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# THE INTERNATIONAL CONSTRUCTION LAW REVIEW

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## INTRODUCTION

This issue of *The International Construction Law Review* contains articles on a number of themes together with reports from two correspondents and three book reviews.

Our first two contributions concern new contracts. Both come from members of our Editorial Advisory Board. At page 5 Mr Christopher R Seppala, who is a partner in White & Case, provides a highly informative introduction to and commentary on the new FIDIC international civil engineering subcontract, intended for use in conjunction with the FIDIC conditions of contract for such works (the "Red Book"). Mr Seppala is particularly well qualified to write about this subcontract since he is Chairman of the FIDIC group responsible for it and one of its draftsmen (although the views expressed in his article are his own). The publication of a subcontract marks a "first" for FIDIC as it has not previously ventured into attempting to set out what might be in a typical subcontract. Contractors have tended to use either their own conditions or ones established elsewhere, such as the form of subcontract conditions published by the United Kingdom Federation of Civil Engineering Contractors, which, despite some infelicities and an understandable (but not excessive) bias towards contractors, has generally been thought to be reasonably compatible with the Red Book and other international contracts. Indeed, as appears from Mr Seppala's article, FIDIC decided that the FCEC form was the model upon which its new subcontract should be based. However, as Mr Seppala explains, the new form is not the same as the FCEC form. Account is taken of the international character of the subcontract (notably in the arbitration clause) and significant changes have been made to the provisions relating to valuations and payment (amongst others) so that for example clause 10 of the FCEC form which can prove troublesome in practice does not survive in anything like its present form. It will be interesting to see whether these and other changes will be adopted in other forms of contract.

HUMPHREY LLOYD  
DAVID WIGHTMAN  
*Editors-in-Chief*

# THE NEW FIDIC INTERNATIONAL CIVIL ENGINEERING SUBCONTRACT

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## INTRODUCTION

Some 37 years after the *Fédération Internationale des Ingénieurs-Conseils*<sup>1</sup> (FIDIC) Conditions of Contract for Works of Civil Engineering Construction (the "Red Book")<sup>2</sup> first appeared in 1957, there is now available from FIDIC a form of subcontract for use on international projects where the main contract is based on the Red Book. The purpose of this article is to provide a brief introduction to this new form of subcontract (the "Subcontract" or "Conditions of Subcontract").<sup>3</sup>

In the discussion below, I shall, first, remind readers of certain features of the Red Book with which the Conditions of Subcontract are meant to operate, then, briefly describe the drafting process in the preparation of the Conditions of Subcontract, then, discuss selected clauses of the Conditions and, finally, provide a brief conclusion.<sup>4</sup>

## THE RED BOOK: GENERAL REMARKS

The Red Book comprises the following documents: a form of tender, form of agreement, and conditions of contract. The conditions of contract are divided into two parts:

\* Chairman, FIDIC's Task Group on Subcontract Documents; Member, FIDIC's Civil Engineering Contracts Committee (1991-1993); and Legal Adviser and Member, FIDIC's Task Group for Updating Red and Yellow Books (since June 1994). The views expressed herein are the author's alone and do not necessarily reflect those of his firm or of any other organization with which he is associated. © Copyright reserved 1994.

An earlier version of this paper was presented to the International Construction Projects Committee of the Inter-Pacific Bar Association at its fourth Annual Conference in Singapore on 3 to 6 May, 1994.

The author is grateful for the assistance of Maurizio Ragazzi, a former associate of White & Case (now with the World Bank) and a fellow member of FIDIC's Task Group on Subcontract Documents, in the preparation of the earlier version of this paper.

<sup>1</sup> In English, the International Federation of Consulting Engineers.

<sup>2</sup> The full title of the current edition in conjunction with which the Subcontract is intended to be used is *Conditions of Contract for Works of Civil Engineering Construction, Fourth Edition, 1987, Reprinted 1988 with editorial amendments, Reprinted 1992 with further amendments*.

<sup>3</sup> The Subcontract, like other FIDIC publications, is available from FIDIC, P.O. Box 86, CH-1000, Lausanne, 12-Chailly, Switzerland (tel: (41-21) 653-50-03; fax: (41-21) 653-54-32).

<sup>4</sup> Unless otherwise indicated, the terms with initial capital letters used herein correspond to defined terms in either the Red Book or the Subcontract, or both.

- Part I—called “General Conditions”, which comprises clauses that are meant to be generally applicable to any contract, and
- Part II—called “Conditions of Particular Application”, which comprises clauses that may or may not apply, depending upon the circumstances and locality of the applicable project.

The general intention is that, in any given contract, Part I will be used as it is, whereas Part II will be specially drafted to suit the needs of the applicable project.

As its official name implies, the Red Book is for use in connection with all kinds of civil engineering works such as roads and highways, dams, tunnels, harbors and airports. But its use is not limited to such works. It is also widely used for building works for the simple reason, it would appear, that there exists no generally accepted international form of contract for such works.

The Red Book is to be distinguished from FIDIC's standard form of conditions of contract for *electrical* and *mechanical* works, or “Yellow Book”. While the Red Book is for civil engineering work, the Yellow Book is designed for the supply and erection of plant and machinery, such as the turbines and gates of a hydro-electric station (although the Red Book does include provision for “Plant”).<sup>5</sup>

As a general rule, the Red Book is used for projects which are let out for international competitive bidding in developing countries which do not have sophisticated procurement laws, or forms of construction contract, of their own. Typically, the employer will be the state or a state-owned entity while the contractor and, often, the engineer, will be from a developed country. While the first edition of the Red Book published in 1957 was derived from an English model (the English Institution of Civil Engineers, or ICE, Conditions of Contract), in subsequent editions an effort was made to make the document more “international”. Now, despite resistance in some civil law countries (e.g., francophone Africa), it is widely used in developing countries around the world. Subject to minor modification, it is specifically approved for use on World Bank-funded projects.

The basic justification for resort to contract conditions like those of the Red Book is that well tested and tried standard conditions, which are widely accepted, will promote more efficient and cost effective construction. In the international construction industry the Red Book is generally accepted, as it is seen as establishing a fair balance in the relationship between the employer and the contractor. It provides an international norm or standard, in fact, by which other forms of construction contract are judged. Thus, even when it is not being used for incorporation into a particular contract, it often serves as a point of reference in contract negotiations.

