

# Unfair Payment Practices in the UAE (Back to Back Payments)

Over two decades, Dubai is trying to create itself to a central hub of economic development which could bridge East and West. Now Dubai has turned out to be the fastest growing nation in the whole world where larger development and infrastructure projects are executed and planned to be implemented. However, none of the above could make successes in Dubai without depending on various stakeholders, who shall directly and indirectly contribute to the construction industry in Dubai. The following parties are considered as the main stakeholders who shall directly and indirectly contributed the growth of the targeted expansion;

- The Client / Developer / Investor,
- The Main Contactor,
- The Sub Contractor.

Despite the expansion targets of Dubai, majority of the subcontractors have become /being victims of unfair payment terms of the industry, which are specifically applied on the sub contract agreements by the main contractor to transfer the risk of any default by the client in payments. It has eventually caused an impact on the sub-contractors survival in the industry.

These unfair payment terms are generally referred as “Back to Back” payment terms, which the interpretation may vary in different circumstances, in terms of either “Pay-if-Paid” or “Pay-when-Paid” as per common practice. Generally the subcontractors who enter into an agreement with the main contractor does not envisage the significant difference between these payment terms, thus end up absorbing the risk of non-payment into their cluster, which eventually causes impacts on sub contractor’s cash flow, net profit, sustainability in the business etc. The may lead to collapse the entire project life cycle, affecting the supply chain, satisfaction of work, poor quality materials, poor workmanship and bad goodwill’s between parties. . The term - “back to back payment” is generally being experienced in most of the other GCC countries other than the UAE, but has remarkably affected in Dubai due to excessive quantum of construction projects executed in comparison to other GCC countries.

Pursuant to the above discussion, the following are identified as the most common reasons where sub-

contractors step themselves to accept unfair payment terms proposed and laid by the main contractor;

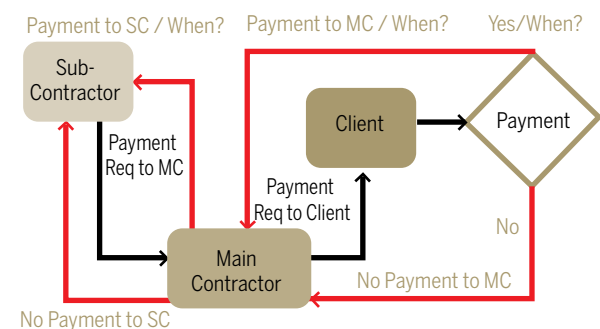
- Lack of knowledge regarding the current market situation,
- over confident on the main contractor and the industry,
- lack of contractual knowledge,
- lack of leverage to negotiate,
- survival in the market etc.

Subcontractors who are knowingly or unknowingly acknowledges the unfair payment terms proposed / laid by the contract shall result various impact in terms of the following way;

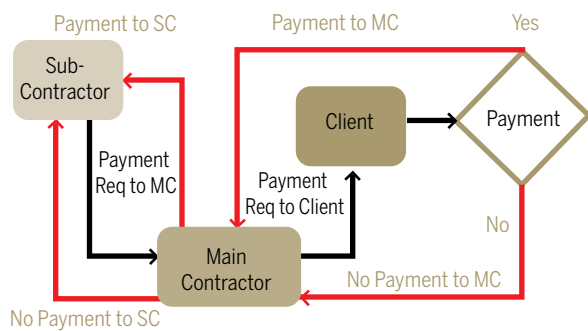
- impacts of sub contractor’s cash flow, profits,
- bad impact on the supply chain,
- work delays to the project,
- involvement in poor quality materials to the construction,
- poor workmanship.

## PAY WHEN/PAY IF CLAUSES IN GENERAL.

There is a significant difference between both of these clauses / terms, in which the “Pay when Paid” clause of a contract, specifically refers to the time of the commitment, when the payment should be affected to the subcontractor. The general contractor’s obligation in settling the payment to sub-contractor shall fall due at the same point of time where the general contractor receives the payments from the employer and a powerful shield from payments (Virene, J.,2013)



The “Pay if Paid” clause constitutes towards a strong statement, where the clause enforces a conditional rule to the contract between the main contractor and sub-contractor with regards to effect the payment against the work carried out. The payment for the sub-contractor shall depend on the process of payment from the employer to the main contractor, subsequently main contractor to the subcontractor. In other words, if the general contractor shall not receive the payment from the employer, in such event the general contractor is not obligated to pay the sub-contractor (Virene, J. 2013), where the risk of non-payment from the employer to the main contractor is automatically shifted to the sub-contractor. Additionally, in the event that the “Pay if Paid” clause is been agreed by the subcontractor and in the event that the employer does not pay, on circumstances of a default of the main contractor, the subcontractor becomes an innocent victim of non-payment for reasons which are not attributable for their works.



