

PAYMENT RISKS IN CONSTRUCTION PROJECT

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SUMMARY: 1.- Introduction. 2.- Payment to Contractors. 3.- Payment for Extra Quantities. 4.- Contractor's Dues upon the Frustration of Contract. 5.- Payment to Subcontractors. 6.- Back to Back Payment Clauses.- 7. Conclusion.

1. Introduction

The construction industry in United Arab Emirates (UAE) is the second largest sector after Oil & Gas. UAE makes sure that this sector is well regulated in order to make sure that the rule of law couples up with the rapid developments in the field.

One of the main challenges for contractors is the security of payment. Contractors need to make sure that they will be paid on time in order to keep the projects running and deliver on time. However, risks are associated with payments of main contractors and sub-contractors. This article looks at the key contractor's risks through lenses of major standard contracts used in UAE and as per UAE law.

Risks are valued in money. This is why it is important for contracts to be aware of their risks at the time of the project tender. It is important for bidders/Contractors to know some rules of law so that they may get familiar with conditions that can increase their risks connected to transactions and payments during the project life and upon completion, suspension or termination of the contract. These rules of law will apply in default unless and otherwise excluded from the contract. Awareness of these risks will be useful for contractors to calculate the quantum of risks and mitigate them through estimated cost or sharing them with the employers. It will give sustainability and reliance to the industry as well. Parties may deal with these risks in some particular conditions of their contracts. Most of the rules that govern construction contracts are supplementary in nature. Parties can simply avoid their application by expressly agreeing otherwise in their contracts.

This article deals with the key risks associated with payment. It will shed light on how the local law and courts deal with these risks and whether contractors need to be more cautious when they draft their contracts. This paper deals with the risks associated with the use of back to back terms in subcontracts. It examines their enforceability under UAE law and illustrates the implied duties of the main contractors when the subcontract contains a back to back payment clause.

2. Payment to Contractors

is perhaps the main obligation of the employer in construction projects for which a standard practice has been developed over time. Article 885 of the UAE Civil Code states that "in the absence of arrangement or tradition the employer shall be obliged to pay countervailing value upon submission of the contractual property." Obviously, delaying payment till the end of the project is not realistic as contractors do not finance projects from their own pockets. Therefore, it is quite safe to say that contractors are usually paid throughout the project. In

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fact, contractors expect some advance payment prior to the commencement of the project⁽¹⁾. Advance payment is expected to be used for the mobilization of equipment and preparatory works. Contractors do need advance payment as interim payments are usually linked to the actual progress onsite. Advance money is paid back to the employer throughout the construction time by deducting them from the interim payments. Therefore, Article 885 rarely applies to construction projects and it does not really cause any trouble in the construction market since it is usually set aside by express agreements. If an agreed schedule of payment is not included in the contract, the contractor may still expect payment to be made throughout the works in reliance on custom in the construction field. Indeed, it is commonly known that contractors are paid during the progress of the project.²

FIDIC standard contracts are commonly used in UAE and the region. Government authorities have their own standard contracts that are mainly based on FIDIC red book. FIDIC has a balance approach towards employers and contractors but sometime this balance is disturbed due to particular changes induced by either party mostly by the employers.

FIDIC Red Book 1999 has been widely used in UAE and the region in the last two decades for Traditional Construction Contracts (Design by the Employer). Other forms of FIDIC standard contracts are also used, such as the yellow book and the silver book for “Design & Build” projects. Although the 1999 Red Book is not the most updated version, it is still the most commonly used in the local and regional market. The 2017 version does not add much for the payment clauses and it still has a narrow application in the market. Therefore, this article will refer more to the 1999 red book.⁽³⁾

FIDIC Subcontract is also widely used for projects that are executed under the FIDIC red book. It goes without saying that it is very rare for any construction project to be completed by the contractor with the help of subcontractors. Due to several reasons, subcontractors are used for a construction project. For example, certain parts of the works need specialist subcontractors for that work or cost saving or risk sharing.

¹ FIDIC Clause: Sub-clause 14.2 (Advance Payment) “The Employer shall make an advance payment as an Interest-free loan for mobilisation when the Contractor submits a guarantee in accordance with this Sub- Clause. The total advance payment, the number and timing of Instalments (if more than one) and the applicable currencies and proportions shall be as stated in the Appendix to Tender”.

