part of the of the adjudicated amount.

(5) Leave can only be opposed on the ground that the adjudicated amount has been paid or that natural justice has been denied in the adjudication or that the adjudication decision has been improperly procured through fraud or bribery.

(6) An adjudication decision entered as a judgment carries interest on judgment debt and may be enforced by execution in accordance with the Rules of the High Court 1980.

Suspension and reduction of rate of progress of performance

37. (1) A party who carry out construction work or supply materials or goods or consultancy services under a construction contract may suspend performance or reduce the rate of performance if the adjudicated amount pursuant to an adjudication decision has not been paid in whole or at all and the amount remains unpaid after the expiry of seven (7) days notice in writing served on the other party of the unpaid party's intention to suspend performance or reduce the rate of progress of performance, as the case may be.

(2) If the unpaid party exercises the right in sub section (1), the unpaid party –

(a) is not in breach of contract;

(b) is entitled to a fair and reasonable extension time to complete the obligation under the contract; and

(c) is entitled to recover from the other party loss and expenses incurred as a result of the suspension or reduction in the rate of progress of performance.

(3) Where the unpaid party has suspended or reduced the rate of progress of performance under the contract in accordance with sub section (1), the work or supply or services must be resumed in accordance with the contract within three (3) days after having been paid the adjudicated amount.

Direct payment from principal

38. (1) If a party fails to pay in whole or at all the adjudicated amount pursuant to an adjudication decision, the principal of that party may make payment to the unpaid party the outstanding amount provided that –

(a) the unpaid party must have made a written request to the principal for payment;

(b) the principal must serve a notice in writing on the party who failed to pay stating that direct payment would be made after the expiry of seven (7) days;

(c) the party who has failed to pay must, if payment of the outstanding adjudicated amount has been made, show proof of such actual payment

to the principal within three (3) days after the receipt of the notice referred to in sub section 1(b); and

(d) if that party fails to show proof of payment, the principal is entitled to pay the outstanding adjudicated amount or any part of it to the unpaid party.

(2) The principal may recover the amount paid to the unpaid party as a debt or set off the same from any money due or become due by the principal to the party who has failed to pay the adjudicated amount.

Concurrent exercise of remedies

39. (1) The party to which the adjudication decision favours may exercise any or all of the remedies provided in this Act concurrently if the adjudication decision is not complied with.

(2) The remedies provided by this Act are without prejudice to other rights and remedies available in the contract or at law.

PART V

CONSTRUCTION COURT

Creation of Construction Court

40. (1) There shall be established a Construction Court which shall be a division of the High Court to discharge the duties assigned by this Act and such other duties as may be assigned by the Chief Justice of the High Court.

(2) The Construction Court is empowered to make rules or practice directions in the discharge of its duties.

PART VI

MISCELLANEOUS

Service of notices and documents

41. All notices or other documents to be served under this Act may be served on the person –

(a) by delivering it to the person personally;

(b) by leaving it during the normal business hours at the usual place of business of the person; or

(c) by sending it by AR registered post to the usual or last known place of business of the person.

Regulations

42. (1) The Minister may make regulations for or with respect to any matter that by this Act is required or necessary for carrying out or giving effect to this Act

(2) Without prejudice to the generality of sub section (1), regulations may be made for –

(a) the manner in which the Adjudication Control Authority is required to exercise or perform its duties and functions;

(b) the conduct of adjudicators;

(c) the form of records to be kept and maintained, information to be recorded and the submission of records; and

(d) the prescribed form of payment bond.

Exemption

43. The minister may, by regulations, exempt –

(a) any person or class of persons; or

(b) any contract, matter or transaction or any class thereof,

from all or any provisions of this Act, subject to such terms and conditions as may be prescribed.

5.5.4 Rationale of the Proposed Act

The proposed statute has been drafted based on a combination of the provisions in the United Kingdom (HGCRA), New Zealand (CCA) and Singapore (SOPA) statutes after taking into account the impact of the provision on the respective country's construction industry payment problem. In addition, new provisions have been suggested, particularly on payment bond and creation of the Construction Court.

The drafting also takes into account problems that had occurred in these jurisdictions as evident from reported court cases especially with regard to challenges to adjudications in the United Kingdom.

(a) PART I

The scope of the proposed statute as laid sown in Part I is widened in terms of the definition of construction work, coverage and type of the construction contract. There have been many cases of challenge in the United Kingdom on these grounds because the provisions in the HGCRA are narrower, as the coverage of the statute is limited and the HGCRA requires construction contract to be in writing.