Since the first edition was published, many contractors, engineers and owners have had experience of working with successive editions of the Red Book with the result that its clauses and their particular numbering have

<sup>5</sup> The Red Book, Sub-Clause 1.1(f)(iv).

become well known in the international construction industry. Furthermore, the Red Book has been the subject of numerous legal commentaries, reported court cases and published international arbitral awards.<sup>6</sup> FIDIC has itself published an official commentary on the Red Book.<sup>7</sup>

This is not to say that the Red Book is above reproach. In the author's view, it is still excessively English ("Victorian" might be more accurate)<sup>8</sup> in form and content for a contract that purports to be "international". It makes few, if any, concessions to contracting practices in civil law countries, which are different from those in common law countries. Moreover, some of its procedures are too complex (e.g., the disputes procedure in Clause 67) and its sentences too long, given that it is intended for use in developing countries, by persons whose native language may not be English. Finally, some may not wish to have their contracts administered by an "independent" (albeit hired and paid by the employer) engineer.

Nevertheless, it is easier to criticize the document than to propose positive improvements to it. The drafting of a form of contract for international use in a field as complex as civil engineering is no small undertaking. When it is appreciated that this has been done to date principally by a few civil engineers working without remuneration, and with little help from lawyers, the achievement is all the more remarkable. Furthermore, the author believes FIDIC is conscious of the above criticisms or limitations and will be addressing them in its future work.

The official and authentic text of the Red Book is the English language version. This being so, the format and legal terminology of the Red Book is also that of a common law form of contract. Nevertheless, translations of the Red Book into the Arabic, Chinese, French, Japanese and Spanish languages are also available from FIDIC.

### THE FIDIC CONDITIONS OF SUBCONTRACT: THE DRAFTING PROCEDURE

While the Red Book has been increasingly widely used during the last 20 years, no form of subcontract had been published by FIDIC to go with it. Understandably, therefore, FIDIC has received more and more requests for the issuance of such a form.

Having identified a real need for such a form of subcontract, how was FIDIC to address it?

The Red Book itself did not provide much guidance as it says relatively little

<sup>6</sup> There are two commentaries on the Red Book in book form, one by an engineer and another by a lawyer; see Nael G. Bunni (a consulting engineer), *The FIDIC Form of Contract*, BSP Professional Books, Oxford 1991, and EC Corbett (a lawyer) *FIDIC 4th: A Practical Guide*, Sweet & Maxwell, London 1991.

<sup>7</sup> *Guide to the Use of FIDIC Conditions of Contract for Works of Civil Engineering Construction, Fourth Edition*, published by FIDIC in 1989.

<sup>8</sup> The lengthy sentences and somewhat Gothic style derive (like the system for certification by an independent Engineer) through the ICE Conditions, from conditions of contract used for civil engineering projects in nineteenth century England, during the industrial revolution.

about how the contractor should go about sub-contracting work.<sup>9</sup> The only provisions on the subject are the following:

- (a) under Sub-Clause 4.1, the contractor may not subcontract the whole of the works and must ordinarily obtain prior consent of the engineer to subcontract part of the works (or risk having its employment terminated for default under Sub-Clause 63.1(e));
- (b) under Sub-Clause 4.2, the contractor must, after the expiration of the Defects Liability Period,<sup>10</sup> assign to the employer any continuing obligations of subcontractors;
- (c) Clause 59 relating to nominated subcontractors, which are of practical importance principally in England and certain former English colonies, e.g., Singapore and South Africa; and
- (d) under Sub-Clause 63.4, in case the contractor is terminated for default, the engineer may instruct the contractor to assign to the employer any subcontracts (among other agreements for the supply of goods, materials or services) it may have entered into for purposes of the main contract (although, under the present edition of the Red Book, subcontracts are curiously not expressly required to be assignable to the employer in such a situation).

While the terms of the Red Book themselves did not provide much guidance, as the objective was that the new conditions function in tandem with the Red Book, it followed that the Conditions of Subcontract should be "back-to-back" with the provisions of the Red Book. In other words, the policy of the new Conditions should be, wherever practicable:

- (a) for the contractor to have, in relation to the subcontract works, the rights and obligations (except as to price) of the employer, and
- (b) for the subcontractor to have, in relation to the subcontract works, the rights (except as to price) and obligations of the contractor, under the Red Book.

It was also felt desirable to have a form that (subject to minor modification) would be appropriate even where the subcontractor had been nominated by the employer, inasmuch as the Red Book contains, as mentioned earlier, a clause (Clause 59) especially addressed to nominated subcontractors.

With these objectives in mind, it was decided that the "Form of Sub-Contract (September 1991)", issued by The English Federation of Civil Engineering Contractors (the "FCEC form"),<sup>11</sup> should serve as the original

<sup>9</sup> For an example of a form of main contract which provides for far more regulation and policing of the main contractor's relations with its subcontractors, see AIA Document 201 ("General Conditions of the Contract for Construction", 1987 edition) of the American Institute of Architects, 1735 New York Avenue, N.W., Washington D.C., 20006 USA, especially Article 5, paragraph 9.3.1.2, Article 9.6, paragraph 10.2.1 and Article 14 thereof. In principle, employers and subcontractors are likely to favor more extensive regulation of subcontracting by the main contract.

<sup>10</sup> See the Red Book, Clause 49.1.

<sup>11</sup> This form is available from The Federation of Civil Engineering Contractors, Cowdray House, 6 Portugal Street, London WC2A 2HH, England (tel: (44-71) 404-40-20; fax: (44-71) 242-02-56).

model for the drafting of the FIDIC subcontract. Use of this model seemed desirable for two reasons:

First, the FCEC form had been drafted for use in conjunction with the standard ICE Conditions of Contract (the "ICE Conditions"), a standard form that has much in common with the Red Book. Indeed, as indicated previously, the early editions of the Red Book were modelled closely on the ICE Conditions. Therefore, as the Conditions of Subcontract are intended for use in conjunction with the Red Book, it was natural to take the FCEC form as a model, especially as, in the absence of a FIDIC form of subcontract until now, the FCEC form, with adaptations, has frequently been used in conjunction with the Red Book on international projects.

