

Back To Back Payment Clauses Under UAE Law

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Conditional payment clauses, often referred to as 'Back to Back' clauses, or 'Pay when Paid' clauses are a common feature of construction contracts within the UAE and the Gulf region more generally.

Principally deployed in subcontracts, they are the bane of many a subcontractor in their efforts to obtain prompt payment, and a last line of defense for main contractors...sometimes.

In brief, these clauses provide that a main contractor is not under an immediate obligation to make payment to a subcontractor, until it receives equivalent payment (or similar) from the employer.

The purpose of these clauses is to protect main contractors against cash flow issues, avoiding a scenario in which the main contractor is squeezed from both sides (i.e. employer not paying and subcontractor demanding payment). Effectively they provide for main contractors and their subcontractors to share the risk of non-payment from the employer.

Naturally, the wording and formulation of these clauses varies widely, subject to how they have been drafted. However, they often contain a phrase to the effect that a subcontractor will be paid within x days of receipt of equivalent payment from the employer.

The applicable UAE law behind these clauses is often misunderstood and sometimes lacks clarity, owing in part to the fact that the UAE operates within a civil law jurisdiction, with no binding precedent and significant judicial discretion. This article seeks to provide guidance in respect of certain features of these clauses, albeit with the usual caveats applicable to civil law systems, namely the relative lack of comprehensive precedents and the risk of unpredictable judicial decision making.

This guide will address the following nine features of these clauses:

- Legislative background
- Validity under UAE law
- 'Pay when Paid' vs 'Pay if Paid'

- Materialisation (Payment)
- Impossibility
- Completion (of the works) / lapse of time
- Termination
- Deemed Materialisation (main contractor's efforts to pursue the employer)
- Waiver

NB. This article describes these clauses in the context of a contract between a subcontractor and a main contractor, however, these clauses also arise in contracts further down the project line (e.g. between a subcontractor and its own subcontractor/supplier).

Legislative Background

'Back to Back' clauses in respect of payment are more accurately described as conditional payment clauses (as 'Back to Back' clauses may refer to other obligations in a subcontract, which are back to back with the main contract, e.g. regarding release of bonds). In conditional payment clauses, a main contractor's obligation to make payment to the subcontractor is subject to a certain condition being fulfilled (namely receipt of payment from the employer or similar). As such, receipt of 'equivalent payment' becomes a condition precedent which must be fulfilled before a main contractor has an immediate obligation to make payment to the subcontractor.

The most relevant parts of the UAE Civil Code (Federal Law No. 5 of 1985) ("Civil Code") which provide in respect of conditions precedent are found at Article 420, 422, 425 and 427.

These articles respectively provide:

"A Condition is a future matter upon the existence or absence of which the full effectiveness (of a dis-position) depends."

"A conditional disposition is one which is dependent on a not yet existing Condition or on a future event, and whose effect is suspended until such Condition is satisfied."

"A disposition dependent upon a Condition not incompatible with the contract shall be ineffective, unless the Condition materializes."

"(A disposition) dependent upon a Condition shall be affirmed upon its being established that the Condition has materialized."

The effect of these provisions is that under the Civil Code, if an obligation is the subject of a condition precedent (referred to under UAE law as a suspensive condition), this obligation is suspended until the condition is materialized (i.e. satisfied).

Applying this to conditional payment clauses, a main contractor's obligation to make payment to a subcontractor is suspended until the condition precedent is satisfied, namely it receives payment from the Employer.

Validity under UAE law

Whilst conditional payment clauses in construction contracts have been outlawed in other jurisdictions (most notably in England & Wales and Scotland, where most forms of

such clauses have been prohibited under the Housing Grants Construction and Regeneration Act 1996), these clauses are valid in the UAE and are routinely upheld by the UAE courts.

Pay when Paid vs Pay if Paid

There is a considerable amount of commentary which seeks to distinguish between two types of conditional payment clause, one type being a 'Pay when Paid' clause the other a 'Pay if Paid' clause.