It is seen that the scope of the statutory coverage and requirements differ amongst the Commonwealth countries examined in Chapter 3 probably for their own policy reasons. In creating exceptions particularly with regard to the scope of coverage of the statute and the requirement that the construction contract be in writing, it is seen in the United Kingdom that this has given rise to many jurisdictional issues and problems in adjudication. For instance, questions often arise as to whether the dispute is covered by the HGCRA. Thus in *The Project Consultancy Group v The Trustees of the Gray Trust*,[52] the issue raised in resisting enforcement was that there was no construction contract within the meaning of the HGCRA. The issue with regard to the requirement that the contract be in writing was raised time and again in numerous cases.[53] Similar problems are seen in Australia.[54]

To overcome the aforesaid problems, the provisions on the scope of the application of the statute and definition of construction contract are widely couched in Part I of

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[52] [1999] BLR 337.

[53] *Carillion Construction Ltd. v Davenport Royal Dockyard* [2003] BLR 79; *RJT Consulting Engineers v DM Engineering* [2002] BLR 217; *Thomas-Fedric's (Construction) Limited v Keith Wilson* [2004] BLR 23; *Trustees of Stratfield Saye Estates v AHL Construction Limited* [2004] EWHC 3286 (TCC).

[54] *Boutique Developments Ltd v Construction & Contract Services Pty Ltd & Anor* [2007] NSWSC 1042.

the proposed Malaysian statute. In this respect, the definition of construction work in the CIDB Act[55] is wide and serves as a useful guide. Accordingly, it is suggested that the definition in the CIDB Act be adopted. This is to also to maintain consistency between the related statutes in Malaysia. Besides, the proposed statute does not confine the construction contract to those which are in writing. This is because there is in principle no necessity for construction contract to be in writing pursuant to the Contracts Act 1950. In fact, there are construction contracts in Malaysia that are oral as previously discussed as well as those in writing and supplemented with oral collateral agreements.[56]

(b) PART II

The provisions of Part II of the Act particularly the provision prohibiting conditional "pay when paid" payment terms do not appear to have been subject to challenge in the countries examined in Chapter 3. The provision implying progress payment terms in the absence of express term in the construction contract is not novel as it is likewise provided in the New Zealand CCA and the Singapore SOPA with a degree of success.

There is also the provision for the unpaid claimant to make a statutory payment claim demand to elicit the response and reasons from the non paying respondent. This is akin to JCT sub contract procedure seen in Chapter 3 where the non paying party exercising the right of set off must give notification and reasons accordingly. This is also to prevent ambush during adjudication.

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[55] *Supra* n. 50.

[56] *Industrial & Agricultural Distribution Sdn Bhd v Golden Sands Construction Sdn Bhd* [1993] 4 CLJ 140.

This part does not deal with implied payment terms for supply of construction materials or goods and equipment as it is thought that the Sale of Goods Act (1957) is adequate. Further, just like in all of the countries examined in Chapter 3, there will nevertheless be no attempt to overly regulate and restrict freedom of construction contracting in this Part of the Act.

(c) PART III

The provisions of the key feature of the Act on adjudication in Part III have been widened and tightened to remove certain ambiguities. All disputes instead of only payment disputes are adjudicatable following the United Kingdom HGCRA and New Zealand CCA. The position is different in the statutes in the various states of Australia and Singapore where only payment disputes are adjudicatable. It is also specifically provided that the parties are allowed legal representation. Since adjudication is a rights based process, it is thought that the prohibition of legal representation as in New South Wales Australia is unsatisfactory. The adjudicators must be compulsorily accredited following the Singapore SOPA to ensure strict and standardized control of adjudication standards. This is not so in the other countries where the nomination and appointment of adjudicators is left to various professional bodies. Be that as it may, there is also the provision for ad hoc authorization in the proposed statute to cater for the situation where there is no local accredited expertise.

