

**M A S O N S   T H E L E N   R E I D   L L P**

**OCAJI Construction Seminar**

**MANAGING PAYMENT RISKS ON INTERNATIONAL  
CONSTRUCTION PROJECTS**



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# The Risk of Employer Insolvency

- Employer insolvency is a risk for every contractor on a private work of improvement.
- In some western countries, including the United States, unpaid contractors have a right to place a lien on the property on which the project was built. These rights, called mechanic's liens, in effect give the contractor a security interest in the construction project.
- The mechanic's lien right is one way for a contractor to manage the risk of owner insolvency or failure of payment.
- In Asia, the local laws do not provide the contractor with mechanic's lien rights.



# No Viable Legal Remedies

- Another way to manage against the risk of owner insolvency or non-payment is to only work for the very rich Employer.
- These days, even the very rich Employer is not a guarantee of payment. Enron example.
- And in any event, the Contractor may be forced to file a lawsuit in order to get paid.
- The option of a lawsuit is not very helpful if the Japanese Contractor is forced to file a lawsuit in a country where the chance of winning the lawsuit, or collecting on a judgment, is non-existent.



# Indonesia Case Study

- We were once contacted by a Japanese contractor who had recently completed construction of an office building in Jakarta. It was 1997, but before the South Asian economic crash.
- The Employer, an Indonesian company formed to build, own and operate the office building, simply refused to pay the Contractor the retention and contract balance.
- The contract contained a clause requiring the parties to resolve all disputes by arbitration in Indonesia, applying Indonesian law, utilizing the Indonesian National Arbitration Body Rules ("BANI"). BANI is an Indonesian form of arbitration.
- The next step in the process was to contact local claims consultants and attorneys to learn more about BANI and the Indonesian legal system.



## Indonesian Case Study, continued

- The information we obtained was disturbing. For a period of many years prior to 1997, none of the attorneys and consultants we contacted had ever heard of a BANJ arbitration in Indonesia where the foreign entity obtained an arbitration award against an Indonesian entity.
- And even if an arbitration award had ever been issued against the Indonesian entity in favor of the foreign entity, no one had ever heard of such an award being confirmed in the Indonesian courts, a necessary step to take to collect on the award.
- So in effect, the Contractor had no legal remedy to collect the money due to the Contractor.
- Payment was eventually secured through “political” means, discussed below.



# Other Tools to Secure Payment

- Basically there are two different methods for securing payment on a construction project in South Asia:
  1. Obtain third party guarantees; or
  2. Ensure that the Contractor has resort to meaningful legal remedies to collect.



# Third Party Guarantees

- These can take many forms:
  - *Letters of credit*
  - *Bonds*
  - *Parent Company Guarantees*
  - *Bank Guarantees*
- Regardless of the form, the third party guarantee should be issued by a substantial international financial institution.



## **Third Party Guarantees, continued**

- Payment guarantees are being sought more often by the international contractor.
- This reality is reflected by the fact that in 1999 FIDIC added a Form of Payment Guarantee By Employer as an annex to the revised Red Book and the new Yellow Book.



# Annex G EXAMPLE FORM OF PAYMENT GUARANTEE BY EMPLOYER

[See page 17: Contractor Finance]

Brief description of Contract

Name and address of Beneficiary

(whom the Contract defines as the Contractor).

We have been informed that (whom the Contract defines as the Employer and who is hereinafter called the "Principal") is required to obtain a bank guarantee.

At the request of the Principal, we (name of bank) hereby irrevocably undertake to pay you, the Beneficiary/Contractor, any sum or sums not exceeding in total the amount of (say: ) upon receipt by us of your demand in writing and your written statement stating:

(a) that, in respect of a payment due under the Contract, the Principal has failed to make payment in full by the date fourteen days after the expiry of the period specified in the Contract as that within which such payment should have been made, and

(b) the amount(s) which the Principal has failed to pay.

Any demand for payment must be accompanied by a copy of [list of documents evidencing entitlement to payment], in respect of which the Principal has failed to make payment in full.

Any demand for payment must contain your signature(s) which must be authenticated by your bankers or by a notary public. The authenticated demand and statement must be received by us at this office on or before (the date six months after the expected expiry of the Defects Notification Period for the works) when this guarantee shall expire and shall be returned to us.

This Guarantee shall be governed by the laws of and shall be subject to the Uniform Rules for Demand Guarantees, published as number 458 by the International Chamber of Commerce, except as stated above.

Date

Signature(s)

## FIDIC Form of Third Party Guarantee



# FIDIC Form of Third Party Guarantee, continued

- In order to implement the FIDIC Form of Third Party Guarantee into a prime contract, a Contractor need only attach the form in the previous slide as an Exhibit to the contract and include the following language in the prime contract:

The Employer shall obtain (at his cost) a payment guarantee in the amount of 20% of the Contract Sum, and provided by an entity approved by the Contractor (said approval not to be unreasonably withheld). The Employer shall deliver the guarantee to the Contractor within 28 days after both parties have entered into the Contract. The guarantee shall be in the form set forth in Annex \_\_ hereto. Unless and until the Contractor receives the guarantee, the Contractor shall not be required to commence work and the Contract Time shall not run. The guarantee shall be returned to the Employer at the earliest of the following dates:

- (a) when the Contractor has been paid the agreed Contract Sum;
- (b) when the obligations under the guarantee expire or have been discharged; or
- (c) when the Employer has performed all obligations under the Contract.