² B. Mpofo, et al, Profiling Causative Factors Leading to Construction Project Delays in The United Arab Emirates. Emerald Publishing Limited, 2017.

³ Sub-Clause 4.12 (Unforeseeable Physical Conditions) It provides guidelines regarding payment of cost incurred by the contractor due to unforeseeable physical conditions (falls under claims)

- i) Clause 8.10 (Payment for Plant and Materials in Event of Suspension)
- ii) Clause 12 (Measurement and Evaluation) It provides ways of Measures and Evaluation
- iii) Clause 13 (Variations and Adjustments) It addresses variations (Additions & Omissions)
- iv) Clause 14 (Contract Price and Payment) It provides terms of payments
- v) Sub-Clause 15.5 (Employer’s Entitlement to Termination) If Employer terminates Contract on its convenience, contractor entitlement as per Sub-Clause 19.6 (Falls under claims)
- vi) Sub-Clause 16.4 (Payment on Termination) by the Contractor
- vii) Sub-Clause 17.3 (Employer’s Risks) It provides guidelines regarding payment of rectification of loss or damage due to ‘operation of forces of nature’ and Employer’s use of project during certain time (Falls under claims)
- viii) Sub-Clause 19.1 (Definition of Force Majeure) It provides guidelines regarding payment of any cost incurred due to War, Terrorism, disorder and/or explosive material except natural catastrophes against which only extension of time will be granted (Falls under claims).
- ix) Sub-Clause 19.6 (Optional Termination, Payment and Release) It provides guidelines regarding payment of any cost incurred due to termination by the Employer and/or as per sub-clause 19.1 (Falls under claims).

3. Payment for Extra Quantities

In some projects, for various reasons, the bill of quantities (BoQ) appears to be disconnected with reality. While the BoQ is known to provide an estimate for the quantities, one may expect a degree of precision used in the BoQ. In some projects, the BoQ does not really respond to designs and this results in a substantial difference between the actual quantities used in the project and the quantities stated in the BoQ. Article 886(1) of the UAE Code provides for the contractor's rights to be paid for the extra quantities that are used for the implementation of the design. This article seems to deal with cases where the design is not altered and the extra quantities do not result from a variation order. It rather deals with the case where the quantities are expected to be much more than what is estimated in the BoQ. This is not uncommon in the construction industry. It states that

“If a contract is made under an itemized list on the basis of unit prices and it appears during the course of the work that it is necessary for the execution of the plan agreed substantially to exceed the quantities on the itemized list, the contractor must immediately notify the employer thereof, setting out the increased price expected, and if he does not do so he shall lose his right to recover the excess cost over and above the value of the itemized list.”

Article 886(1) deals with re-measurement contracts and has nothing to do with lump sum contracts. In lump sum contracts, whether the quantities used onsite are more or less than the stipulated quantities have no relevance to the contractor's payment.

In re-measurement contracts, the contractor is paid as per the actual quantities used onsite. The BoQ is merely an estimate. However, if it appears to the contractor during the execution of the contract that the quantities needed for a certain stage or unit will substantially exceed what is mentioned in the BoQ, the contractor will become at risk. This may occur when the BoQ is not realistic. The contractor will need to inform the employer of such expected substantial difference between the quantities in order to be fully paid according to the actual quantities used. If he does not do so, Article 886(1) will allow the employer to pay him according to the quantities mentioned in the BoQ. The contractor may have to pay for the excess in quantities from his own pocket.

The Article requires the contractor to inform the employer *immediately* of such an expected substantial increase in the quantities. Assuming that this means that the contractor must inform the employer immediately at the time that the former becomes aware of such an expected substantial increase. This may occur any time prior to the commencement of a stage in the life cycle of project. The exact time is very difficult to prove. Under the good faith principle, the employer may not rely on the requirement of immediate notification if he is aware of this expected substantial increase in the quantities. The good faith principle is well applicable under UAE law. Article 246(1) of the Civil Code states that “The contract must be performed in accordance with its contents, and in a manner consistent with the requirements of good faith.”

