

MDA PRESENTS



FIRST AID FOR CONTRACTS



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PAID WHEN PAID CLAUSES

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This year, First Aid For Contracts will place a specific focus on subcontract agreements. To start things off, we thought it would be apt to cover one of the contractual provisions (often effected through an amendment to a standard form subcontract) which causes difficulty for subcontractors.

This clause is the “paid when paid” clause. In broad terms, these clauses provide that the payment of amounts due to a subcontractor for work done only becomes due for payment by the contractor upon the contractor receiving payment from the employer. A subtle variation of the “paid when paid” clause is the “paid if paid” clause. The differentiation between these two arrangements is self-evident.

Typically, these clauses read as follows, *“Payment to the subcontractor shall be subject to the contractor having received payment from the employer of the*

amount certified in its interim payment certificate and become due for payment by the contractor to the subcontractor upon receipt of such payment by the contractor from the employer”.

For obvious reasons, these clauses can be incredibly onerous on subcontractors and suppliers. These clauses very often result in extended delay between completing work and receiving payment. Typically, in order for a subcontractor to receive payment, the following steps need first be completed: (i) the subcontractor completes work on an interim basis (ii) they make an application for certification (iii) they have their works certified (iv) they transmit a tax invoice detailing the amount certified and (v) finally, once the employer makes payment to the contractor then the contractor will process payment to the subcontractor.

This, at the best of times, results in a lengthy period from attending to work to receiving payment for such works and often has cash flow implications for a subcontractor.

An additional difficulty and risk faced by subcontractors engaged on a paid when paid basis is that the contractor is able to delay and frustrate payment to the subcontractor by contending that the contractor has not yet received payment from the employer and thus the subcontractor's payment is not yet owing. If this is correct, the subcontractors payment is not yet owing - this despite them completing the works and having them certified for payment.

If the subcontractor suspects that the contractor has received payment and that the contractor is alleging that they have not yet received payment in an effect to avoid having to make payment, the difficulty for the subcontractor now lies with them needing to adduce evidence to prove that the contractor has received payment – the subcontractors only option in this circumstance is to approach the employer and / or agent of the employer directly and request clarification.

The practical effect of this is that in the first circumstance, the subcontractor faces difficulty in exercising its right to payment. In the second circumstance, the ability of the subcontractor to enforce its right to payment is contingent on its being able to prove that the employer has made payment to the contractor.

The effect of these clauses is so detrimental to subcontractors that in many jurisdictions outside of South Africa have outlawed these type of payment arrangements.¹ While there was an effort in South Africa to follow this international jurisprudence through the promulgation of draft regulations under the CIBD Act (38 of 2000), this seems to have faded away and the proposed amendments to the Construction Industry Development Regulations never came into effect.

In addition, our courts are yet to deal with these clauses. We feel that there are likely grounds, depending on the circumstances, for enforcing a subcontractor's right to payment through one of the following avenues:

1. Recent jurisprudence in South Africa has resulted in courts setting aside or declaring invalid clauses and contracts which are unfair / unjust and deemed contrary to public policy.² There is likely grounds for advancing this line of jurisprudence in respect of "paid when paid" clauses.
2. The subcontractor, owing to the fact that the subcontractor has completed works and these have been certified for payment, will have a claim for unjustified enrichment against the contractor and / or the employer.

¹ See for example, the Housing Grants Construction and Regeneration Act 1996 which has outlawed a "paid when paid" / "paid if paid" arrangement in the United Kingdom.

² See *Barkhuizen v Napier* 2007 (5) SA 323 (CC).

3. By establishing that the contractor has an implied obligation under the subcontract to enforce its entitlement (to the best of its ability) to receiving payment under its contract, the doctrine of fictional fulfilment may find applicability insofar as the contractor has failed to comply with its obligation (and hence prevented the fulfilment of the condition for payment) and that accordingly is deemed to have been fulfilled. In addition, should the subcontractor establish that the contractor has the abovementioned implied obligation, a failure to comply with such obligation would constitute a material breach of the subcontract which would entitle the subcontractor to a claim for damages.

The potential avenues of judicial recourse for the subcontractor are not without risk, complexity and are in no way established practices for enforcing a subcontractor's right to payment under a "paid when paid" arrangement. The simple solution to avoiding these difficulties faced by subcontractors would be to simply refuse to agree to subcontracting on a paid when paid basis. The reality is however that many subcontractors are unfortunately placed in a position where if they want to be awarded the work, they are required to agree to these types of clauses.

We advise that subcontractors try attempting to mitigate the risk posed by these "paid when paid" clauses by (i) agreeing to amendments to their subcontracts with contractor and / or (ii) carefully considering and ensuring that they are satisfied with the strength of the financial position and payment history of the contractor.

Some amendments that we suggest that subcontractors consider are as follows:

1. Making all outstanding payment due, notwithstanding the paid when paid clause, on the happening of a specific event. This can be either on the termination of the subcontract, the contractor or subcontractor reaching completion in terms of the subcontract or possibly on suspension by the subcontractor of the works for non-payment. Additionally, the contractor can include a provision which requires the employer to provide notice (within a specified period and with documentation in support of such notice) to the subcontractor when the employer has failed to effect payment to the contractor and should the contractor fail to do so, the amount outstanding to the subcontractor becomes due and owing for payment.
2. Ensure that the subcontract includes an express provision which entitles the subcontractor to suspend (on short notice) and / or terminate for non-payment. We have found that the ability to suspend / terminate on short notice has allowed subcontractors to enforce their rights.
3. Include a provision which allows for an automatic extension of time to the date for completion and additional payment (including any costs incurred as a result of such non-payment) in the event of a non-payment by the employer.

4. Include an express obligation on the part of the contractor which requires such contractor to ensure that it enforce its rights to payment under its contract with the employer.

The reality of the matter is that a “paid when paid” arrangement is incredibly onerous for a subcontractor. The risk of payment not becoming due and owing should the employer fail to make payment is a reality which will create difficulty in enforcing a subcontractors right to payment. The key is to properly negotiate subcontracts with amendments which allow the subcontractor to mitigate the risks of a strict “paid when paid” arrangement. If the contractor is unwilling to negotiate such amendments our experience is that it is most likely that the risk of executing that subcontract, may outweigh the potential reward.

At MDA, we have expertise in negotiating and advising on suitable amendments to both standard form and bespoke subcontracts on behalf of subcontractors and contractors as well as assisting both subcontractors and contractors in enforcing their contractual rights to payment.