Managing Payment Risks on International Construction Projects

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The Risk of Owner Insolvency

Owner 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 South 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 very rich owners. These days, even contracting with a very rich owner is not a guarantee of payment because the seemingly rich owner may have financial problems.

And, in any event, the contractor may be forced to file a lawsuit in order to get paid even by a rich owner. The option of a lawsuit is not very helpful if the contractor is forced to file a lawsuit in a country where the chance of winning the lawsuit is non-existent.

Indonesia Case Study

We were once contacted by a Japanese contractor that had recently completed construction of an office building in Jakarta. It was 1997 but before the South Asian economic crash.

The owner, 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. The information we obtained was disturbing. For many years before 1997, none of the attorneys and consultants we contacted had ever heard of a BANI arbitration in Indonesia in which a foreign entity obtained an arbitration award against an Indonesian entity.

And, even if an arbitration award had ever been issued against an Indonesian entity in favor of a foreign

entity, no one had ever heard of such an award being confirmed in the Indonesian courts, a necessary step to collecting on the award.

So, the contractor had no effective legal remedy to collect the money due it. Payment eventually was secured through "political" means, which are discussed below.

Other Tools to Secure Payment

Basically there are two methods for securing payment on a construction project in South Asia:

Obtain third party guarantees; or

Ensure that the contractor has resort to meaningful legal remedies to collect.

Third Party Guarantees

Third party guarantees can take many forms, including:

Letters of credit.

Bonds.

Bank guarantees.

Regardless of the form, the third party guarantee should be issued by a substantial international economic institution.

Payment guarantees now are being sought more often by international contractors. This reality is reflected in FIDIC's 1999 decision to add a Form of Payment Guarantee By Employer as an annex to the revised Red Book and the new Yellow Book.

FIDIC Form of Third Party Guarantee

To incorporate the FIDIC Form of Third Party Guarantee into a prime contract, a contractor need only attach the form 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 __ [enter its letter or number] 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:
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> (a) when the Contractor has been paid the agreed Contract Sum;

(b) when the obligations under the guarantee expire of have been discharged; or

(c) when the Employer has performed all obligations under the Contract.

Contractor's Response to a Refusal to Provide a Third Party Guarantee

Unfortunately, the reality is that owners typically are reluctant to provide third party guarantees. The guarantees usually are expensive and provide no value as far as the owner is concerned. Local contractors are not as concerned about owner insolvency.

This may cause the owner to reject requests for third party payment guarantees. If the owner will not provide a third party guarantee, then the contractor's next step is to attempt to secure a viable legal remedy in case the owner breaches the contract or becomes insolvent.

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 almost *never* should agree to have disputes resolved under local laws and in local courts. The court systems may be undeveloped, corrupt or biased against outsiders. And, as discussed below, an arbitration award often is much more enforceable than a court judgment.

So, the key is deciding which arbitration rules to use, the venue of the arbitration and the applicable law.

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 then must attempt to enforce there or 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 provides for enforcement of such judgments or on the willingness of courts to enforce foreign judgments.

Such judgments often are not warmly received. For example, foreign judgments obtained outside Indonesia are not enforceable in Indonesia, period.

New York Convention

As a result of the 1958 New York Convention on the Recognition of Foreign Arbitration Awards, arbitration awards issued in one country usually are enforceable in other countries, provided that both countries are signatories to the New York Convention. More than 125 countries are signatories, including the United States, Japan, Singapore, Thailand, Indonesia, the Philippines, Malaysia and China.

Arbitration Rules

The most popular arbitration rules for international construction projects in South Asia are:

International Chamber of Commerce (ICC); or

United Nations Commission on International Trade Law (UNCITRAL).

Other country-specific rules that have proved to be of use to the international contractor are:

Singapore International Arbitration Center Rules (SIAC); and

Philippines Construction Industry Arbitration Commission Rules (CIAC).

Characteristics of the ICC Rules

Their 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 less common, this kind of management seems to have been regarded as a good thing. Current attitudes view ICC administration as an extra layer of trouble and expense, and ICC administrative expenses can be quite costly.

Characteristics of the UNCITRAL Rules

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 an UNCITRAL arbitration cheaper than its ICC equivalent. UNCITRAL, however, recognizes that some institution is needed 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 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, will 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 owner 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, foreign lawyers can represent clients in Singapore in international arbitrations.

The Law of the Arbitration

Frequently the laws of two countries are at work in an 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.

British law frequently is designated as the applicable law of the contract. British law is fairly well-developed in the area of construction disputes. Because many countries in South Asia once were part of the British Empire, using British law as the governing law is common and comfortable to most people. Using Singapore law is effectively the same as using British law, as Singapore law is based on British law and, when in doubt as to the law in Singapore, the parties will revert to British authority.

Model Arbitration Clause

The following arbitration clause will be useful 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:
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> (a) the dispute shall be finally settled under the Rules of the United Nations Commission of International Trade Law (UNCITRAL);
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> (b) the dispute shall be settled by three arbitrators appointed in accordance with these Rules; and
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> (c) the arbitration shall be conducted in the English language, in Singapore, and the Contract shall be governed by British law.

Frequently, employers considering using a foreign contractor are inclined to insist that the law of the employer's country apply and are unwilling to consider using the law of another country. This is difficult because construction law in most South Asian countries is not well-developed.

However, of the big three -- arbitration rules, arbitration venue and arbitration law -- the owner likely will be most concerned with the law. The foreign contractor should consider being flexible about which law to use. Most South Asian countries, being former parts of European empires, have laws that are based on European law, be it British, French or Dutch.

Advance Payment as an Insolvency Hedge

It may 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's law.

In other words, even though the contractor has understood and tried to implement everything we have discussed up to this point, if the contractor wants the job, the contractor must agree to the employer's terms on these issues.

This is when 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 10 to 20 percent of the contract sum.

In a negotiation in which the employer has rejected the contractor's request for new provisions for payment guarantees, the contractor can take the moral high ground by asking for a substantial advance payment. The contractor's position is: "You would not give me any payment guarantees. At least give me a 20 percent advance payment."

This is quite a reasonable request, particularly when the contractor posts an Advance Payment Bond or Guarantee.

The Advance Payment provides a hedge against owner insolvency. The 20 percent is reduced proportionally as each progress payment is processed by crediting a portion of the 20 percent against each progress payment so until the end of the project, there still is some paid but unearned money in the contractor's possession that the contractor can use to cover non-payment in the event of owner insolvency.

Political Mechanisms to Manage Payment Risk

Generally, even in South Asian countries with economic problems, the contractor does not face non-payment risks on public projects arising from owner insolvency. This is because the public project is either 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 consequence for the country's economy and the value of its currency.

Similar "political" considerations can also come into play on private construction projects. Recall the office building in Jakarta discussed earlier. Given that the contractor had no effective 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 that 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 court proceedings would not have been effective in securing payment.

Summary

The principal tools for managing payment risks on construction projects in South Asia are:

1. Obtaining third party payment guarantees;

2. Including arbitration provisions in prime contracts with favorable provisions regarding 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.