

ISSUES OF CONTRACTUAL CHAIN AND SUB-CONTRACTING IN THE CONSTRUCTION INDUSTRY

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Issues and implementation difficulties relating to sub-contracting such as payment matter are not uncommon in the construction industry. Recently, this situation is made worse by the decline in the growth of Singapore domestic construction sector. Theoretically, many problems of sub-contracting can be traced back to the main source rooted in the concept of contractual chain of liability which largely dictates the legal basis of contractual relations among parties. Characteristically, the chain of liability binds the three main project parties by two separate links: one exists between project owner & main contractor and the other between main contractor & sub-contractor. Notably, the absence of a direct link between owner & sub-contractor in this chain gives rise to much of the implementation difficulties. This paper presents a review of the legal basis of this contractual arrangement, examines the current state of development in the local building and construction industry, and summarized the industrial efforts and attempts made in the bid of resolving these problems and alleviating the potential adverse impact. Drawing cases from building construction industry, this paper reviews and addresses the common problems faced by project parties, the contractual issues in sub-contracting, and the acute payment issues relating sub-contractor. The study reveals that certain measures on payment such as having an appointed authority for independent adjudication can be considered for implementation so as to enhance the cash flow and financial security of sub-contractors and help to establish a more stable sub-contracting system.

Keywords: arbitration, adjudication, chain of liability, payment, sub-contracting.

INTRODUCTION

Sub-contracting is commonly used in building and construction projects in the construction industry. It frequently appears as a common arrangement for the main contractor to complete works of specialised natures or for the project developer to make direct purchase of materials. Such sub-contracts would include the supply and installation of plants, equipments, machineries, materials, fittings, which are often carried out at the site, in factories or workshops. It is also not uncommon to have incorporated a design and build sub-contract into a development project. Due to the nature and the complexity of sub-contracting works, which depend much on the arrangement and terms of agreement between the parties involved, practical issues and problems relating to sub-contracting in the construction industry are often encountered. The following common issues relating to sub-contracting are discussed in the following sections:

- Unsatisfactory arrangement on terms of payment for sub-contracting work.

- Lack of understanding on the implication of the sub-contractor's work onto the main building contract work.
- Co-ordination, integration, interfacing of sub-contractors' works and the main contractors' works.
- Inconsistencies on the terms and conditions of the main contractor vis-a-vis sub-contracts.
- Ownership of nominated suppliers' materials.
- Defects and design of work done by sub-contractors
- Incomprehensive terms and conditions of sub-contracts.

DOMESTIC SUB-CONTRACTORS

In practice, there are two types of sub-contracting, namely domestic sub-contract and nominated sub-contract. In domestic sub-contract, the main contractor remains fully liable to the employer for the works particularly in respect of the workmanship and delay caused by the sub-contractors. In practice, the right and duties of the sub-contractor are not governed by the terms of the main contract because such terms are not incorporated into the sub-contract.

In most building contracts, there are clauses in the General Conditions of Contract, which explicitly states that appointment of domestic sub-contractors can only be appointed with the approval of the Superintending Officer (SO). In this respect, such consent should not be unreasonably withheld because an arbitrary and unjustified refusal particularly in respect of the replacement of a sub-contractor, who is in financial difficulties, could result in a breach of implied terms of the contract.

NOMINATED SUB-CONTRACTORS

It is a common practice in the building industry for specialist work such as mechanical & electrical installation or structural steel work, which form a substantial part of a building project, to be awarded on a nominated sub-contract basis. In many instances, this has been necessitated by the fact that the specialist works are manufactured installation such as lifts, electrical switchgears or waste disposal plant where the required expertise lies beyond the duties and professional services of the project's design professional. In practice, the employer has to rely on the specialist manufacturer or the supplier of the goods for their design and installation.

The factors that an employer would take into consideration for the types of specialist work would include pricing, technical capability and consideration on the long delivery time which may result in orders being placed well before the appointment of main contractor. The co-ordination and interfacing of specialist sub-contracts to the main building contract can result in problems for which the employer may find himself with claims for extension time and extra payment for disruption due to faulty work or defective materials and delay. In order to avoid these said problems, the employer usually obtains tender for this type of specialist work, then instruct the main contractor to enter into a sub-contract with the successful tenderer on a nominated sub-contract basis.

NOMINATED SUPPLIERS

Goods and materials required to be obtained from a nominated supplier are frequently included in the contract bills of quantities as a prime cost sum, with the right of nomination of the SO.

The nominated supplier is required to make good any defect in the materials or goods, which appear before the expiry of the defect liability period. Any cost that may be incurred by the main contractor in re-fixing the defective materials supplied, should be reimbursed by the nominated supplier and this may include loss and expense caused by delay.