The powers conferred on the adjudicator in the statute are the widest in comparison with the other statutes. The adjudicator is nonetheless dutibound to be independent, impartial and to dispense natural justice in the same way as any legal rights based process. It is submitted that natural justice cannot be adequately defined in the statute and that the court is in a better position to deal with it on a case by case basis along the lines of the English Court of Appeal cases of *AMEC Capital Projects Ltd v Whitefrairs City Estates Ltd*[57] and *Carillion Construction Ltd. v Davenport Royal Dockyard Ltd.*[58]

The prescribed time limits of the adjudication is a compromise amongst the time lines prescribed by the various countries. It is seen that the time limits in the Singapore SOPA is the tightest and probably impracticable though it is acknowledged that the adjudicatable dispute therein is only also limited to payment disputes. Based on the time lines in the proposed statute, the adjudication is expected to take around 70 working days from commencement to decision unless extended with the consent of the parties. The administration of the adjudication process is also more elaborate and comprehensively set out in the proposed statute as per the SOPA. The adjudicator is able to conduct the adjudication process as he sees fit so long natural justice is observed. In addition to adversarial advocacy by the parties, the adjudicator has inter alia inquisitorial powers as well as the right to use his own expertise in making the adjudication decision.

[57] [2005] BLR 1.
[58] [2006] BLR 15.

As with the SOPA, there is the provision for adjudication review. It is also thought that adjudication review by a panel is desirable to promptly cure a patently erroneous and/or legally incorrect decision (including those which might have been improperly procured but could not be sufficiently proved to have the adjudication decision set aside).

It is also provided that besides the parties and contract administrator under the contract, an adjudicator appointed to subsequently adjudicate on other disputes between the parties must give effect to the adjudication decision. This deals with problems that are likely to be encountered in multiple adjudications as seen in *Quietfield v Vascroft.*[59]

Finally, to facilitate cash flow, it is provided that there will be no stay of the adjudication decision even if it is challenged and being re-determined finally in arbitration or in court.

(d) PART IV

As to Part IV, the statute is substantially akin to that of the Singapore SOPA in terms of remedies provided. The proposed remedies are of two types, to wit, to procure the recovery of the unpaid payment and to prevent further financial exposure. The former is addressed via enforcement of the adjudication as a judgment debt, seeking direct payment from the principal and/or demand against the payment bond. The latter is addressed by suspension or reduction of rate work

[59] [2006] EWHC 174 (TCC).

execution until payment is made. The aforesaid remedies can be exercised concurrently. It is also provided that the remedies are without prejudice to other rights, for instance, the right to terminate the construction contract.

Nevertheless, the remedies are only exercisable after an adjudication decision is found in favour of the claimant. This is unlike the position in the United Kingdom HGCRA where the alleged unpaid claimant has the right of suspension of work notwithstanding that the dispute has yet to be resolved. The charging order provision found in the CCA of New Zealand is very much a lien and is thought to be unsuitable here in Malaysia. The additional remedies afforded in the proposed statute which are not found in the Singapore SOPA are the reduction of rate of execution of work (in lieu of suspension of work) and the making of demands against the payment bond. The former provides the avenue to avoid further financial exposure on the part of the aggrieved claimant whereas the latter provides recovery of the outstanding debt or damages. The remedies are two prong and they can be exercised concurrently.

In addition, the statute should also regulate the demand against the performance bond furnished to be on par with the payment bond. In this regard, the demand against either bond can only be made after a successful decision is obtained at least in adjudication. This is to curb the present unfairness seen from the performance bond injunction cases in Chapter 2 where a party in a dispute would often call upon the on-demand bond to financially burden, if not terrorize the other party.

(e) PART V

Part V deals with the creation of the Malaysian Construction Court. It has been commented[60] that the success of adjudication in the United Kingdom is also significantly contributed by the robust enforcement of adjudication decisions by the Technology and Construction Court (TCC)[61]. The TCC was formerly known as the official referees court that dealt with claims which involve issues or questions which are technically complex. The majority of construction contract actions in the High Court are tried by the judges of the TCC.[62] The immense benefit of the TCC is that it is a specialist court housed with judges who are familiar with complicated factual and legal construction issues. Thus they can easily understand and appreciate the adjudicated issues and should have little difficulty in deciding whether to enforce the adjudication decision. They further try the dispute if it is finally determined in court. This is to avoid the problem as seen in the unjustified review and setting aside of the adjudication decision by the New South Wales Court.[63]

In the premises, it is thought that the statute should also create a Malaysian construction court having similar duties and powers of the TCC as provided in Part V of the proposed statute. The specialist court enables the dispensation of expert

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[60] Interview with Nicholas Gough, solicitor of Fenwick Elliot and Adam Constable and Humphrey Lloyd, barristers of Keating and Atkins construction law chambers at their offices in London, United Kingdom in May 2006.