Secondly, although issued by an organization of contractors—The English Federation of Civil Engineering Contractors—the FCEC form was felt to be relatively fair as well to subcontractors. Indeed, although not stated in the FCEC form itself, it has been approved by two English organizations of subcontractors.<sup>12</sup>

Having said that, it would be wrong to assume that the Conditions of Subcontract are merely a revision of the FCEC form. By comparison with the FCEC form, they present considerable differences, both in substance and form.

As to substance, being essentially a domestic form, numerous changes were necessary to the FCEC form in order to develop a form suitable for international works. For example, unlike the FCEC form, the Conditions of Subcontract contain provisions for Performance Security (Sub-Clause 2.2),<sup>13</sup> Subcontractor's Programme (Sub-Clause 2.3), Language/s (Sub-Clause 3.1), Governing Law (Sub-Clause 3.2),<sup>14</sup> Changes in Cost and Legislation (Clause 21) and Currency and Rates of Exchange (Clause 22).

As to form, two major differences relate to the presentation and structure of the new document.

First, unlike the format of the FCEC form, the form of the Conditions of Subcontract is not that of a subcontract with attached schedules, but of "conditions", general and particular, of subcontract. The drafting of "conditions" of subcontract is in accordance with FIDIC practice and with the structure of the Red Book.

Therefore, as in the case of the Red Book, Part I (the "General Conditions") of the Conditions of Subcontract are meant to be generally

<sup>12</sup> The 1984 edition of the FCEC form, at least, was approved by the Committee of Associations of Specialist Engineering Contractors ("CASEC") and the Federation of Associations of Specialists and Subcontractors ("FASS"); see the commentary on *NEI Thompson Ltd. v. Wimpey Construction UK Ltd.* (1987) 39 BLR 65, 66.

<sup>13</sup> The FCEC form contains a different provision providing for an "undertaking" by the subcontractor; see Article 15(5) thereof.

<sup>14</sup> In the absence of an express choice of governing law, and assuming a subcontract is "back-to-back" with a Red Book-based main contract, then under English law the subcontract is likely to be governed by the same law as the one selected to govern the main contract. See *JMJ Contractors Ltd. v. Marples Ridgway Ltd.* (1985) 31 BLR 100.

applicable, while Part II (the "Conditions of Particular Application") should be specially drafted to suit each individual contract, e.g., by providing information to complete, and indicating any changes or deletions in, Part I, the General Conditions.

Secondly, unlike the FCEC form, in the Conditions of Subcontract each sub-clause has been given a heading, consistent with FIDIC practice. This also makes the Conditions of Subcontract more readily accessible, in that the headings facilitate the reading of this relatively complex document, consisting of almost 70 sub-clauses. In selecting the headings, an attempt was made to adopt the style and wording of the corresponding headings in the Red Book.

Finally, given the need for the Conditions of Subcontract to be "back-to-back" with the Red Book, it was necessary that the language and terminology of the FCEC form be adapted so as to correspond as closely as possible to the language and terminology of the Red Book. Indeed, the need to tie in "back-to-back" with the Red Book (the main contract) precluded consideration of numerous proposals and comments for this form of subcontract which, while good in the abstract, were inconsistent with the language or style of the Red Book.

The principal draftsmen of the Subcontract were the present author and Maurizio Ragazzi, both lawyers in private practice in Paris. The drafting was carried out under the general direction of the FIDIC Contracts Committee comprising K.B. (Tony) Norris, consulting engineer, the UK, Michael Mortimer-Hawkins of SwedPower, Sweden and John Bowcock of Sir Alexander Gibb & Partners Ltd., UK.

Among those consulted in the preparation of the Conditions were the World Bank, the European International Contractors, the European Confederation of Construction Specialists (an organization of subcontractors), the International Bar Association and three independent construction experts external to FIDIC (an engineer, a lawyer and an insurance broker).<sup>15</sup>

## THE FIDIC CONDITIONS OF SUBCONTRACT: DISCUSSION OF SELECTED CLAUSES

As was said earlier, the underlying principle of the Conditions of Subcontract is that, whenever applicable, the terms and conditions of the Red Book (the

<sup>15</sup> Among those whose contributions were particularly valuable were Mario Asin, a consulting engineer of TAMS USA, Anthony Blackler a solicitor and partner of Rowe & Maw, London, acting for a subcommittee of Committee T (International Construction Projects) of the International Bar Association, and Edward Corbett, a solicitor, of Corbett & Co., London, acting as one of the independent construction experts.



main contract) flow down to the Conditions of Subcontract. But how does this work in practice?

To consider this issue, we will review certain clauses of the Conditions of Subcontract. The provisions we will examine are Clause 4 (Relationship of the Subcontract to the main Contract), Sub-Clause 7.2 (Extension of Subcontractor's Time for Completion), Clauses 11.2 and 16 (Payment) and Clause 19 (Settlement of Disputes).

#### **Clause 4 (Relationship of the Subcontract to the Main Contract)**

Few provisions are more regularly the source of disputes in subcontracts than those by which the provisions of the main contract are said to be incorporated by reference, in some manner, into the subcontract. While simple in concept, such provisions are not easy to draft. Yet, if the parts of the main contract to be incorporated are not sufficiently identified or if the purpose of the incorporation is not evident or if the intended operation of the parts of the main contract to be incorporated with that of the subcontract is not sufficiently clear, it will be difficult or impossible to determine which provisions of the main contract are part of the subcontract and which are not, leading to disputes.<sup>16</sup>

This matter is addressed in Clause 4 of the subcontract. Sub-Clause 4.1 provides that the contractor shall make the main contract, other than details of the contractor's prices, available to the subcontractor for inspection and, if requested by the subcontractor, provide the subcontractor with a true copy thereof (less price information), at the cost of the subcontractor. In any event, the contractor must provide the subcontractor with a copy of the appendix to tender to the main contract (Red Book) together with Part II of the conditions of the main contract. Sub-Clause 4.1 further provides that the subcontractor shall be deemed to have full knowledge of the main contract (less details of the contractor's prices).