One may suggest that the contractor can simply inform the employer of such an expected excess and avoid any unfavorable circumstances. Unfortunately, this does not put the contractor in a secure position. If the excess in quantities is so substantial, the employer will have the right to withdraw from the contract under Article 885(2) of the UAE Civil Code. So, the contractor will be at the risk of losing the whole project. If the employer does not withdraw from the contract, the contractor will be fully paid according to the actual quantities used onsite. Article 886(2) of the UAE Civil Code states that

“If the excess required to be performed in carrying out the plan is substantial, the employer may withdraw from the contract and suspend the execution, but he must do so without delay and must pay the contractor the value of the work he has carried out, assessed in accordance with the conditions of the contract.”

Obviously, Article 886 imposes on the contractor a significant risk that he needs to take into account at the time prior to the submission of his bid. Although the contractor is not the one who determines the quantities stated in the BoQ, Article 886 makes the inaccuracy of such quantities his risk. In other words, the contractor may need to check the accuracy of the BoQ before deciding to participate in the project. This will require time and cost that the contractor will not be paid for. The contractor may spend a significant amount of time and money checking the accuracy of the BoQ and does not win the project. In some cases, the contractor may not even have time to check the accuracy of the design and BoQ.

The good news for the contractors is that Article 886 is not a matter of public order. In other words, parties can agree to exclude it by an express agreement in the contract. I know that it is not easy to convince an employer to drop such an article that shifts the risk of the inaccuracy of the BoQ to the contractor. Still, the contractor may use it for the purpose of negotiating the price. Furthermore, under this Article, where the employer is to withdraw from the contract, he must do so without delay. Although the term “delay” is not easy to define or determine, the employer must do so prior to the commencement of the stage that is expected to consume substantially extra materials.

It is necessary to emphasize that Article 886 has nothing to do with variations. The cost and time impact of variations are dealt with under the variation clause. Article 886 applies in cases where the implementation of the agreed design requires substantially more quantities than the quantities stated in the BoQ. In other words, it deals with the risk of unrealistic BoQ. If the extra quantities are due to amendments of the design, then the contractor may claim extra payment and time. Article 887(2) of the UAE Civil Code states that “If any variation or addition is made to the plan with the consent of the employer, the existing agreement with the contractor must be observed in connection with such variation or addition.”

The calculation of payment for the variations depends on whether the contract is lump sum or measurement. “If the contract does not specify the remuneration for additional work, then the contractor will be entitled to a fair price, in addition to the value of the materials required by the work. If, however, the contract is made on a measurement basis, then the contractor may demand remuneration for the excess works on the agreed unit basis.”⁽⁴⁾

4. Contractor’s Dues upon the Frustration of Contract

Another risk concerning payments is the calculation of payment in cases of termination due to an externus cause. One may expect the contractor to be paid according to the contract’s rate. However, under Article 894 of the Civil Code, the contractor “shall be entitled to the value of the work he has completed and to the expenses he has incurred in the performance up to the amount of the benefit the employer has derived therefrom”.

Accordingly, the contractor will be paid according to the contract’s rate or the market value at the time of termination, whichever is the least. If the market price falls down, the contractor will not be fully paid. In the case of 213/Judicial Year 23, The UAE Union Supreme Court held that

⁴Dubai Court of Cassation, 44/2008.

“the effect of article 894 of the Civil Code is that if the contractor is unable to complete the works that he has begun to execute for some force majeure reason in which he played no part, then the contract will be set aside and the positions of the contracting parties will be liquidated. The employer must pay to the contractor the value of the works that he has completed, and what he has expended in executing what has not been completed, to the extent of the benefit devolving on the employer from such works and expenses.”

However, Article 894 of the UAE Civil Code has no relevance in other cases of termination. In other words, in the cases where the contract is terminated due to other than force majeure causes, the contract’s price will apply. In Dubai Court of Cassation, 138/2009, the Court held that “A muqawala is a continuing contract, and the cancellation or termination of such contract will have no effect in respect of the work that has already been provided. A demand by the contractor for his dues in respect of the work that he has carried out is no more than an enforcement of the muqawala contract and is not an effect of the termination of the contract. It is a matter of fact for the trial court to determine whether the muqawala works have in fact been carried out within the agreed period and in accordance with the agreed conditions and specifications.”⁵

5. Payment to Subcontractors

Subcontracting is very important in construction contracts. While most standard contracts allow subcontracting part of the works, the UAE law allows subcontracting all or part of works. Article 890 of the Civil Code states that

- 1- A contractor may entrust the performance of the whole or part of the work to another contractor unless he is prevented from so doing by a condition of the contract, or unless the nature of the work requires that he do it in person.
- 2- The first contractor shall remain liable as towards the employer.