[61] Chapter 3.2.5(d).

[62] Stephen Furst and Vivian Ramsey, *Keating on Construction Contracts* (Sweet & Maxwell 8th ed., 2006) at 18-003. The landmark UK construction cases that reached the House of Lords which originated from the TCC (or its predecessor the Official Referees Court) including *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* (1973) 1 BLR 73, *Anns v London Borough Council of Merton* (1977) 5 BLR 1 and *Royal Brompton Hospital NHS Trust v Hammond (No. 3)* [2002] BLR 255.

[63] Brody v Davenport [2004] NSWSC 394.

and efficient construction justice though there will be extra expenditure to the Government to create the court and its registry.

In summary, the proposed statute have addressed most of the Malaysian Construction Payment Problems identified in Chapter 2. Nevertheless, it is acknowledged and submitted that it will not be possible to address all the problems due to practical realities and limitation especially to balance competing interests of opposing parties to the construction contract when modification of existing norms are in issue. In this regard, examples are to continue to allow payment in kind to be good consideration as well as to allow skewed "back loaded" stages of payment in a construction contract.

5.6 Conclusion

In Chapter 1, this dissertation postulates three hypotheses to be examined, to wit:

i) that the contract terms commonly employed in the Malaysian construction industry do not sufficiently and fairly allocate the risks between the parties and do not provide adequate remedy late or non payment for work done and services rendered;

ii) that the statutory provisions and common laws of Malaysia are not adequate to safeguard and balance the risks between the parties and provide for relief for late or non-payment for work done or services rendered; and

iii) that the procedures presently available in the Malaysian legal system are not adequate and effective in protecting and enforcing the claim for late or non-payment for work done or services rendered in the construction industry.

It is now proposed to verify each of the hypotheses set out seriatim.

5.6.1 First Hypothesis

In Chapter 2 of this dissertation, the standard forms of construction contracts used in Malaysia are examined. They include the PWD and PAM forms used for public sector and private sector construction respectively as well as the CIDB form which could be used for either sector. The standard forms are available only for contracts at the main contract level and for nominated sub contracts at the sub contract levels.

It is rare nowadays that construction contracts are undertaken on an entire contract basis except for a handful which are undertaken through special arrangements between the parties having a bank guarantee for payment in place. Thus all the standard forms provide for progress payments and this in principle alleviates the financing risks. The progress payments include the value of work properly done and materials (not prematurely) brought to site. The PWD and CIDB forms nevertheless require a certain stipulated minimum value to be achieved before payment becomes due. There is however a stipulated percentage to be retained against payment as security for non performance.

In addition, the standard forms also provide for final payment for the ultimate value of the work done, including variation work carried out.

In all the standard forms, both the progress and final payments are subject to the certification of a third party who is often a construction professional. This in principle ensures honest, expert and independent assessment of the value of work.

There are nevertheless also provisions in the standard forms for deductions for delayed completion and defective work rectification subject also to the certification of the third party. This again in principle safeguards against abuse.

The common remedy provided in the standard forms for non certification by the third party is arbitration. As for non payment, the remedies in the standard forms vary and range from suspension/ slow down of work and/or determination of the employment in the CIDB form to only determination of employment in the PAM form. There is none provided in the PWD form. Furthermore, there is also no remedy provided in the standard forms for late payment.

It is plain that the contractual provisions in the standard forms are effective provided that the third party certifier acts as expected and the non payment is not disputed. Both these conditions are much too often unmet in reality. Besides, the terms in these standard forms of contract are often amended or adulterated in

favour of the paying parties. The original allocation of risk assumption and provision of remedies are thus destroyed.

Other than the standard forms which are of only limited availability and usage as aforesaid, it is seen in Chapter 2 that there are lots of construction contracts including supply and consultancy services contracts that are settled ad hoc on a negotiated basis. Although they are also not entire contracts, the construction contracts at the sub contract levels are pervasively on a "pay when paid" basis thus shifting the financing risks unfairly to the party undertaking the work. In addition, the value of work done is assessed not by an independent and professional third party but instead by the paying party. Unlike the provisions in the UK JCT sub contract forms, there is generally also no provision here requiring deduction/set off against payment to be sufficiently particularized and notified in writing to the other party before they can be exercised. Moreover there is hardly any provision provided in these ad hoc contracts on remedies for non or late payment.