Sub-Clause 4.2 then provides that the subcontractor shall generally have all the obligations and liabilities of the contractor under the main contract in relation to the subcontract Works:

"Save where the provisions of the Subcontract otherwise require, the Subcontractor shall so design (to the extent provided for by the Subcontract), execute and complete the

<sup>16</sup> For an authoritative ruling on the subject of the incorporation of provisions of a main contract into a subcontract, see the decision of the United States Supreme Court in *Guerini Stone Co. v. P.J. Carlin Construction Co.*, 240 US 264 (1916). In that case, the subcontract had provided that the work should proceed in a manner "agreeable to the drawings and specifications" in the main contract and the employer had made changes and suspended work under the main contract, as it was authorized to do thereunder. Due to the delays caused by the employer's actions, the subcontractor terminated the subcontract and brought an action for damages against the main contractor. The Supreme Court held that the reference to "drawings and specifications" merely indicated what work was to be done, and in what manner it was to be done, by the subcontractor and that the holding of the lower court that the subcontractor was bound by the main contract (not just the drawings and specifications), so as to be obliged to submit to delays resulting from the actions of the employer, was erroneous. See also T Bart Gray, "Incorporation by Reference and Flow-Down Clauses", *The Construction Lawyer* (publication of the Forum on the Construction Industry, American Bar Association) vol. 10, no. 3, August 1990, p. 1.

Subcontract Works and remedy any defects therein that no act or omission of his in relation thereto shall constitute, cause or contribute to any breach by the Contractor of any of his obligations under the Main Contract. The Subcontractor shall, save as aforesaid, assume and perform hereunder all the obligations and liabilities of the Contractor under the Main Contract in relation to the Subcontract Works."

Sub-Clause 4.3 then provides that no privity shall exist between the subcontractor and the employer. This provision will, of course, be subject to the provisions of mandatory law (in the usual case, the law of the place where the works are being executed). Thus under the laws of some countries (e.g., France and certain countries that derive their law from French law) the subcontractor may have, by virtue of mandatory law, irrespective of what the subcontract may provide, a right of direct payment from, or direct legal action against, the employer.<sup>17</sup>

Sub-Clause 4.4 then deals with breaches by the subcontractor of the subcontract which cause damage to the contractor under the main contract. Sub-Clause 4.4 provides:

"If the Subcontractor commits any breaches of the Subcontract, he shall indemnify the Contractor against any damages for which the Contractor becomes liable under the Main Contract, as a result of such breaches. In such event the Contractor may, without prejudice to any other method of recovery, deduct such damages from recoveries otherwise becoming due to the Subcontractor."

Frequently, subcontracts will not contain liquidated damage provisions since the financial consequences of a subcontractor's delay are often unpredictable and may depend on whether the subcontractor's work is on the "critical path" of the contractor's actual progress. For this reason, no liquidated damages clause is contained in Part I of the subcontract. However, Sub-Clause 4.4 may serve in lieu of a liquidated damage provision as it provides that if the subcontractor breaches the sub-contract (e.g., by being late for a reason which does not entitle the subcontractor to an extension of time) then the damages, if any, resulting from the subcontractor's breaches (including liquidated damages the contractor may have to pay under the main contract), will be recoverable by the contractor from the subcontractor.

However, in the event that it is desired to include a liquidated damages clause in the subcontract itself, an example liquidated damages clause is contained in Part II, together with proposed language for amending Sub-Clause 4.4 accordingly.

### **Sub-Clause 7.2 (Extension of Subcontractor's Time for Completion)**

Under Clause 44 of the Red Book, where the contractor has been delayed it

<sup>17</sup> E.g., under French law, *see* Law No. 75-1334 of December 31, 1975, as amended (for a commentary on this law, *see* the author's "French Law on Subcontracting", [1991] ICLR 78). Subcontractors also have a right of direct action against the employer under certain Arab Civil Codes, e.g., Article 565 of the Algerian Code, Article 662 of the Egyptian Code, Article 882 of the Iraqi Code, Article 682 of the Kuwaiti Code, Article 661 of the Libyan Code and Article 628 of the Syrian Code. Under most of these Codes the subcontractor's right is probably mandatory and would, therefore, override a contract provision to the contrary.

may in certain circumstances, upon compliance with stipulated notice provisions, be entitled to an extension of its time for completion.

In parallel with this clause of the Red Book, Sub-Clause 7.2 of the subcontract provides that the subcontractor may also, in certain circumstances, be entitled to an extension of time. The subcontractor is entitled thereto where it has been delayed by any of three specified events or circumstances:

- “(a) by any circumstances in regard to which the Contractor is entitled to receive from the Employer an extension of his time for completion of the Main Works under the Main Contract,
- (b) by any instruction pursuant to Sub-clause 8.2 to which paragraph (a) of this Sub-Clause does not apply, or
- (c) by any breach of the Subcontract by the Contractor or for which the Contractor is responsible.”

The first case is straightforward: it deals with where the subcontractor has been delayed by an event on the critical path of the contractor's progress for which the contractor is entitled to an extension of time under the main contract. The subcontractor is entitled to an extension of time if the contractor is entitled thereto.<sup>18</sup> The extension under the subcontract cannot (according to Sub-Clause 7.2) exceed the extension of time to which the contractor is entitled under the main contract.

The subcontractor is to be advised of relevant extensions under the main contract as Sub-Clause 7.3 provides that the contractor must notify the subcontractor of all extensions of time obtained thereunder which affect the subcontract.

The second case deals with where the contractor gives an instruction (or confirms an instruction of the engineer under the main contract) in circumstances which do not entitle the contractor to an extension under the main contract.

The third case, breach of the subcontract by the contractor, requires no explanation.

Sub-Clause 7.2 contains detailed notice requirements designed to ensure that the subcontractor will give adequate notice to the contractor of requested extensions in time to enable the contractor to give proper notice to the engineer under the main contract (the Red Book).

### **Clauses 11.2 and 16 (Payment)**

The manner of payment of the subcontract price is perhaps *the* critical issue in a subcontract for the subcontractor.