This commentary often suggests that the distinction between these clauses is as follows:

- Under a 'Pay when Paid' clause, a main contractor always has an obligation to make payment to the subcontractor, however this is only triggered when it actually receives payment. The sub-contractor always has an entitlement to be paid the full amount charged (at some stage). Such a clause only imposes a condition on the timing of payment. The assessment of quantum due to the subcontractor is unaffected.
- Under a 'Pay if Paid' clause, the main contractor's obligation to make payment only arises if it receives payment from the employer, and the sub-contractor is only entitled to payment in the sum received from the employer (meaning the assessment of quantum due to the subcontractor is directly linked to the amount received from the employer).

This alleged distinction is sometimes relied upon to suggest that if a clause is a 'Pay when Paid' clause, payment must be made 'within a reasonable time', and/or that payment must be made if it appears the employer does not intend to pay the main contractor. It is alleged that in such circumstances, under a 'Pay when Paid' clause, the main contractor will be obliged to make payment regardless of the receipt of payment from the employer.

There is no formal distinction between these two types of clause under UAE law. There is no legislative basis for any such distinction, and the UAE courts have not recognized any distinction between these two types of clause. Under UAE law, there is only one type of conditional payment clause. In particular, a main contractor's obligation to make payment is suspended until equivalent payment is received from the employer. As such, the obligation does exist, it is simply suspended. However, if payment is not received (or the condition does not become impossible to perform and/or the condition is not deemed materialized – see below), a subcontractor would not be able to enforce any obligation to make payment and this may ultimately affect the quantum of the sum received by a subcontractor.

However, whilst there is no formal distinction between these two types of clause, the wording of the clause, and the disposition of the relevant court / tribunal, may affect whether a court / tribunal determines that this clause has 'lapsed' through time / completion of works. These are discussed below.

Materialisation (Payment)

The usual operation of a conditional payment clause is that the suspension (of obligation) will cease once the suspensive condition has been materialized.

The legislative background confirming this operation is Article 423 of the Civil Code, which provides:

"In order that suspension be valid, the context of the condition must neither be materialized or impossible."

If the condition has been materialized, the suspension is no longer 'valid' or operable, and the obligation becomes activated.

In the context of a conditional payment clause, this means once appropriate payment has been received by the main contractor (from the employer), the suspension on the main contractor's obligation to pay the subcontractor is lifted, and the main contractor is required to make payment (usually of the appropriate payment received from the employer).

The reason the reference to payment above is qualified by the word 'appropriate', is because it is often argued by main contractors that even if they have received payment from the employer, this was not payment in respect of the subcontract works (which are subject to the conditional payment clause).

As held by the Dubai Court of Cassation in a number of cases, whether such an appropriate payment has been received (and as such whether the main contractor is obliged to make onward payment to the subcontractor) is one of the matters which rests within the discretion of the first instance court or tribunal. In the UAE onshore courts, this is often answered by a court appointed expert, with the court typically adopting the expert's findings.

To provide an example, in a Dubai Court of Cassation case in 2016, in circumstances where an employer had issued a payment certificate for final payment to the main contractor, and 31 months had elapsed since this certificate would have become due for payment, and as the main contractor had not provided any evidence that it had not been paid, the main contractor was found to have been paid by the employer, and the condition precedent was found to have materialised.

Impossibility

Article 423 of the Civil Code, as set out above, also provides a further circumstance in which a suspension will no longer be valid/will be lifted, which is if the condition becomes impossible.

In the context of a conditional payment clause, notionally, which circumstances might make receipt by the main contractor of payment from the employer 'impossible' could be wide ranging. This may include, for example, a situation where the main contractor is no longer permitted to receive payment from the employer under the law, if for example the employer became subject to sanctions. However, in reality this provision is likely to be restricted to circumstances in which the employer is being liquidated or similar.

Completion / Lapse of Time

Whether completion or a mere lapse of time has any effect on a conditional payment clause is often a point of contention raised in court and arbitration proceedings. Unfortunately, the UAE case law on this issue is not entirely clear and is therefore, often misunderstood.

Subcontractors will often rely upon a Dubai Court of Cassation case from 1996, in which the Court held:

“There is no justification for the outstanding dues of all the subcontractors to be subject, after the completion of the works they undertook, to the main contractor receiving its outstanding dues from the employer after completing the whole project and handing it over to the employer, otherwise, the subcontractor, which has completed its own work, would be harmed for a reason in which it has no hand.”