In the circumstances, the first hypothesis is verified.

5.6.2 Second Hypothesis

It is also seen in Chapter 2 that there is no specific statute in Malaysia that deals with payment problems arising from construction contracting.

The other statutes such as the Contracts Act 1950 and Specific Relief Act 1950 only provide general remedies for breach of contract principally in damages and on rare occasions, injunction or specific performance.

The common law does not favour the unpaid party either. There is no general right to suspend or slow down the rate of working. It is only in a sufficiently serious situation which is very fact sensitive that the unpaid party may terminate the contract. Otherwise the unpaid party may sue for payment but is nevertheless still obliged to carry out the work in accordance with the contract expectation. Pending recovery of payment in the lawsuit, the unpaid party must necessarily finance the work to carry on and complete it. In reality, most of them can ill afford to do so and is likely to result in their demise before the payment is resolved.

Consequently, the second hypothesis is plainly as postulated and thus verified.

5.6.3 Third Hypothesis

The construction industry is prone to dispute. The limited remedies provided in the standard forms of contract for late or non-payment cannot be safely and effectively exercised unless the dispute thereto is resolved. Otherwise, it is likely to result in a wrongful exercise which in turn puts the party exercising it in breach of contract.

It is thus essential that the dispute resolution process be capable of being swift and yet binding on the parties.

As seen in Chapter 2, the present modes of construction dispute resolution are mediation, arbitration and court litigation. Mediation is a process that facilitates settlement and is not binding on the parties unless a settlement is reached. It has been of little success principally because the disputes are either complex and/or non genuine, to wit, the disputing party is merely creating a dispute to postpone the payment day. Arbitration or court litigation is final and binding but is too-time consuming. This lengthy process is necessary to achieve traditional adversarial fine justice. Besides, the lengthy procedure also makes it expensive and increasingly unaffordable to the parties particularly the already aggrieved unpaid party. It is seen that most summary judgment applications including those based on third party certificates have failed. They all have to undergo protracted trials or arbitrations. Although there is now the new Arbitration Act 2005 in force, the aforesaid problems are likely to persist.

That notwithstanding, until the dispute resolution is concluded, there is the absence of both security for payment as well as limitation of further exposure to the unpaid party during the course of the lengthy dispute resolution. The present available interlocutory remedy of Mareva injunction or Section 19 of the Debtors Act 1957 application is rarely allowed as the burden of meeting the prescribed requirements is extremely onerous. Furthermore, these interlocutory remedies do not make the successful applicant a secured creditor. It must also be borne in mind that many contracting parties particularly the apex private sector owners are often limited

companies with low capitalization. Thus, the ultimate outcome is often a hollow victory.

It is also seen that in the Malaysian contracting environment the position of the paying party at the higher levels of the construction pyramid is secured by retention money or performance bond or both. The performance bonds are always "on-demand" type and the courts have largely declined granting injunction to restrain demand or payout pending dispute resolution unless fraud is established. This problem further excruciates the aggrieved unpaid party.

In the circumstances, the third hypothesis is also verified as postulated.

5.6.4 The Strategy and Solution for Reform

The construction industry payment in Malaysia needs reform.

In gist, there is the need to address the following concerns:

i) There must be fair and balanced contractual terms and provisions on risk allocation. Progress payment must be the norm. Unfair contract terms and practices must be prohibited or curbed. The crucial ones are the "pay when paid" provision and the demand against performance bond pending dispute resolution;

ii) There must be a new swift, economical and yet binding dispute resolution process;

iii) There must be security for payment which remains enforceable after the conclusion of dispute resolution; and

iv) There must be effective remedies providing reliefs and sanctions and limiting further exposure after the conclusion of dispute resolution.

From the examination of the collective experiences and strategies of the other countries examined in Chapters 3 and 4 of this thesis, it is plain that the solution for reform in Malaysia has to be by way of statute.

The proposed statute is the Construction Industry Adjudication and Security of Payment Act as set out in this Chapter addresses the aforementioned concerns and other related matters. The proposed Act in crux provides as follows:

i) Default progress payment terms by implication and prohibition of "pay when paid" clauses;

ii) A new mechanism for speedy dispute resolution by adjudication;

iii) Security and remedies for non payment.

Thus, the Malaysian strategy and solution is the enactment of the proposed Construction Industry Adjudication and Security of Payment Act.

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