<sup>18</sup> Note that, as in the case of the FCEC form (Clause 6(2)), the subcontractor's right is not dependent upon the contractor's *receipt* of the extension. To compare the rule as to payments, *see* under Clauses 11.2 and 16 (Payment), below.

Under any main contract incorporating the Red Book, the contractor must necessarily assume certain payment risks, including that:

- (i) the engineer will be late in certifying the contractor's monthly statements or will not certify them in full, or at all, because it does not accept them, and
- (ii) the employer will be late in paying certified amounts, or will refuse to pay them in full, or at all, because it disagrees with the engineer's certification, or becomes unable to pay them because of its financial difficulty, insolvency, bankruptcy, or bad faith.

When subcontracting work, the contractor will normally endeavor to pass on some portion of these risks (up to the value of subcontracted work) to its subcontractors by virtue of so-called "pay when paid", "payment on payment" or "if and when" clauses, the precise legal consequences of which are often difficult to determine.<sup>19</sup> Thus, the subcontractor may be made to bear some at least of the risk of delay or failure in certification or payment.

In addition to the payment risks borne initially by the contractor, the subcontractor must also bear the risks of late payment and of non-payment by the contractor itself (even if paid by the employer) in the event, for example, of a dispute between the subcontractor and the contractor or if the contractor suffers financial difficulty, insolvency, bankruptcy, or is in bad faith.

Given the widespread industry practice world-wide of "pay when paid" clauses, and the no less prevalent view that subcontractors are an abused class entitled to protection, how should a new international form of subcontract address the issue of payments to subcontractors?

Clauses 11 and 16 of the Conditions of Subcontract attempt to answer this question, basically by incorporating the policy already embodied in the FCEC form.

The Conditions of Subcontract distinguish between:

- (a) how the subcontractor is to be paid for the value of the original Works included in the subcontract, variation orders instructed by the

<sup>19</sup> Nowhere have such clauses been the subject of more analysis than in the United States, where they have been considered in literally hundreds of reported Federal and State decisions. According to these cases generally, the essential legal issue presented by such clauses is whether they establish a condition precedent to the contractor's obligation to pay the subcontractor or, instead, merely regulate the time for payment by the contractor of the subcontractor. The majority view (reflecting, I suggest, a policy in those jurisdictions to protect subcontractors, as generally the weaker party) is that they regulate only the time for payment, see *Thomas J. Dyer Co. v. Bishop International Engineering Co.*, 303 F.2d 655 (6th Cir. 1962) and subsequent cases following it. A respectable minority, however, attaches more weight to the precise wording of the clause in question and may be cited for the opposite view that they establish a condition precedent, see *Mascioni v. I.B. Miller*, 261 N.Y. 1, 184 N.E. 473 (1933) and subsequent cases following it.

For a recently reported British Commonwealth case which, drawing on the wealth of US case law, gives a useful analysis of "pay when paid" clauses, see *Smith & Smith Glass Ltd. and Winstone Architectural Cladding Systems Limited*, High Court of New Zealand (Master Towle), 4 October, 1991 (reported in the *Construction Industry Law Letter*, November 1993, London, page 898).

In some civil law jurisdictions, a "pay when paid" clause may be void. Thus, according to some legal authors, it is invalid in French domestic law as it is incompatible with Law No. 75-1334 of 31 December 1975, as amended (referred to in note 17 *supra*); see Michèle Klein, *L'Assurance-Crédit et les Autres Risques dans le Commerce International*, thesis, Paris, 1983, pp. 493-494.

contractor and other amounts regularly payable (that is, excluding claims) to the subcontractor under the subcontract, and

- (b) how the subcontractor is to be paid for claims under the subcontract which correspond to claims that the contractor may advance under the main contract, e.g., under Clause 12 of the Red Book dealing with unforeseeable physical conditions or obstructions.

I shall deal first with the situation of payment for the original subcontract works and other amounts regularly payable under the subcontract.

*Subcontract Works (excluding claims for additional payment) (Clause 16)*

Under Clause 60 of the Red Book, the contractor is paid during the progress of the works based on monthly statements which the contractor submits to the engineer for certification. Likewise, Clause 16 of the Conditions of Subcontract provides that the subcontractor shall submit monthly statements to the contractor in such manner and time as to enable the contractor to incorporate these in its monthly statements to the engineer under clause 60 of the Red Book.

In the normal situation, the contractor will incorporate the subcontractor's monthly statement in the contractor's own statement under the main contract and the amounts requested by the contractor (which will include the amounts requested by the subcontractor) will be certified by the engineer under the main contract and paid by the employer. Upon receipt of payments from the employer, the contractor will then pay to the subcontractor the amounts due to it.

However, Sub-Clause 16.3 of the subcontract (like Clause 15(3)(b) of the FCEC form) provides that the contractor is entitled to withhold or defer payment of any part of the sums due to the subcontractor on five different grounds. Of these, three are of great practical significance, namely, paragraphs (c), (d), and (e) of Sub-Clause 16.3:

- “(c) the amounts included in any Statement [author's note: a monthly statement of the Subcontractor] *are not certified in full by the Engineer*, providing such failure to certify is not due to the act or default of the Contractor,
- (d) the Contractor has included the amounts set out in the Statement in his own statement in accordance with the Main Contract and the Engineer has certified but *the Employer has failed to make payment in full to the Contractor*, providing such failure is not due to the act or default of the Contractor, or
- (e) *a dispute arises or has arisen between the Subcontractor and the Contractor and/or the Contractor and the Employer involving any question of measurement or quantities or any other matter included in any such Statement.*”<sup>20</sup> (Emphasis added)

Where only a portion of a subcontractor's monthly statement is

<sup>20</sup> The other grounds for withholding payment are where the amounts due are less than the minimum amounts for monthly statements under the subcontract or main contract.

questioned, the contractor may not refuse to pay the balance. Sub-Clause 16.3 expressly provides that any withholding:

“... shall be limited to the extent that the amounts in any Statement are not certified, not paid by the Employer or are the subject of a dispute, as the case may be”.