# The Contractor's Response to the Refusal to Provide Third Party Guarantee

- Unfortunately, the reality is that Employers are typically reluctant to provide these sort of third party guarantees.
- The guarantees are usually expensive, and provide no value as far as the Employer is concerned.
- Local contractors, with whom the Japanese contractor is competing, are not as concerned about Employer insolvency. This also tends to cause the Employer to reject any requests for third party payment guarantees.
- If the Employer will not provide a third party guarantee, the prudent Contractor will attempt to secure a viable legal remedy in response to the Employer's breach of contract or insolvency.



# Ensuring Viable Legal Remedies

- Legal remedies are purely a matter of contract.
- Dispute resolution provisions are something that EVERY contractor should review and consider in connection with EVERY contract.
- The contractor should almost NEVER agree to have disputes resolved under the laws and courts of the South Asia country.
- The court systems of most South Asia countries are either undeveloped or corrupt. And, as discussed below, an arbitration award is much better than a judgment in many South Asia countries.
- So the key is deciding which arbitration rules to use, the venue of the arbitration, and the applicable law.



# Dispute Adjudication Boards

- Before discussing the arbitration related issues, we would like to briefly review something which has become popular over the past 10 years on construction projects in Asia – Dispute Adjudication Boards (“DAB”).
- Dispute Adjudication Boards are typically comprised of 1 or 3 members who are experienced construction professionals, not lawyers. The FIDIC 1999 Red Book and Yellow Book both include DAB provisions and require that the DAB members be “experienced in the Work” to be carried out under the Contract.
- The Dispute Adjudication Board typically issues a decision on a disputed matter and, if either party is dissatisfied with the decision, the matter will subsequently be submitted to binding arbitration.
- While the use of DABs is really not a method of protecting a Contractor from Employer insolvency, it does provide a method for resolving disputes on an ongoing basis, rather than having the disputes linger to all be resolved on completion of the Project.



# Case Study of a Successful DAB

## Case Studies of Dispute Adjudication Boards in Asia.



# Why Arbitration Is Essential

- If no arbitration clause is included in the Contract, then the parties have, by default, agreed to resolve their disputes through litigation in the country where the project is located.
- Thus, the winning party will obtain a judgment in one country, which that party may then attempt to enforce in another country.
- But the ability to enforce a judgment from one country in another country depends on whether there is a treaty between the two countries that allows the enforcement of such judgments.
- For example, foreign judgments obtained outside Indonesia are not enforceable in Indonesia, period.





# The New York Convention

- As a result of the New York Convention of 1958 on the Recognition of Foreign Arbitration Awards, arbitration awards issued in one country are enforceable in other countries, provided that both countries are signatories to the New York Convention.
- The total number of countries that are signatory as of 2002 was 125.
- Signatory countries include:
  - USA
  - Indonesia
  - Japan
  - Philippines
  - Singapore
  - Malaysia
  - Thailand
  - China





# The Arbitration Rules

- The most popular arbitration rules for international construction projects in South Asia are:
  - International Chamber of Commerce (or “ICC”)
  - United Nations Commission on International Trade Law (or “UNCITRAL”)
- Other country specific rules that have proved to be of use to the international contractor are:
  - Singapore International Arbitration Center Rules (or “SIAC”)
  - Hong Kong International Arbitration Center and China International Economic and Trade Arbitration Centre (or “CIETAC”)



# Characteristics of the ICC and UNCITRAL Rules – ICC

- Its distinctive characteristic is that the ICC plays an active role in the proceedings.
  - Before the arbitration even begins, each party must submit to the ICC a document known as the terms of reference.
  - The award of the arbitrators must be submitted to the ICC for review before being issued.
- In earlier times, when international arbitration was more rare, this kind of management seems to have been regarded as a good thing.
- Current attitudes are beginning to see ICC Administration as an extra layer of trouble and expense, and the ICC administrative expenses can be quite costly.

# Characteristics of the ICC and UNCITRAL Rules - UNCITRAL

- It is more common in recent years for the parties to choose UNCITRAL Rules.
- UNCITRAL rules are designed for use in “ad hoc” arbitrations, that is arbitration without any supervising institution. This tends to make UNCITRAL arbitration cheaper than its ICC equivalent.
- UNCITRAL has, however, recognized that some institution will need to appoint arbitrators if the parties themselves cannot agree on the composition of the tribunal.
- In the case of arbitrations in Singapore, the chairman of the SIAC will make the appointment.
- Current FIDIC forms suggest that, in the event UNCITRAL rules are used, the President of FIDIC, or a person appointed by the President, appoint the arbitrators if the parties cannot agree.