Of course, Article 890 is not a matter of public order and thus the contract can simply restrict the subcontracting and provide for its prior approvals. The UAE does not really distinguish between nominate and domestic subcontracts when it comes to the continuing responsibility of the main contractor for the subcontracted works. The UAE Federal Supreme Court emphasized that “the contractor may entrust the implementation of all or some of the work to another contractor if a condition in the contract does not prevent him from doing so, or if the nature of the work does not require him to do it himself...”⁽⁶⁾

The UAE law and practice show that the relationship between the contractor and subcontractor is independent from the relationship between the contractor and employer. The Federal Supreme Court makes it clear that “the relationship of the first contractor with the second - regulated by a subcontract, is independent of the original contracting contract”⁽⁷⁾ It provides that “A sub-contractor shall have no claim against the employer for anything due to him from the first contractor unless he has made an assignment to him against the employer.”

⁵ S. Fawzy, et al Claims for extension of time and additional payment under common law FIDIC: Civil law analysis. *Journal of Legal Affairs and Dispute Resolution in Engineering and Construction*, 10(4) (2018).

⁶ Federal Supreme Court - Civil and Commercial Judgments - Appeal No. 312 of the Judicial Year 19 - Civil Department - dated 1999-01-12 Technical Office 21 Part No. 1 Page No. 29.

⁷ Federal Supreme Court - Civil and Commercial Judgments - Appeal No. 312 of the Judicial Year 19 - Civil Department - dated 1999-01-12 Technical Office 21 Part No. 1 Page No. 29.

The UAE Federal Supreme Court held that “The main contractor shall be responsible before the subcontractor to pay the value of the works completed by the latter according to the subcontracting contract concluded between them alone, and the subcontractor is not permitted to claim any amounts from the employer that were owed to it by the main contractor because the employer is considered one of the third parties in relation to the subcontract and the subcontractor may not refer directly to the employer unless the main contractor referred it to the employer by assigning its rights to it”⁽⁸⁾

This is in line with the privity principle that does not allow third party to rely on the contract. Actually, Article 891 of the Civil Code expressly emphasizing the privity principle. It states that “A sub-contractor shall have no claim against the employer for anything due to him from the first contractor unless he has made an assignment to him against the employer.” Furthermore, Article 2 of the UAE Civil Procedures Law states that “No application or defence shall be allowed unless the person submitting it has an existing and lawful interest therein”.

6. Back to Back Payment Clauses

Generally speaking, back to back payment clauses refer to the clauses used in subcontracts to shift the risk of nonpayment or late payment to the subcontractor. Accordingly, the contractor will pay the subcontractor when/if he is paid by the employer for the subcontracted work. The back to back payment term is either “pay when paid” or “pay if paid”. While the former indicates the time when payment is due, the latter is generally considered as a condition precedent.⁽⁹⁾ Under the “pay if paid” clause, the subcontractor has no right to payment unless the main contractor is paid by the employer. The term was recognized by Dubai court. In the case of *Dubai Court of Cassation, 240/2006* involving a contract which contained a back to back payment arrangement, the Court held that “the effect of that is that as head contractor, the appellant company imposed a condition on the respondent as sub-contractor that the monies due to the latter would not be paid until materialization of the condition, namely receipt by the head contractor of such monies from the employer.

“Pay when paid” clause indicates that the payment becomes due when the main contractor is paid. That is to say, if the main contractor is not paid for some reasons, such as the insolvency of the employer, the subcontractor’s right to payment will not be affected. Furthermore, if the main contractor dies or becomes insolvent, the payment becomes due.

⁸ Federal Supreme Court - Civil and Commercial Judgments - Appeal No. 534 of 2008 Judicial - Civil Department - dated 2009-04-07, Page No. 178. Similarly, the Abu Dhabi Court of Cassation emphasize in appeal No 54 Of 2017 on 20-06-2017 held that “Article (891) indicates that the subcontractor is not entitled to claim directly from the employer for his entitlements before the main contractor unless the latter referred it to the employer explicitly or implicitly, except that it is with respect to the entitlements or claims that arise to the subcontractor As a result of direct agreements between him and the employer, he may refer directly to him with these claims, and there is no room for the aforementioned article to be implemented.