The ownership of the materials or goods will pass to the main contractor upon delivery to site by the nominated supplier regardless whether payment has been made, unless contract states otherwise. Although there may be conditions of sale in the supplier's quotation and invoices, these conditions will not overwrite the conditions in the contract. Should the SO decides to waive the conditions in the main contract with the nominated supplier, he must obtain approval from the employer as the main contractor would obviously be released of the same obligation towards the employer.

THE NATURE OF CONTRACTUAL CHAINS OF LIABILITY

The basic position in law is that the main contract and the sub-contract are regarded as links that forms a contractual chain. The doctrine of privity of contract means that the rights and obligations contained in each contract apply only to those who are parties to it (Lee 2001). Thus the main contract affects only the employer and the main contractor and the sub-contract affects only the main contractor and the sub-contractor.

For both nominated and domestic subcontract, there is no privity of contract between the employer and sub-contractor (Lee 2001). Therefore the sub-contractor is not liable in contract to the employer for any default or breach of contract on his part. The employer likewise cannot make any contractual claims against the sub-contractor. The sub-contractor's claim must be against the main contractor, who may then in turn have a contractual remedy against the subcontractor.

However, a chain is only as strong as its weakest link, and considerable problems arise as soon as one of the links breaks. For example, the position where the terms of the two contracts are significantly different, a liability may then arise which cannot simply be passed down the chain. Notably, this can also happen in a case where one of the parties is insolvent and therefore unable to meet its liabilities.

Given that there is an absence of contractual bond between the employer and the sub-contractor, the employer cannot successfully claim against the sub-contractor particularly in delay, defective work and design. The employer has to rely on the chain of liability, namely employer recovers from the main contractor under the main contract; main contractor recovers from sub-contractor under the sub-contract. In practice, problems frequently arise where there is no link or there is a break in the chain of liability. Theoretically, this culminates into a number of problems including payment to sub-contractor where a subcontractor does not have any recourse against the employer for payment due under the sub-contract.

It is commonly practiced that if a nominated sub-contractor fail to complete the sub-contract work within the allocated time on the contract program or revision thereto, the contractor should inform the SO accordingly, and who should then take appropriate follow-up action. The main contractor is not able to give the nominated sub-contractor an extension of time without the written consent of the SO.

Sometimes a clause stating to the effect that the employer will reimburse the contractor for his expenses not recoverable from subcontractor is incorporated into the General Conditions of Contract to alleviate some of the inherent legal and practical difficulties created by the system of nominated sub-contracting.

Under such situation, the employer may become financial responsible for losses resulting from the nominated sub-contractor's default when the main contractor are unable to recover his losses from the defaulting sub-contractor.

Subject to the terms and conditions of contract, when a sub-contractor goes into liquidation, a main contractor would normally require the SO to nominate alternative sub-contractor, order variation of the work or arrange for the main contractor to finish the sub-contract work. Although the chain of liability which binds the employer to the main contractor and main contractor to sub-contractor, but when a sub-contractor becomes obviously not able to pay in this instance, the risk of insolvency of a nominated sub-contractor may be borne by the employer who chooses him, not the main contractor, as evidenced in the following case (Hudson & Wallace 1970):

A sub-contractor nominated under a prime cost sum, went liquidation and the liquidator refuses to complete the sub-contract. In the absence of appointment of second nominated sub-contractor by the employer, the main contractor completed the sub-contract work under protest.

Held: *That they were entitled to extra payment for doing so.*

OWNERSHIP OF MATERIALS

At common law, as soon as any materials or goods are incorporated into a building, they cease to belong to the contractor and become the property of the employer. In general, unless the contract between the main contractor and his supplier provides otherwise, the property in the supplier's goods would pass to the main contractor upon delivery of the goods to the site. Thus, until the materials are built into the works, even though they have been delivered to site, they remain the property of the main contractor. This is despite that fact that even the employer has paid the contractor for the materials, unless the contract makes express provision for this.

However, situations may arise where there is retention of title clause in the contract between the supplier and the main contractor, namely a clause providing that property in the goods does not pass to the purchaser on delivery, but say, on payment only. An issue may arise as to who has the right to these materials when property to the materials has not even passed to the main contractor. The question would be whether the supplier could be bound by a provision in a contract to which he is not a party.

Generally, terms in the contract between the employer and the main contractor cannot affect the supplier's position, since he is not a party to that contract. Also, the *nemo dat* principle applies, which means a person cannot give a better title than what he has. Therefore, if the main contractor does not have title in the goods, he cannot then confer the good title to the employer. The following case (Lee 2001) illustrates the

issues on the ownership as well as the inconsistent terms of conditions between the main and the sub-contract:

***Dawber Williamson Roofing Ltd v
Humberside County Council***

The main contractor, who had been paid by the employer for the materials delivered to site by a sub-contractor, went into liquidation without paying the sub-contractor. The main contract contained a clause which stated that:

"any unfixed materials and good delivered to, and placed on, or into the works, shall not be removed except for use upon the works, unless consent in handwriting be given, and when the value of the goods has been included in any interim certificate under which the contractor has received payment, such materials and goods shall become the [employer's] property".