However, the issue with regards to the “Pay when paid” term was effectively addressed by Sir Latham, M (1994), in his report (the Latham Report), prepared considering the construction industry in the UK at the point of time the report was written. By his report it was recommending that a period should be specifically mentioned within which the payment has to be made; regardless it has been paid or not paid by the employer to the main contractor. Unless and otherwise main contractor, failing to comply the requirement, Sir Latham, M (1994) had recommended an automatic right to the payee to receive an compensation from the main contractor for payment of interest. But, as these terms are not in favour of the main contractors, these terms were purposefully made ignorant in implementing on to the contracts with the subcontractors.

**LEGAL BACKGROUND OF PAY-IF-PAID / PAY-WHEN-PAID TERMS IN DUBAI**

In accordance to article 890(1) of the UAE Federal Law No. 5 of 1985 the main contractor is permitted to sub-contract the works in part or as a whole, unless and

otherwise specifically provided a conditions in the contract, preventing the main contractor to do so. Further, article no. 890 (2) have made the main contractor as the responsible party to the employer, though the entire works or part of the works have been carried out by the main contractor or performed by an involvement of a subcontractor. In relevance to the same, article no. 890(2) of the UAE Federal Law No.5 of 1985, constitutes similarity to clause 4.4 of FIDIC (1999), Red Book where it denotes that “The Contractor shall be responsible for the act or defaults of any Subcontractor, his agents or employees, as if they were the acts or defaults of the Contractor. Unless otherwise stated in the Particular Conditions”

The above legalization laid by the UAE Federal law No.05 of 1985 have directed the main contractor to enforce back to back terms in to their contracts with the subcontractors, on whole or in specifically in terms of payment. These terms may vary depending on the circumstances and the interest of the main contractor, whether it is to be either Pay-if-Pay or Pay-when-Paid clause will be included in the sub contract.

However, in view of the provisions made for the sub contractors in the UAE Law, Article No. 891 of the UAE Federal Law No. 05 of 1985, it defines that “A sub-contractor shall have no claim against the employer for anything due to him from the first contractor unless he had made an assignment to him against the employer”. Thus the sub-contractor has made no other option other than depending on the main contractor for their payment.

In further exploration on the UAE Federal Law No.05 of 1985, there are several legalization clauses which have made available for the main contractors in relevant to due payments, Article No. 879 (1) of the UAE Federal Law No. 05 of 1985, grants the permission to the contractor to retain the property until the full payment is been paid off in the event the works carried out by the main contractor on a property. In addition, the UAE Federal Law No.05 of 1985 is the power granted to priority right to the contractor in lieu of the payments owed from the employer. The subject legal provision is provided under Article 1572 (1) of the UAE Federal Law No. 05 of 1985, stating that, “Amounts due to contractors and architects who have undertaken to construct buildings or other installations, or to reconstruct, repair or maintain the same, shall have the status of a priority right over such structures, but to the extent to which it exceeds the value of the land at the time of sale, by reason of such works”

However, pursuant to the above it is now emphasis that whatever the provisions made available under the UAE Federal Law No. 05 of 1985 is of the interest of securing the payment of the main contractor, but not specifically made available any provisions as such, which is in favor of the subcontractor.

### LEGAL BACKGROUND OF UNFAIR PAYMENT IN OTHER COUNTRIES

In view of the legal background of back to back payment terms in the world, it is envisaged that most of the jurisdiction have been provided against the enforcement of such terms in contracts between the main contractor and the subcontractor. Woods & Aitken LLP (2011) describes that States of USA such as Alabama, Alaska, Arizona etc. have legally permitted the main contractors to use back to back payment terms, while States such as California, Illinois, Indiana, Nevada etc. treats "Back to Back" payment terms as illegal clauses in contracts between main contractor and the subcontractor. However, in exploration of the legality of back to back payment terms, the following jurisdiction were found available, which have clearly stated the unenforceability of including the same in contracts.

#### New York Courts - USA

Fiorito, M. (2012) refers to a legal case viz Otis Elevator Co. v. Hunt Const. Group (2008) in New York Courts, where the jurisdiction states that, regardless of a clause being included in the sub contract as "pay-when-paid", the subcontractor shall be entitled for payment as the clause "pay-when-paid" only have regulated the time for payment, but do not shift the risk of non-payment to sub-contractor for the works carried out.

#### Nevada Supreme Court - USA

The case between McGovern Bovis vs. Bullock Insulation, Inc (2008) is one of the most popular cases with regards to Pay-if-Paid clauses, where Nevada Supreme Court, used the Jurisdiction to dismiss a lower court's verdict, on enforcing Pay-if-Paid provision to the contract between McGovern Bovis and Bullock Insulation, Inc (Glendhil T.G, 2009)

Glendhil, T.G (2009), further describes that due to the strong public policy which are in favour of sub contractor's mechanics lien rights, Nevada supreme court had decided that, the Pay-if-Paid provisions in a contract shall enforce limitation on the payment for the works been done by the subcontractor, and shall breach the statutory rights in accordance to the public policy of Nevada. Thus that the court dismissed the lower court's decision, and favoured the subcontractor in their rights.