Often the contractor will withhold payments to the subcontractor without explaining to the subcontractor why such payments are withheld. The subcontractor will thus not know the cause of the delay in payment and, hence, whether he should be entitled to payment. Sub-Clause 16.3 deals with this by providing that, where the contractor withholds or defers any payment, the contractor must notify the subcontractor in writing of his reasons for doing so not later than the date such payment would otherwise have been payable.<sup>21</sup>

Under the Red Book, the employer is expressly liable to interest at a stipulated rate per annum where the employer is late in paying certified amounts.<sup>22</sup> Similarly, Sub-Clause 16.3 of the subcontract provides that, where the employer has failed to pay any amount the engineer has certified or the contractor has failed to pay any amount that is properly due and payable to the subcontractor, the contractor will be liable to interest on the overdue amount at the rate payable by the employer to the contractor under the main contract.

Sub-Clause 16.3 provides that the subcontractor must claim for this interest in writing for it to accrue. However, even if the subcontractor fails to do so, the Sub-Clause provides that the subcontractor will be entitled to be paid any interest actually received by the contractor from the employer attributable to monies due to the subcontractor.

Thus, so far, it may be said that, as regards the original subcontract price, authorized variation orders and other amounts regularly payable to the subcontractor under the subcontract, the subcontractor is to be paid only “if and when” the contractor is paid. To this extent, the subcontractor bears the risk of payment delays in respect of the subcontract works.

However, payments are only on an “if and when” basis temporarily. After the main contract works have been completed and the Defects Liability Certificate thereunder has been issued (which may be sometime after the Subcontract Works are completed),<sup>23</sup> the Subcontractor is entitled to be paid the balance of the subcontract price, authorized variations and other amounts regularly payable under the subcontract, whether payment has been certified by the engineer or not and whether the contractor has been paid by the employer or not under the main contract. This is plain from Sub-Clause 16.5 which provides in its entirety, as follows:

“Within 84 days after the Subcontractor has finally performed his obligations under Clause 14 [author’s note: this refers to the Subcontractor’s obligations after Taking-Over which will normally have been performed after the Defects Liability Certificate under the

<sup>21</sup> The requirement that such notification be in writing is provided for in Sub-Clause 1.5.

<sup>22</sup> Sub-Clause 60.10.

<sup>23</sup> See Sub-Clause 60.1 of the Red Book.

main contract is issued], or within 14 days after the Contractor has recovered full payment under the Main Contract in respect of the Subcontract Works, whichever is the sooner, and provided that 35 days have expired since the submission by the Subcontractor of his statement of final account to the Contractor, *the Contractor shall pay to the Subcontractor the Subcontract Price, and any additions to or deductions from such sum as are provided for in the Subcontract, or are otherwise payable in respect thereof, less such sums as have already been received by the Subcontractor on account.*" (Emphasis added).

Thus, as regards the original subcontract price, as varied ("additions" or "deductions") and other amounts "payable" in respect of the subcontract (which would generally exclude the subcontractor's claims unless they had been accepted by the contractor, *see* the discussion of Sub-Clause 11.2 below), less previous payments to the subcontractor, while the subcontractor takes the risk of delays in payment by the employer (although normally being entitled to interest on the overdue amounts), the subcontractor does not take the risk of the complete failure of the employer to pay on account, for example, of its financial difficulty, insolvency, bankruptcy or bad faith. The subcontractor only takes the risk of delays in payment, or failures to pay, of the other party to the subcontract, namely, the contractor, as in any contract.<sup>24</sup>

#### *Claims for additional payment (Clause 11)*

Having dealt with payment of the subcontract price and other amounts regularly payable under the subcontract, what are the subcontractor's rights with respect to the payment of claims under the subcontract, which the contractor may advance under the main contract, such as for:

- unforeseeable physical obstructions or conditions at the site (Clause 12 of the Red Book),
- damage to the works by one of the employer's risks (Clause 20 of the Red Book),
- failure by the employer to give adequate possession of the site (Clause 42 of the Red Book), and
- late issuance of drawings or instructions by the engineer (Sub-Clause 6.4 of the Red Book)?<sup>25</sup>

This subject is addressed in Sub-Clause 11.2. This Sub-Clause requires the contractor to:

"take all reasonable steps to secure from the Employer such contractual benefits

<sup>24</sup> Clause 16 is unlikely to exclude the contractor's right of set off under the common law. *See NEI Thompson Ltd. v. Wimpey Construction UK Ltd.* (1987) 39 BLR 65 which concerned Clause 15, the corresponding clause in the 1984 edition of the FCEC form.

<sup>25</sup> This list is illustrative only. For a comprehensive list of the claims that the contractor (and, thus, through the contractor, the subcontractor) may assert under the fourth edition of the Red Book, *see* the author's "Contractor's Claims under the FIDIC Civil Engineering Contract, Fourth Edition", *The International Business Lawyer* (published by the International Bar Association) 1991, pages 395 and 457.

(including additional payments, extensions of time, or both), if any, as may be claimable in accordance with the Main Contract on account of any adverse physical obstructions or physical conditions or any other circumstances that may be encountered during the execution of the Subcontract Works."

On receiving such benefits, the contractor must pass on to the subcontractor:

"such proportion thereof as may in all the circumstances be fair and reasonable",

but *that is the limit of the contractor's liability*. If the contractor is not paid by the employer for the subcontractor's claims, despite the contractor having taken "all reasonable steps", then the subcontract provides that the contractor will have no liability to the subcontractor therefor:

"Save as provided in this Sub-Clause, or in Sub-Clause 7.2 [author's note: dealing with extensions of time], the Contractor shall have no liability to the Subcontractor in respect of any obstruction, condition or circumstance that may be encountered during the execution of the Subcontract Works."

Thus, so far as concerns claims for additional payment, unless the contractor has accepted them or has been at fault in some manner, the subcontractor bears the risk of the employer's failure to pay on account, for example, of its financial difficulty, insolvency, bankruptcy or bad faith.

The contractor has a duty to keep the subcontractor regularly informed of his steps to pursue claims under the main contract, which involve the subcontractor, and to get them settled. Sub-Clause 11.2 provides as follows:

"The Contractor shall notify the Subcontractor regularly of his steps to secure such contractual benefits and of the Contractor's receipt thereof".