However, the interpretation of the actual ruling in this case is often misunderstood. When this case was before the Court of Merits (i.e. first instance court), the Court of Merits had decided that the parties had not intended for the conditional payment clause to apply after completion of the works, and as such the Court used its discretion to interpret the terms of the contract (pursuant to Article 265 of the Civil Code) in such a manner as to give effect to this intention.

The Cassation Court’s decision in this case needs to be read in line with the first instance decision. Through this lens, this illustrates that the only authority that this case provides is that the Court of Merits (i.e. first instance court) has within its discretion the ability to interpret the terms of the contract. As held by the Cassation Court in this matter:

“This argument is groundless as it is held by this Court that the Court of Merits has sole discretion to interpret the facts of the case and construe contracts, agreements, stipulations and all documents as nearly as it thinks reflects the intention of the parties, in the light of the facts and circumstances of the case, without supervision by the Court of Cassation as long as its interpretation does not go beyond the meaning of the wording of the contract and its conclusions are sound and acceptable.

The challenged judgment concluded in its findings that regard in contracts should be given to meaning and intention and not to mere words. Where there is scope for interpreting the contract, this should be done by analysing the mutual intention of the parties and not so much the literal meaning of words, in the light of the nature of the transaction and the expected trust and good faith that must exist between contracting parties, according to the standard practice in the industry, for the sake of their common interest.”

For the sake of completeness, Article 265 of the Civil Code provides the legislative authority for construing contracts in light of the parties’ intentions:

“1-When the wording of a contract is clear, it cannot be deviated from in order to ascertain by means of interpretation the intention of the contracting parties.

2- Where the contract has to be construed, it is necessary to ascertain the common intention of the contracting parties and to go beyond the literal meaning of the words, taking into account the nature of the transaction as well as that loyalty and confidence which should exist between the parties in accordance with commercial usage.”

Accordingly, in certain cases, especially in matters concerning vaguely drafted conditional payment clauses (i.e. where the wording of the contract may not be clear), creatively minded judges or tribunals may have a discretion to interpret a contract’s provisions to reflect an intention that the conditional payment clause was not to apply to payments after the completion of works. However, if a conditional payment clause is comprehensively drafted and very clear in its continuing application after completion of the works, this may limit the ability of a judge/tribunal to apply the parties’ intention otherwise (cf. Article 265(1)).

It is for this reason that there are plausible grounds for the existence of an argument that two types of conditional payment clause exist, albeit informally. 'Pay when Paid' clauses would be clauses that are interpreted to cease to have effect after completion/lapse of time, due to the parties' intention, whereas 'Pay if Paid' clauses continue to have effect regardless. However, as discussed above, such a distinction is not formally recognized in the UAE courts, and efforts to formalize a distinction between two types of conditional payment clause are both artificial and likely to create confusion. Conditional payment clauses are more accurately described as one type of clause, whose effect in certain circumstances can be subject to the interpretation of contract terms by the court/tribunal.

Neither the completion of the works nor lapses of time themselves have any legal effect on the continuing applicability of a conditional payment clause. This is supported by a number of Dubai Court of Cassation Cases in which conditional payment clauses have been upheld despite completion of works.

In a 2009 case, a subcontractor completed all the works that were required of them and had been given a completion certificate by the project consultant (engineer). However, despite this completion, it was still held that because the main contractor and subcontractor had agreed a conditional payment clause, the subcontractor was not entitled to request any payment until the main contractor had been paid (and the condition precedent was satisfied), and the subcontractor had the burden of proving this condition had been satisfied.

In a 2017 case, a subcontractor completed all the original and additional subcontract works, yet the conditional payment clause remained effective and the subcontractor was not entitled to payment from the main contract. The Court held:

"...it completed all original and additional subcontract works contracted in accordance with the terms and conditions and it was paid an amount of AED (6,123,846) and the remaining of AED (763,654) the appellees failed to pay, which led it to file the claim

...

the agreement of main contractor with the subcontractor on the payment of the latter's dues only after the receipt of the main contractor of such dues from the employer shall result that the obligation of the main contractor becomes dependent on a pre-condition that would cease the enforceability of this obligation until the satisfaction of the condition. The subcontractor shall not be entitled to claim the main contractor for its dues as long as this condition is not satisfied and the creditor shall assume the burden of proving the satisfaction of the condition."