The subcontract, which was a supply and install contract, contained a clause whereby "the sub-contractor shall be deemed to have knowledge of all the provisions of the main contract..."

Since the sub-contractor was not paid, they sued the employer for the return of the goods delivered to site. They argued that their contract was a "supply and fix" one, which meant that they were not selling the goods to the employer. Thus property in the goods could not have passed to the main contractor before installation.

Held: *the provision in the sub-contract that the sub-contractor was deemed to have knowledge of the terms of the main contract did not have the effect of making the main contract terms part of the sub-contract. The provision in the main contract regarding the passing of property upon payment did not apply to the sub-contractor since he was not a party to that contract. The provision would only have force if the title had passed to the main contractor from the sub-contractor: The sub-contractor was accordingly entitled to succeed in its claim for the goods against the employer.*

The position is different in the case of goods which have been fixed and incorporated into the works. In such cases, as soon as the goods are incorporated into the works, they become the property of the employer. In practice, a contract between the employer and main contractor may contain a clause for the passing of property in materials delivered to the site by the main contractor, for example Clause 16(2) of the SIA Conditions (SIA 1999).

DEFECTS

A main contractor is generally held liable for defective work or materials delivered by a nominated sub-contractor, unless the employer is responsible for a break in the chain of liability.

The nominated sub-contractor must rectify any defective work before final payment is made and discharged from the sub-contract. In this respect, it is also possible to arrange for the nominated sub-contractor to provide some form of indemnity to the main contractor against the possibility of defect occurring and the cost of making good. The reason why this may be necessary is due to the fact that when a sub-contractor fails to rectify defective work, it is the responsibility of the main contractor to carry out relevant remedial measures in full compliance with the main contract.

If the main contractor becomes liable to pay compensation to employer for a breach of the main contract due to a breach in the sub-contract caused by a sub-contractor, the employer cannot enforce any arbitration award or court judgment for compensation

until and unless the contractor recovers the amount from the sub-contractor. This restriction is subject only to the proviso that the contractor must take all necessary steps and proceedings to recover from subcontractor as required by the employer. Notably, the main contractor's liabilities may end if and when a nominated sub-contractor becomes insolvent or liquidated.

DESIGN WORK

The main contractor, in the traditional method of project delivery, undertakes no design responsibility, as he is only responsible for carrying out his work in compliance with the design of the employer's consultant. Therefore, unless the main contract states otherwise, the main contractor may not be liable to the employer regarding nominated sub-contract work for any design responsibility that may be undertaken by the nominated sub-contractor.

In a case of specialist design work or detailed shop drawings produced by a sub-contractor, this may result in the employer relying on the sub-contractor for matters which may not form part of the main contract at all. Under such circumstance, it is difficult to imply into the main contract that the main contractor is accepting the design responsibility.

In a case where the specialised sub-contractor provides design warranty as to quality, design or suitability of the specialised sub-contract work directly to the employer, an employer may recover some losses directly from the sub-contractor under the general law of negligence if he can prove that the sub-contractor failed to take reasonable care in performing the sub-contract, including the design of the work.

PAYMENT TO NOMINATED SUB-CONTRACTOR

The contractual position between the main contractor and the sub-contractor is governed purely by the sub-contract. Thus a sub-contractor's right to be paid arises from the sub-contract.

A common clause of 'pay when paid' is sometimes found in sub-contracts. Such clause purports to provide that payment will be made to the sub-contractor only after the main contractor has received the payment from employer. As a common practice, upon the issue of each interim certificate, the SO must inform the main contractor of the amount that has been included for each nominated sub-contractor and the individual sub-contractor will also be informed accordingly. The main contractor then makes these payments as directed. In addition, the contractor must also provide some evidence that appropriate amounts shown on previous certificate had been paid to the respective nominated sub-contractors.

This will be different when the contract conditions provide a remedy for paying the sub-contractor direct. In this case, when the main contractor default in payment, and based upon the SO's relevant certificate, the employer may pay the sub-contractor direct and deduct these amounts from future payments due to the main contractor.

Such an arrangement was provided in Clauses 30(1)(b), 30(2)(a) & (b), 30(3), 30(4) and 30(5) of the SIA Article and Conditions of Building Contract (SIA 5th Edition). In particular, clause 30(2)(a) states clearly that if the sole reason for non-receipt from the employer of the amounts certified by the SO in favour of a nominated sub-contractor or supplier is a defence, set-off, counterclaim or deduction by the employer against the contractor not related to any default by that nominated sub-contractor or

supplier, the amounts shall be treated as having been paid to the contractor (SIA 5th edition).