Naturally, the contractor remains liable to the subcontractor for the contractor's own defaults, including failure to take reasonable steps to pursue the subcontractor's claims under the main contract.<sup>26</sup>

The payment scheme described above, which distinguishes generally between the payment of the original works as varied, on the one hand, and the payment of claims, on the other, generally follows that embodied in the FCEC form.<sup>27</sup>

### Clause 19 (Settlement of Disputes)

Sub-Clause 19.1 deals with disputes between the contractor and the subcontractor, whereas Sub-Clause 19.2 deals with disputes between the employer and the contractor under the main contract which "touch or concern" the subcontract works.

Sub-Clause 19.1 assumes that the contractor and subcontractor will be from different countries or will otherwise wish to provide for the international arbitration of their disputes. This will not necessarily be so. They may, for example, both be from the same country and therefore prefer

<sup>26</sup> See the last sentence of Sub-Clause 11.2 of the subcontract. "Reasonable steps" may, as a last resort, include international arbitration.

<sup>27</sup> Compare Clauses 10 and 15 of the FCEC form.



to have recourse to their own national courts or tribunals, even though the contractor may have agreed to the international arbitration of disputes under the main contract, as provided for by Clause 67 of the Red Book. Where they prefer to have recourse to their own national courts or tribunals, Clause 19 will need to be appropriately modified in Part II.

Sub-Clause 19.1 provides, essentially, that if any dispute arises between the contractor and the subcontractor then either may give a notice of the dispute to the other in which case the two parties shall for the next 56 days attempt to settle such dispute amicably.<sup>28</sup> If such dispute is not settled amicably within such period, then it is provided that it shall be finally settled by arbitration under the rules of arbitration of the International Chamber of Commerce, the same rules as are provided for by the Red Book. Arbitration may be commenced before or after completion of the subcontract works.

As is well known, the Red Book (Clause 67) provides for a lengthy and complex procedure for the settlement of disputes.<sup>29</sup> Under this procedure, a dispute must first be referred to the decision of the engineer, who has 84 days to give notice of his decision. Then each party has 70 days thereafter to challenge the decision. A further 56 days must be allowed for amicable settlement before either party may take the matter to arbitration.

Accordingly, to allow time for the procedure in Clause 67 to be completed (which, if the engineer's decision is favorable to the contractor, and not objected to by the employer, would relieve the subcontractor from going to arbitration), the parties to the Conditions of Subcontract may wish to agree to a longer period than 56 days before either may commence arbitration. For example (and as explained in Part II of the Conditions of Subcontract) a period of 210 days from the date that a party gives a notice of a dispute under Sub-Clause 19.1 would be the sum of the various time periods in Clause 67 (namely, 84 days for the Engineer's decision, plus 70 days for the notice of intention to commence arbitration, plus 56 days for reaching an amicable settlement) before arbitration may be commenced thereunder.

Sub-Clause 19.2 provides that, if a dispute arises between the employer and the contractor in connection with the main contract and the contractor is of the opinion that such dispute "touches or concerns the Subcontract Works"<sup>30</sup> and an arbitration of such dispute under the main contract commences, then the contractor may require the subcontractor to provide information and attend meetings in connection with the arbitration. As the subcontractor's rights against the contractor may, to some extent at least, depend upon the

<sup>28</sup> In providing a 56-day period for amicable settlement, Sub-Clause 19.1 corresponds to Sub-Clause 67.2 of the Red Book.

<sup>29</sup> See the author's *The Pre-Arbitral Procedure for the Settlement of Disputes in the FIDIC Civil Engineering Conditions of Contract*, [1986] ICLR 316 (for a commentary on the procedure in the third edition of the Red Book); *Id.*, *The Principal Changes in the Procedure for the Settlement of Disputes (Clause 67)*, [1989] ICLR 177 (for a commentary on the changes effected in such procedure by the fourth edition); and *Id.*, *Pre-Arbitral Decisions and their Impact on the Arbitration: the Decisions Made by the Consulting Engineer* in International Council for Commercial Arbitration Congress Series no. 5 (Effective Proceedings in Construction Cases), Kluwer, The Netherlands 1991, p. 377.

<sup>30</sup> This expression is taken from the FCEC form, Article 18(8).

outcome of that arbitration (e.g., in the case of the subcontractor's claims for additional payment under Clause 11 of the subcontract), the subcontractor will ordinarily have an incentive to provide the contractor with all due assistance.

Although both the Red Book and the Conditions of Subcontract provide for the final settlement of disputes by ICC arbitration and although it may be highly desirable for disputes under both contracts to be finally settled in certain instances (e.g., where they involve common questions of law and fact) in a single ICC proceeding, paradoxically there is no means under the ICC Rules themselves for ensuring that this will occur. There is no provision under the ICC system for the joinder by the ICC International Court of Arbitration of claims arising in separate proceedings except in the very rare instance where they arise out of the same contract ("legal relationship") and between the same parties.<sup>31</sup> Disputes under the Red Book and Conditions of Subcontract would arise neither out of the same contract nor between the same parties.

In the absence of an appropriate provision for joinder in the ICC rules, there is, of course, nothing to prevent an employer, a contractor and subcontractor, at the contract negotiation stage, from agreeing on a provision for the multi-party arbitration of disputes among the three of them. However, the possibility of multi-party arbitration is not envisaged by the current edition of the Red Book presumably because, when this edition was prepared in 1987, no FIDIC form of subcontract then existed. As this edition does not envisage multi-party arbitration nor provide even for the possibility of the employer's consent thereto, no multi-party arbitration clause is provided for in the conditions of Subcontract. (But parties are not prevented from providing for the multi-party arbitration of disputes under the Red Book and the Conditions of Subcontract, should they choose to do so in Part II of those documents.)

However, while the drafting of such a multi-party arbitration clause is often attempted, in the author's experience, such attempt is rarely successful due to underestimation of the difficulties involved. In order that parties may be better prepared should they wish to draft a multi-party arbitration clause, Part II of the new subcontract includes a list of some of the principal issues or matters that will need to be considered<sup>32</sup>:

- (1) The consent of the employer, the contractor and the subcontractor to multi-party arbitration will be required.
- (2) The multi-party arbitration procedure must tie in with the procedure

<sup>31</sup> In addition to these requirements, the Terms of Reference must not yet have been signed. *See* Article 13 of the Internal Rules of the International Court of Arbitration.