In a 2015 case, the original subcontractor in a project argued that the subcontract was effectively terminated and the remainder of the works were completed by a new subcontractor, who had then been paid more than the employer had paid the main contractor (for that portion of the subcontract works). As such, it was argued the conditional payment clause was no longer operable. Nevertheless, despite the subcontract works being completed and the main contractor making payments to the new subcontractor in a potentially greater sum than that received from the employer, it was held that the main contractor was only liable to pay the original subcontractor upon receipt of equivalent funds from the employer.

Termination

Whether termination has an effect on conditional payment clauses is a frequent issue of contention in disputes between subcontractors and main contractors. The applicable UAE law on this issue is unfortunately unclear.

In a 2014 Abu Dhabi Court of Cassation case, it was found:

“Since the annulment of the contract results in the expiry of the condition stipulated in the contract of the failure to pay the dues of the First Respondent until the Contestant receives those dues from the Employer, the Contestant shall be obligated to pay the value of the completed works.”

However, in this case, the contract was terminated as a result of a force majeure pursuant to Article 273 of the Civil Code.

Further, in various decisions the Dubai Court of Cassation has found that despite termination, conditional payment clauses continue.

In a 2001 case, the court dismissed a subcontractor’s argument that as a result of the termination of the subcontract, the conditional payment clause should collapse. The court held that as muqawala contracts are continuous contracts, conditional payment clauses continue to have effect. As held by the Court:

“This shall not be changed by the arguments made by the Appellant Company that the termination of the Subcontracting agreement shall drop the terms and conditions of this Company. This is because the contracting agreement is one of the continuous contracts whose termination shall not affect the works previously submitted. Also, the Appellant's claim of its dues for the works executed is just but an implementation of the contracting agreement and is not an effect of termination.”

In a 2015 case, the court rejected a similar argument by a subcontractor, who had argued *“if the main contractor replaced the subcontractor by other subcontractor, that means, the main contractor has terminated the contract, following which, the “back to back” clause stipulated in the subcontract cease to operate is considered as terminated”*.

In summary, there is some conflict between the UAE court judgments in respect of the effect of termination. It is possible that termination may have the effect of annulling any conditional payment clause. However, it is more likely (especially in Dubai), that as muqawala contracts are continuous, conditional payment clauses will continue after any termination.

Deemed Materialisation (main contractor efforts to pursue employer)

Whilst the legislation appears only to envisage the suspension of obligations in respect of conditional payment clauses to be lifted if there is impossibility or materialization (cf. Article 423), there is a further generally recognized circumstance when this suspension is lifted, deemed materialization.

It is within a court or tribunal’s discretion to find that a condition precedent is deemed to be materialized, the effect being that the obligation (or right) is no longer suspended, just as if normal materialization (e.g. in a conditional payment clause – receipt of payment from the employer) had taken place.

However, deemed materialization can only take place in specific circumstances. In particular, if there is evidence that the person who owes the obligation (i.e. a main contractor under a conditional payment clause) has through their own fault (i.e.

negligent act) or deceit (deceitful act), caused the condition precedent not to materialize.

The concept of deemed materialization arises from the obligation of good faith under Article 246(1) of the Civil Code:

"The contract shall be implemented, according to the provisions contained therein and in a manner consistent with the requirements of good faith"

In particular, the purpose of this principle is that it provides protection for obligees of suspensive obligations (i.e. subcontractors in conditional payment clauses) in circumstances where an obligor does certain acts which prevent the condition precedent from being materialized. For example, if a main contractor conspired with the employer, agreeing that the employer would not have to make payment to them in respect of the subcontract works (perhaps in exchange for the award of contracts for future projects), the condition precedent would be deemed materialized and the main contractor would be obliged to make payment to the subcontractor regardless of receipt of sums from the employer.

There are a number of cassation court decisions which reiterate/re-state this principle as a matter of UAE law.

As held by the Dubai Court of Cassation in a 2003 decision:

"If the obligation is suspended on a precedent condition, the obligation is not enforceable unless this condition is fulfilled, but before it is fulfilled, the obligation is not subject to compulsory or voluntary implementation; however, the precedent condition may be achieved even if it doesn't actually occur, if a deceit or fault occurs by the debtor with the intention of preventing the condition being met; and that suspending the obligation on a condition provided for in favour of the debtor permits the same to waive it explicitly or implicitly, and to conclude whether the obligation is suspended on a precedent condition or not, and whether the debtor has waived it explicitly or implicitly and whether there was deceit or fault committed by the debtor with the intention to prevent the condition from being fulfilled."