⁹ Under UAE law, parties may make their obligations conditional upon the materialization of a future matter. This falls under the principle of freedom of contract which is recognized by Article 243 of the Civil Code. In the case of Abu Dhabi Court of Cassation, 462/Judicial Year 2, it was held that “if the obligation or the right is suspended on a suspensive condition, it will not be effective unless the condition materializes. As for the period before materialization of the condition, it will not be a compulsorily or voluntarily enforceable obligation if there is a suspending condition, and the obligee may not get in his right compulsorily or voluntarily save by the consent of the obligor.” Similarly, in the Union Supreme Court, 700/Judicial Year 22, it was held that “the effect of articles 420, 425 and 427 of the Civil Code is that the admission of a debt as a legal disposition means that it must be immediately satisfied unless it is suspended by a condition, and may not be enforced unless that condition materializes, because that which is suspended by a condition is established by proof that the condition has materialized. A finding as to whether or not there is a condition is a matter of fact within the independent discretion of the trial court.”

The back to back payment clause seems to be acceptable by UAE courts. The Dubai Court of Cassation held that

“...it is ruled by the present court that the agreement between the original contractor and the subcontractor stipulates that the subcontractor’s entitlements, for his completion of the subcontract works, shall not be paid until after the original contractor had received such entitlements from the employer. As such, the original contractor’s obligation to pay the subcontractor’s entitlements becomes conditional on the cessation of the enforceability of the original contractor’s obligation, in order to prove the fact, which is conditional on proving that he received his entitlements from the employer. Therefore, the subcontractor may not be entitled to his claim unless such condition is proven, and he shall provide proof that the original contractor received his entitlements from the employer.”⁽¹⁰⁾

Further, the Dubai Court of Cassation held that

“it is also determined that the main contractor agreement with the subcontractor to pay the dues of the latter for the performed works of the Subcontract only become due after receiving the main contractor of such dues from the employer that the main contractor's obligation to pay the subcontractor's dues becomes dependent on a pre-condition, which shall suspend the main contractor's obligation until the occurrence of the conditional fact by the proof of receipt of his dues from the employer, i.e, the subcontractor is not entitled to his claim unless this condition is fulfilled and it has the burden of proofing his verification by proving that the main contractor has received its dues from the employer.”¹¹

The cases highlighted above clarify the position under UAE law that back to back payment clause is a condition precedent. The condition within the clause (that the contractor received payment from the employer) must be satisfied before the subcontractor is entitled to receive any sums. The subcontractor is only entitled to receive sums which the contractor has been paid by the employer.¹²

Back to back clauses will affect the downstream cash flow. Any crisis in the upstream cash flow may affect the payment to subcontractors. The use of such terms must be done with some cautions. The subcontractor needs to realize the risks associated with such clauses. The disturbance of the cash flow chain may result in the delay or even suspension of the work.

¹⁰ Dubai Court of Cassation Case No. 188 / 206 of 2018 dated 28th October 2018.

¹¹ Dubai Court of Cassation Case No. 220 of 2012, on 22nd April 2012. In Dubai Court of Cassation Case No. 240 of 2006, on 31st January 2007, it was held that “... the contract concluded between the appellant company and the main contractor, according to which the payment is with the (back to back) system as the appellant company receives from the main contractor, which means that the appellant company as a main contractor stipulated that the appellee as a subcontractor should not pay the latter's company dues until the conditional incident has been realized, which is the receipt of the main contractor for such dues from the employer, and its obligation is suspended on a precedent condition that would stop the entry into force of this obligation until the conditional incident is realized and the appellee shall not be entitled to claim the remaining dues as long as this condition is not met.

¹² See also Abu Dhabi Court of Cassation No. 83 of 2009 where it was held that “The main contractor's agreement with the subcontractor not to pay the latter's dues until and after the main contractor receives those dues from the employer and this clause is a condition precedent therefore subcontractor is not entitled to claim his dues as long as the condition is not met. “It is also an established jurisprudence of this court that the burden of proving the fulfillment of the condition rests on the creditor”

The purpose of back to back payment mainly is to transfer the risk of non-payment to the subcontractor from the main Contractor.