# Venue for the Arbitration

- The location of the arbitration does NOT have to be the country where the project is located, or even the country of domicile of the Employer or contractor.
- In fact, a neutral site is to be preferred, as it will tend to avoid prejudice in favor or against either party, and the neutral locale will tend to promote settlement.
- The Singapore International Arbitration Center is becoming a popular location for international arbitrations.
  - SIAC provides efficient administration of the arbitration.
  - Under the Singapore arbitration act, in international arbitrations foreign lawyers can act in the arbitration in Singapore



# The Law of the Arbitration

- Frequently there are the laws of two countries at work in a given arbitration.
- The law of the country where the arbitration is taking place frequently applies to procedural matters.
- The law designated by the parties in the Contract generally governs the substantive matters.
- The Singapore Arbitration Act expressly states that the procedural law shall be the law of Singapore.



# The Law of the Arbitration, continued

- English law is frequently designated as the applicable law of the Contract.
- English law is fairly well-developed in the area of construction disputes.
- As many countries in South Asia are former British colonies, using English law as the governing law is common and comfortable to most people.
- Using Singapore law is effectively the same as using English law, as Singapore law is based on English law and, when in doubt as to the law in Singapore, the parties will revert to English authority.



# Model Arbitration Clause

- It is submitted that the following arbitration clause will be favorable to the Japanese Contractor on most international construction projects:
- If a dispute (of any kind whatsoever) arises between the Parties in connection with, or arising out of, the Contract or execution of the Works, including any dispute as to any certificate, determination, instruction, opinion or valuation of the Engineer, it shall be finally settled by international arbitration. Arbitration may be commenced prior to or after completion of the Works. Unless otherwise agreed by both Parties:
  - (a) the dispute shall be finally settled under the Rules of the United Nations Commission of International Trade Law (UNCITRAL);
  - (b) the dispute shall be settled by three arbitrators appointed in accordance with these Rules; and
  - (c) the arbitration shall be conducted in the English language, in Singapore, and the Contract shall be governed by English law.



# The Employer's Position

- Frequently Employers considering whether to use a foreign contractor are very inclined to have the law of the Employer's country apply and are unwilling to consider using the law of another country, as with requests for payment security or guarantees.
- This is difficult, as the law in most South Asian countries is not well-developed in the area of construction disputes.
- However, of the big three, the arbitration rules, the arbitration venue and the arbitration law, the Employer will likely be the most concerned with the law, and the foreign contractor should be flexible in the decision of which law to use.
- Most South Asian countries, being former colonies of European countries, have laws that are based on European laws, be it English, French or Dutch.





# Advance Payment as an Insolvency Hedge

- It may frequently be the case that the Employer will not provide any payment guarantees or security, and will insist on arbitration in the Employer's home country using the home country law.
- In other words, even though the Japanese contractor has understood and tried to implement everything we have discussed to this point, if the Contractor wants the job, the Contractor must agree to the Employer's terms on these issues.
- This is where the Advance Payment can become a factor.
- It is common in South Asia for prime contracts to provide that the Contractor will receive advance payment, within a fixed period of time following execution of the contract, of between 10 – 20% of the Contract Sum.



## **Advance Payment as an Insolvency Hedge,** *continued*

- In a negotiation where the Employer has rejected the Contractor's request for provisions for payment guarantees, the Contractor can take the moral high ground and ask for a substantial advance payment.
- The Contractor's position is: "You would not give me any payment guarantees, at least give me the 20% Advance Payment."
- This is quite a reasonable request, particularly where the Contractor posts an Advance Payment Bond or Guarantee.
- The Advance Payment provides a hedge against Employer insolvency. The 20% is reduced proportionally as each progress payment is processed, by crediting a portion of the 20% against each progress payment, so up until the end of the project, there is still some paid but unearned money in the Contractor's possession that the Contractor can use to cover non-payment in the event of Employer insolvency.



# Political Mechanisms to Manage Payment Risk

- Generally, even in the economically challenged South Asian countries, on public projects there is not a fear that the Contractor will not be paid because of Employer insolvency.
- This is because either the public project is financed with foreign grants or loans (frequently from Japan), or because the government realizes that if the government does not pay its bills, this will cause tremendous negative consequences on the country's economy and the value of its currency.
- Similar "political" considerations can also come into play on private construction projects.



# Political Mechanisms to Manage Payment Risk, *continued*

- Recall the Office Building in Jakarta that we discussed earlier.
- Given that the Contractor had no legal remedy, why would the Employer bother to issue any further payments after the Contractor finished the work?
- The entity providing the financing for the project, and who sold the land to the Employer, was a Japanese trading company. The Japanese trading company brought the Japanese contractor into the deal.
- So the Japanese contractor appealed to the Japanese trading company to put pressure on the Indonesian owner to pay the Contractor the contract balance. This “political” pressure helped the Contractor to get paid, even though purely “legal” methods would not have been effective to secure payment.



# Summary

To summarize, the principal tools to manage payment risks on construction projects in South Asia are:

1. Obtaining third party payment guarantees;
2. Including arbitration provisions in the main contracts with favorable provisions regarding the arbitration rules, venue and applicable law;
3. Securing a substantial Advance Payment; and
4. Implementing other political and social, as opposed to strictly legal, methods to secure payment.



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