As held by the Dubai Court of Cassation in a 2001 decision:

"However, the condition is deemed to be met – even if it has not actually occurred – if the debtor commits deceit or fault to prevent the occurrence thereof, as well as the act or obligation is void when the condition on which it depends is impossible, contrary to religious precepts, public policy or morality."

Similar findings have also been made by the Abu Dhabi Court of Cassation, for example in a 2008 decision, it was held:

"Occurrence of a deceit or fault by the debtor for purpose of preventing fulfillment of the clause. Effect: fulfillment of the suspension clause, even if it is not actually fulfilled."

A fault under UAE law is effectively a tortious act. Fault/tort is provided for under the Civil Code at Article 282:

"The author of any tort, even if not discerning, shall be bound to repair the prejudice."

Deceit is defined at Article 185 of the Civil Code:

“Deceit is the act by which one of the contracting parties deceives the other through the use of fraudulent means, in words or other means, inducing him to assent to what he would have never consented to do in the absence of such means.”

One issue of dispute which sometimes arises in respect of this principle, is whether in order to achieve deemed materialization, there is a requirement of active intention by the obligor to prevent the condition being materialized (through their deceitful/faulty actions). From the above cases, it appears that there is such a requirement. This would also be consistent with the origins of this principle in the requirement of good faith. However, it is possible that a court or tribunal may use their discretion to interpret this principle without such a requirement of intention, especially if there is some degree of sympathy for a subcontractor who has not been paid as a result of the main contractors (non-intentional) negligence.

This principle is often invoked by subcontractors who complain of a main contractor’s failure to actively pursue an employer to make payment.

Whether such conduct amounts to deemed materialization will depend on the circumstances of the case, and of course the discretion of the court/tribunal. Further, the burden of proof is on the party alleging that the condition has been materialized/deemed materialised.

Waiver

Finally, it is also possible that the right to rely upon a condition precedent could be waived by a main contractor.

As held in the aforementioned Dubai Court of Cassation case from 2003 (emphasis added):

“however, the precedent condition may be achieved even if it doesn’t actually occur, if a deceit or fault occurs by the debtor with the intention of preventing the condition being met; and that suspending the obligation on a condition provided for in favour of the debtor permits the same to waive it explicitly or implicitly, and to conclude whether the obligation is suspended on a precedent condition or not, and ,whether the debtor has waived it explicitly or implicitly and whether there was deceit or fault committed by the debtor with the intention to prevent the condition from being fulfilled”

It is not clear exactly what conduct may amount to waiver. It is possible that such a waiver is limited to circumstances which would lead to deemed materialization (i.e. deceit or fault to prevent the condition precedent being met), and that these circumstances are merely being referenced in the context of a waiver. However, it is also possible that a main contractor could waive its right to rely on such a clause, if it acts inconsistently with the operation of the conditional payment clause. For example, it may be that a main contractor waives its rights to rely on such a clause, by making payment to a subcontractor before it had received such payment from the employer. This latter definition is supported to some extent by a decision in the Dubai Court of Cassation in 2003, in which it was held that a conditional payment clause in a contract between a subcontractor and its supplier was no longer effective, as the supplier had been provided with a letter of credit by the subcontractor, which replaced the conditional payment clause with non-conditional payment terms, and this amounted to a waiver of the conditional payment terms.

Article 468 of the Civil Code provides in respect of ‘voluntary discharge’:

"In case the creditor willingly discharges his debtor from a right he has on him, the right is extinguished."

Whether this article can be relied upon in the context of a right to rely on a condition precedent is not entirely clear. Further, there is likely to be a reasonable evidential burden to prove that there had been a willing discharge.

Summary

Conditional payment clauses do appear to afford main contractors a reasonable degree of protection from payment claims by subcontractors. However, these clauses are not unlimited, and in a variety of circumstances the protection they offer can drop away. This is especially the case as the law appears to offer the courts / tribunals a variety of ways to get around these clauses (in the right circumstances).

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