<sup>32</sup> This list owes much to a stimulating paper by Humphrey Lloyd, QC (now His Honour Judge Humphrey Lloyd, QC) entitled "*A National Experience*" contained in Chapter 2 "Multi-party arbitral clauses and conventions" of a dossier entitled "*Multi-party Arbitration—Views from International Arbitration Specialists*" of the Institute of International Business Law and Practice published by the International Chamber of Commerce, Paris, 1991, pp. 61–79.

under the Red Book requiring the reference of a dispute to the engineer under Clause 67 as a condition precedent to arbitration.

- (3) A test in the form of words must be developed for determining when a dispute under the subcontract is to be deemed sufficiently similar to a dispute under the Red Book to be referable to arbitration under the Red Book (assuming the dispute is to be resolved under the dispute resolution provisions of the main contract). For example, will it be sufficient to state that a dispute in connection with or arising out of the Red Book "touches or concerns the Subcontract Works" or presents "common issues of law and fact" with a dispute under the Subcontract?
- (4) As a practical matter, someone—perhaps the contractor—will probably have to be given the power to decide when the test is satisfied, that is, when the disputes under the two contracts are to be deemed sufficiently similar to justify being heard in one arbitration under the Red Book. If someone is not designated to have this power, the issue would normally fall to be decided by the competent courts, resulting often, as a practical matter, in much delay.
- (5) A determination will have to be made as to the action (e.g., a notice to the other parties) which must be taken to permit the hearing of the two disputes in a single arbitral proceeding.
- (6) A determination will have to be made as to when action must be taken to permit the joint hearing of the two disputes. Before arbitrators are appointed in any Red Book proceeding? Earlier than that?
- (7) A decision must be made as to the maximum number of parties that would be acceptable in any multi-party arbitration proceeding:
  - (a) horizontally, all subcontractors of the contractor in relation to the project; and
  - (b) vertically, subcontractors, sub-subcontractors, and so on down the line?

To the extent any multi-party arbitration will include parties in addition to the employer, the contractor and the subcontractor, the participation of those parties must also be consented to by all the parties involved in the proceeding.

- (8) The procedure for appointing the arbitral tribunal so as to ensure equal treatment of all parties.<sup>33</sup>
- (9) As yet, no international arbitration rules (e.g., ICC or UNCITRAL) address satisfactorily multi-party arbitration problems.

As an alternative to a multi-party arbitration, the parties may wish to provide for separate Red Book and subcontract arbitrations but arrange for some or all of the arbitrators to be common to both proceedings.

<sup>33</sup> See in this connection the decision of the French Supreme Court in *Siemens AG and BKMI Industrienlagen GmbH v. Dutco Consortium Construction Company Ltd.*, Cass. Civ. 1ère, 7 January, 1992 and the author's commentary on that decision, *French Supreme Court Nullifies ICC Practice for Appointment of Arbitrators in Multi-Party Arbitration Cases* [1993] ICLR 222. Item (8) is, in fact, additional to the list of items in Part II of the subcontract, which is not exhaustive.

The foregoing indicates some of the complexities involved in providing for the resolution of multi-party disputes under the Red Book and the subcontract by international arbitration. Much more work needs to be done by the international arbitration community<sup>34</sup> and the international construction industry before satisfactory standardized solutions are available.<sup>35</sup>

## CONCLUSION

The Conditions of Subcontract represent the first attempt by FIDIC to draft a form of subcontract to function "back-to-back" with the Red Book. As the Conditions of Subcontract must tie in with, and be subordinate to, the Red Book, there has been little room for innovation. Consequently, FIDIC has largely had recourse to provisions or procedures that are in current use in the FCEC form or the Red Book, which have hitherto proved workable.

If the Conditions of Subcontract provide a serviceable form of subcontract for the current edition of the Red Book, they will have accomplished their purpose. When the Red Book is next revised, consideration should be given to the desirability of more extensive treatment of subcontracting in the Red Book. This, coupled with experience of the use of the subcontract in practice, should contribute to improving the subcontract in future.

<sup>34</sup> Despite years of work, a Working Party on Multi-party Arbitration set up by the ICC Commission on International Arbitration achieved little more in its Final Report than to describe the problems and complexities of multi-party arbitration under the ICC Rules, many of which were already well known. Although the existing constraints on multi-party arbitration seriously hamper the development of international arbitration, regrettably, the Working Party was unable to present any practical solutions to those problems, such as changes in or improvements to the ICC's Arbitration Rules or to ICC procedures. See the ICC Commission on International Arbitration's Final Report on Multi-Party Arbitrations (Report by the Working Group approved by the Commission submitted to the 77th Session of the Executive Board, Paris, 14 June 1994) ICC, Paris 1994.

<sup>35</sup> Although there has been no opportunity in this article to discuss Clause 17 ("Termination of Main Contract") of the subcontract, it may be noted that the difficulty that arose in *E.A. Dyer Ltd. v. The Simon Build/Peter Lind Partnership*, (1982) 23 BLR 23 in relation to the corresponding Clause of the FCEC form (Clause 16) should not arise under the subcontract. In that case, following the employer's termination of the contractor's employment under Clause 63 of the ICE Conditions (which is very similar to Clause 63 of the Red Book), the contractor maintained that the main contract had been determined (terminated) and that therefore it was entitled, under Clause 16 of the FECE form (which refers to "(i)f the Main Contract is determined for any reason whatsoever"), to terminate the employment of the subcontractor without being liable for profit on the balance of the work as provided for in Clause 16. The arbitrator held that this was wrong (and the court refused leave to appeal from his decision) as the main contract had not been terminated—only the contractor's employment had been terminated—and therefore Clause 16 did not apply.

As Clause 17 of the subcontract provides that the contractor may terminate the subcontractor's employment *whether the contractor's employment under the main contract is terminated or the main contract is itself terminated*, the difficulty that arose in *E.R. Dyer* in relation to Clause 16 of the FCEC form (from which Clause 17 is derived) should not arise under the subcontract.