Adjudication of construction disputes in Malaysia

A new approach to dispute resolution

Introduction

Earlier this year, the Construction Industry Payment and Adjudication Act 2012 (“CIPAA”) became effective, introducing statutory adjudication as a means of resolving payment disputes under construction contracts for projects carried out in Malaysia. The provisions of the CIPAA will be relevant if you are involved at any level in a construction or engineering project wholly or partly being carried out in Malaysia. In addition to an adjudication regime, the CIPAA introduces default payment terms for construction contracts, stipulating the value and frequency of progress payments where such terms are not provided for under the contract, and prohibits the practice of including ‘pay when paid’ clauses.

Having been in effect since 15 April 2014, the CIPAA, which was accompanied by an order creating two important exemptions to its provisions, has already had a significant impact on the Malaysian construction and engineering industries.

Background to the CIPAA

The CIPAA follows the implementation of adjudication in a number of other jurisdictions as a fast track dispute resolution procedure for construction and engineering contract disputes. In the UK, adjudication was introduced in 1998¹ and has proved a popular and effective means of resolving disputes. Internationally, adjudication is also used in jurisdictions such as Singapore, the various states of Australia and New Zealand, and dispute adjudication boards are used as resolving disputes under the FIDIC suite of contracts.

The CIPAA is a hybrid of the adjudication systems used elsewhere in the world, including the UK model. It was established for the same purpose as in the UK, which is to provide a cash flow remedy during projects and a quicker and more cost-effective remedy than arbitration or court proceedings for parties in dispute. Disputes referred under the CIPAA will typically be resolved within a period of 100 days or less. Prior to its introduction, the construction industry in Malaysia had lobbied for similar legislation for more than 10 years. Guidance from the Kuala Lumpur Regional Centre for Arbitration (“KLRCA”), which is responsible for administering adjudications brought under the CIPAA, makes clear that the “primary objective” of the CIPAA is “to address cash flow problems in the construction industry”.²


Application of the CIPAA

The CIPAA applies to all written contracts for construction work carried out wholly or partly in Malaysia. It affects both domestic and international contracts. ‘Construction work’ is defined broadly, includes water, gas, oil and petrochemical works. Unlike the UK Construction Act it does not provide a list of excluded activities, but does allow for exemptions to the adjudication regime to be made by statutory instrument. More on this below. However, the CIPAA is intended to apply only to large-scale commercial construction, and will not apply to a contract made by a ‘natural person’ for a building he will occupy which is less than four storeys high.

Adjudication under the CIPAA is a mandatory and statutory process that does not require the parties’ agreement to commence the process. The statutory adjudication regime will prevail over any contractual arrangement to the contrary. No contracting out or varying of the statutory regime is permitted, so a party to a construction contract which does not fall within an exemption has the right to submit a payment dispute to adjudication under the CIPAA. However, the right of the parties to refer disputes to another form of dispute resolution concurrently, such as arbitration or to the court, is preserved.

Exemptions to the CIPAA

The CIPAA expressly provides that it will apply equally to contracts entered into by the Government of Malaysia as contracts between parties in the private sector. However, it should be noted that under the Construction Industry Payment and Adjudication (Exemption) Order 2014 (“Order”) exemptions to the CIPAA will apply for certain government contracts. The first of these exempts from all provisions of CIPAA a construction contract:

“(a) that is carried out urgently and without delay due to natural disaster, flood, landslide, ground subsidence, fire and other emergency and unforeseen circumstances;
(b) that relates to national security or security related facilities which includes the construction of military and police facilities, military bases and camps, prison and detention camps, power plant and water treatment plant.”

As the list of exempted contracts under the Order is exhaustive, the CIPAA will apply to contracts relating to oil and gas projects, even where the contract is entered into with the Malaysian government or a state body.

The second exemption is a transitional provision (which applies until 31 December 2015) and applies to contracts with a government party where the contract sum is RM 20million (approximately US $6.275million) and below. It does not exempt such contracts from the scope of the CIPAA, but modifies the timelines for submissions to be made during the adjudication process.

The Order applies only to contracts to which the government is a party. As a consequence, it creates a possibility that the main contractor entering into a contract with a government party has greater financial exposure than a party further down the supply chain, who will be able to rely on the adjudication regime under the CIPAA. This situation will only arise if there has been non-payment. A potential solution for main contractors to avoid this risk arising would be to include contractual adjudication provisions in government contracts which are identical to those in the CIPAA. However, it is unlikely that government parties will agree to such provisions.

The Adjudication Procedure

Parties to a construction contract are required to follow the payment processes set out in the contract (or the default terms provided by the CIPAA if the contract does not contain any – see below).

The procedure is linked to the payment date in the contract (or implied under the CIPAA) and disputes that arise from partial or non-payment of a payment application. The procedure can then be summarised as follows:

- Payment not made on due date (in part or in full);
- Unpaid party issues a claim for non-payment;
- Paying party has 10 working days to make payment or dispute claim;
- Notice of Adjudication is served (at any point thereafter, assuming a dispute arises);
- Adjudicator appointed within 10 working days thereafter (if the appointment is made by the parties) or by the KLRCA within 5 working days of a request submitted by the parties;
- The adjudicator has 10 working days after his appointment to negotiate the terms of his appointment and fees;
- Claimant serves Adjudication claim within 10 working days thereafter;
- Responding party has 10 working days to respond;
- Claimant may issue a reply within 5 working days of the Response;
- Adjudicator has a further 45 working days to reach a decision.

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3 However, as discussed below, contracts relating to the construction of power plants and water treatment plants to which the Malaysian government is party are exempted from the application of the CIPAA.
4 Article 3
5 Article 37
6 Article 2
7 First Schedule of the Order
8 At an exchange rate of 1 US$: 3.187 RM
9 Article 13
It is worth noting that the CIPAA is not prescriptive as to what an adjudication claim must include, but as a minimum it should set out the basis of the claim, the remedy which is sought and attach all relevant supporting documentation.