It should be noted that any such power to make direct payment to nominated sub-contractors becomes ineffective when a contractor becomes insolvent. This is particularly relevant for Singapore where the growth of construction sector has been in decline for the past three years. The Singapore's construction market has become over competitive for too few projects, many building contractors are only surviving or at the brink of collapse, some of the main contractors are likely to face liquidation (Straits Times 2004, Lianhe ZaoBao 2004). In this case, an employer has to be wary of making such direct payment in case of imminent liquidation. This is because such a payment would offend the general principle of insolvency law that all unsecured creditors of the contractor are to be treated equally.

However, these said clauses have been expunged from the current 6th Edition of the Article and Conditions of Building Contract as issued by SIA (SIA 1999). As such, the local industry where SIA contract is widely used is therefore denies the sub-contractor to have payment directly from employer.

The common dispute on payment to a nominated sub-contractor is the allegation by the main contractor that the nominated sub-contractor has delayed his work or their workmanship or materials are defective resulting in main contractor having to incur additional liability and cost.

In practice, delay and effective work caused by a nominated sub-contractor could in fact constitute a reasonable cause for the main contractor in withholding or refusing to pay the nominated sub-contractor. However, the practical difficulty of many cases of non-payment to sub-contractors lies in too many main contractors have relied on the above reason to hold back payment due to sub-contractor, which frequently led to the cash-flow problem and winding up of sub-contracting firms.

REVIEW OF PAYMENT ISSUES

Under the current situation, only the Court can lawfully enforce payment if a person fails to pay a debt. To obtain cross judgment, a creditor must prove that there is a "cause of action" for construction contract (BCA 2002). This can be a time consuming and costly process. It would also mean proving that the value for the work claimed has been completed and lodging cross claim for alleged defective work by defendant. Apart from incurring fees throughout the Court process, the said complications often times frustrated the legitimated claim made by a sub-contractor.

In view of the above discussed practical difficulties and the manner in which payment is to be made to the nominated sub-contractor, sub-contractors in the building industry often encounter failure of payment from the main contractor, which evidently creates substantial adverse impact on their capacity to complete the work.

To alleviate this problem, the government has formed a Task Force with representatives from the various institutions and societies of the building industry to formulate a fair and balanced payment system to sub-contractors for works and services rendered. This should cover progress payment, quick adjudication of dispute over the disputed amount and possibly provision of security for dispute payment whilst dispute is being resolved.

Under the Singapore present situation, it is likely that an act will be promulgated for building and construction contract works involving parties such as project owners,

contractors, sub-contractors, consultants and suppliers. The objective of the proposed enactment should ensure that a person who carries out construction or supply related goods or services under the construction contract is entitled to receive, and is able to recover specified progress payment in relation to carrying out of such work and the supplying of such goods and services.

This will bring parties together early in the dispute and expediting settlement of their dispute without having to rely on the formal dispute resolution process or the court recovery remedies. Cash flow should improve, leading to greater financial security and producing more positive and conducive economical social effect in the building industry.

Under the proposed Act, it is likely that in a case where the respondent claims to have reasons for not paying a claim, the respondent must set out the reasons. If the claimant refutes the reasons for withholding the payment, or if the respondent fails to pay the amount due by the due date, the claimant can apply to a government appointed authority for an independent adjudication. When the adjudicator has decided on the amount due, the claimant needs only to obtain an adjudication certificate from this authority and lodge it with the court without the need of a hearing. It is likely that no appeal would be allowed from an adjudicator's determination, although the respondent who is dissatisfied with the adjudicator's decision may have the option of suing separately for repayment for any alleged over payment. The above proposal would provide a quick and direct recourse to secure payment of debt.

When such a proposed Act is promulgated, it will become part of the local law and it will have a legal effect of overriding any contract provisions that are found contradicting the Act. In this way, much of the issues and practical difficulties relating to sub-contracting should become much more manageable.

CONCLUSION

Whilst there is a general awareness on some of the sub-contracting problems in our construction industry, the inherent practical and legal implications of domestic and nominated sub-contracts need to be suitably and adequately addressed so as to streamline the further development of the construction industry.

Issues on failure of payment from the main contractor need to be resolved to minimize possible adverse impact on sub-contractor's quality and progress of work as well as cash flow problems. The consideration on the enactment of an adjudication process to expedite settlements of outstanding payment to sub-contractors would help to avoid the necessity of recovering outstanding debt through arbitration or litigation. This would not only satisfy the needs and interest of the disputing parties but also maintain a benign working relationship and create a more harmonious environment in the building industry.

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