#### England and Wales Court of Appeal (Civil Division) -UK

In relevance to the section 113 of the Construction Act 1996 in UK, the Pay-when-clause is made illegal to be included in any sub contract agreement, unless otherwise the paying party ( Employer) gets insolvent under the provisions of Enterprise Act 2002. The Contraction Act 1996 of UK, identifies the Pay-when-paid clause as a term where it could be used by the contractors to pass through the all the risks of nonpayment towards the subcontractors entity.

#### (Unreported) Court of Western Australia

The case between Sabemo (WA) Pty Limited vs. O'Donnell Griffin Pty Limited (1983), had involved the clause of Pay-when-Paid in the subcontract agreement between the referred parties, where the main contractor Sabemo (WA) Pty Limited, enforced the use of the referred term when the final payment was due his subcontractor, O' Donnell Griffin Pty Limited.

Though the progress payments were paid to the subcontractor, O' Donnell Griffin Pty Limited, in accordance to the sub contract agreement, the main contractor Sabemo (WA) Pty Limited refused to pay the final payment to the subcontractor, on the ground of the clause included in the subcontract agreement, i.e "Period of Payment after progress claim: Fourteen (14) days after payment from Proprietor". As this matter was progressing longer and was referred to an arbitrator for an award on the conclusion. The parities in this agreement had clearly envisaged that the normal payment to the subcontractor would be upon the payment of the employer to the main contractor. However, there was no express provision found to be available in the sub contract documents with regards to the payment to the subcontractor was conditional and against the receipt of payment to the main contractor from the employer and Sabemo (WA) Pty Limited was ordered to pay the final claim to O'Donnell Griffin Pty Limited without any further delay.

### REMEDIES ON MITIGATING THE RISK OF NON-PAYMENT

#### Remedies under Standard forms of Contract.

Under clause 14.8 of FIDIC (1999), the contract enforces the right to the main contractor to claim for the financial interest rate from the employer , in the event the payment does not make effect within 56 days from the date the payment application been submitted. In general the payment application of the main contractor to the employer shall cover the works carried out by subcontractor and by enforcing the subject clause the main contractor shall also claim the finance charges which are owe to the sub contractor's works. In such cir-

cumstances, once the finance charges enforced to the employer, a proportionate amount could be paid off to the sub-contractor based on his aggregated work done. Clause 16.1 has made right to the main contractor to suspend or reduce the quantum of work under the project and walkout, in the event the engineer (The employer's representative) fails / neglects to issue a payment certificate during the stipulated time for payment or the employer fails to provide a valid financial statement or the employer fails to pay off the due amount, providing which an advance notice of 21 days by the main contractor to the employer. If the contract is drafted in a manner that, the subject clause is enforceable on each and every payment application submitted to the employer, the same eventually enforces the right to suspend the sub contract works as well. Thus that this clause enables both the parties i.e. main contractor and subcontractor to suspend their works immediately provided a notice of 21days in the event the payment is not done by the employer on each payment application. Even though the agreement between the main contractor and the subcontractor is based on "Back to Back" payment mechanism, by the use of the above provisions available in FIDIC and effectively interpreted on the sub contract agreement which is unambiguous in its terms, could be effectively used to secure the subcontractor from the risk of non/late payment from the employer / main contractor.

#### Guaranteed Payment from Main Contractor under Sub Contract Agreement.

In circumstances, sub contract agreements may include clauses of "Back to Back" payment terms, provided with a guaranteed payment within a specified duration from the date, the subcontractor shall submit the progress payment application to the main contractor. The clause generally refers as the payment shall be paid to the subcontractor with in an specified duration from the date the main contractor receives the payment from the employer or failing to receive the payment from the employer, the main contract shall guarantee to pay the subcontractor the payment due within a specified duration from the date of receipt of subcontractors payment application / invoice.

#### Insisting on Defined periods for Payments.

In UK, The Late Payment of Commercial Debts (Interest) Act (1998), subsequently amended by The Late Payment of Commercial Debts Regulations (2013), imposes limitations on payment periods under sections 4(3A) to 4(3C) of the subject regulation, where the payment is to be made within a defined period 30 days, if the purchaser is a Public Authority or the payment is to be made within a defined period of 60 days if the pur-

chaser is of other business. Further, insisting on a defined period for payment, shall contractually bind the main contractor to pay the subcontractor for the work performed despite whether the payment was made by the employer or not.

#### CONCLUSION

On basis of the above discussion, it is self-explanatory that the concern problem requires to be effectively addressed. Hence necessary mitigation measurements require to be implemented in an urgent basis, considering the subject as a matter of utmost importance.

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