However, the use of back to back payment terms may not completely relieve the contractor from the risk of the employer's nonpayment for the subcontracted work. First, whether it is "when" or "if" clause, the main contractor must show evidence of pursuing payment from the employer. The subcontractor may still have a claim against the main contractor where the latter

1. Does not claim subcontractor's payment from the employer.
2. Does not challenge the employer's rejection of payment (lack of pursuit).
3. Defends (or agrees) with the employer on the rejection of payment claim for the subcontract work.

Furthermore, despite the back to back clauses, there are some older cases where the UAE Court allowed payment to subcontractor once the subcontract works are completed despite the fact that payment was not received by the main contractor from the employer. For example, in the Case no. 18/2000, Dubai Court of Cassation found that "a subcontractor is only entitled during the time of performance to a relative reward from the payment the main contractor receives from its customer. The same does not happen after a subcontractor has finished all its work and supplied the job to the main contractor. A subcontractor has no duty to wait until payment has been received."¹³

Finally, it is worth noting that "back to back" clauses cannot be relied on once the subcontract is terminated. These clauses will not survive after the termination of the subcontract. In the leading Case 151/2014, Abu Dhabi Court of Cassation held that "the termination of the subcontract will make the back to back payment clause cease to exist and the subcontractor's payment becomes due and not subject to the back to back payment".

7. Conclusion

Contractors need to be aware of their payment risks upon the frustration of contracts in cases of force majeure. Unless UAE law, contractor's payment will be capped at the benefit conferred on the employer prior to the contract frustration. In other words, agreed payments under the contract may not be enforceable in cases of force majeure. This legal approach is not part of the public order and thus parties may agree on some other arrangements.¹⁴

Contractors may also face unexpected payment risks in cases of re-measurement contracts where the bill of quantities do not contain realistic numbers of quantity. If the contractor was aware or ought to have been aware that the quantities of material, which is needed for a part of a project, is substantially more than the quantities stated in the bill of quantities, the contractor must immediately inform the employer of the anticipated increase in the required quantities; failing to do so, the employer will be entitled to pay as per the quantities stated in the bill of quantities and not as per the actual quantities used. The employer, once notified by the contractor, may decide to go ahead with the project or to withdraw from the contract. This rule of law is not a matter of public order and, thus, parties may choose to expressly agree otherwise. Being aware of this risk, the contractor may negotiate its contract by taking into account this risk. The contractor may also consider the bill of quantities carefully before signing the contract in order to see whether it is realistic or not. Further, subcontractors and

¹³ See also Dubai Court of Cassation Case No. 281/ 1995 where it was held that the main Contractor's duty to reimburse Subcontractor becomes due when the Contractor receives payment and, in the event of the completion of the job, notwithstanding "pay if paid."

¹⁴H. AlRawi, et al Control Environment, Risk Assessment and Monitoring in United Arab Emirates Businesses. In *Creative Business and Social Innovations for a Sustainable Future* (2019): pp. 55-65. Springer, Cham.

suppliers must all be mindful of the "back to back" payment clause's impact; the consequence of contract terms impacting payment commitments must be taken into consideration at the bidding stage of each project. Although there is a number of cases where the UAE courts rejected the enforcement of the back to back clauses, many court held such clauses valid and enforceable. Of course, if a back to back clause is included in a subcontract, the contractor becomes under an implied duty to pursue payment from the employer for the subcontracted works. Further, if the subcontract is terminated, the contractor will not be able to rely on the "back to back" payment clause because it, as a result, ceases to exist.

Abstract. Security of payment is very important for contractors as the cash flow is the lifeblood of most construction projects. The purpose of this article is to look into the risks associated with payments to contractors and sub-contractors working for the construction industry under the law of the United Arab Emirates. This article discusses some mechanisms that may reduce these risks.

Contractors need to be aware of the rules of law that may increase their payments risks during the project time or upon the completion or termination of the contract. Unless excluded by contract, these rules will apply. Contractors may need to be aware of these risks when they calculate the estimated cost at the time of tender. This paper tackles a number of these rules in order to shed light on the contractor's relevant risks.