Typically, an adjudication in Malaysia might be expected to take up to 100 days from issuing the notice of adjudication until a decision is rendered. This is far longer than the process would usually take in the UK, where the Construction Act provides for a period of 28 days from referral of the dispute to the adjudicator to the adjudicator's decision. However, it will on the whole provide for a much faster decision than had the dispute been subject to arbitration or Court proceedings.

As mentioned previously, timelines will be modified for certain government contracts until 31 December 2015 under the Order. These modifications provide for extended 30 day periods for the non-paying party to respond to the payment notice, and to serve its adjudication response. The period for the claimant to serve its reply is also extended to 30 days.

Effect of Adjudication

The adjudicator’s decision is binding, unless set aside by the High Court of Malaya, finally decided by arbitration or the subject of a settlement between the parties. Article 15 of the CIPAA sets out the grounds on which a party can apply to the High Court to have an adjudication decision set aside, and are where:

- (a) the decision was procured through fraud or bribery;
- (b) there is a denial of natural justice;
- (c) the adjudicator did not act independently or impartially; or
- (d) the adjudicator acted in excess of his jurisdiction.

These grounds are closely aligned with those on which the courts in the UK have allowed challenges to adjudication decisions. As experience has shown for adjudication in the UK, it is anticipated that successful applications to set aside decisions will be few and far between, and the court will favour the enforcement of awards.

The adjudicator shall, in making the adjudication decision, order costs ‘to follow the event’ and will fix the amount of costs which are to be paid to the successful party. The adjudicator also has the discretion to make an award in respect of his own costs. Any agreement entered into between the parties prior to the adjudication which is contrary to this, or under which one party becomes responsible for the adjudicator’s own fees, will be ineffective. With respect to the terms of the adjudicator’s appointment and his fees, the parties are, subject to the restriction mentioned above, free to agree on these. In lieu of agreement, the adjudicator may agree to be appointed on the KLRCA’s standard terms of appointment, and default fees and expenses will be applied. The standard fees prescribed by the KLRCA go up to RM50,000 (approximately US $16,000) for an adjudication where the disputed amount is in excess of RM5 million. As in the UK and other jurisdictions, parties will be jointly and severally liable for the adjudicator’s fees and expenses in the first instance and the adjudicator can sue either party for outstanding fees.

The adjudicator is granted a number of powers under the CIPAA, including the power to order the disclosure and production of documents, appoint independent experts and conduct hearings. The adjudicator may also award financing costs and interest. Article 20 provides that the adjudication (including the decision) will be confidential, something which whilst often understood to be the case for adjudications conducted in the UK, the UK Construction Act is silent upon. This gives the parties to an adjudication in Malaysia certainty that the details of their dispute will not be made public.

What if payment is not made after the decision?

The CIPAA offers a toolkit of remedies for the successful party if payment is not made following the adjudicator’s decision, and also provides that remedies may be exercised concurrently. If payment is not forthcoming after a decision, the successful party may apply to the High Court for the enforcement of the decision. The successful party will also have the right to suspend or reduce the rate of progress of the construction works under the contract if the adjudicated amount is not paid in full or in part by the losing party after the decision, provided that it has given written notice to the losing party of its intention to do so. If this right is used, an entitlement to a fair and reasonable extension of time to complete obligations under the contract will arise, and in addition, any loss and expense incurred as a result of the suspension/reduction in work will be recoverable by the successful party.
The CIPAA further permits the right to request direct payment of the adjudicated amount from the principal to the party owing the monies, and in accordance with the CIPAA the principal has obligations to pay that amount. This is likely to be a useful tool for sub-contractors to rely on to recover amounts from the final employer where it has a decision against a main contractor who has failed to pay. Although it should be noted that this remedy can only be invoked where money is due or payable by the principal to the party against whom the decision has been made.

Challenges

One of the main issues which the CIPAA does not address is whether the new adjudication regime will apply to contracts which are entered into before 15 April 2014. While this is unclear under the CIPAA, the KLRCA, which is the sole adjudicating body, has confirmed that it will accept disputes referred to it which arise after 15 April 2014, irrespective of whether the construction contract was entered into before or after that date. However, it remains to be seen whether a losing party may successfully challenge the adjudicator’s jurisdiction to hear a dispute arising under such a contract in High Court enforcement proceedings. Clarification of the scope of the CIPAA through a High Court decision, or through legislation amending the CIPAA, would be welcome.

Payment Procedures in Construction Contracts after the CIPAA

A key feature of the CIPAA is its prohibition on the inclusion of conditional payment (or ‘pay when paid’) clauses in construction contracts. Any clause in a construction contract made after 15 April 2014 which makes payment conditional upon receipt of payment from a third party, or upon the availability of funds or financing facilities to the paying party, becomes void. Such clauses had been seen as a major threat to the solvency of the supply chain. Comparing this with a similar prohibition contained in the UK Construction Act, the CIPAA prohibition of pay when paid clauses does not have an exception for the insolvency of the third party. Therefore, it will not be possible to contract out of an obligation to make payment under a construction contract in Malaysia even where a principal is insolvent. As a main contractor, this is likely to be of concern as it removes the possibility of contractual protection against payments becoming due to sub-contractors where the employer is insolvent. You may then wish to seek additional payment security, such as bonds, from the employer.

Finally, the CIPAA provides for a set of default payment provisions for construction contracts in the absence of alternative payment terms in the contract. Under the default terms, a contractor or consultant is entitled to monthly progress payments. The basis of calculation will be the fees for such work prescribed by the relevant regulatory board by law or, if no prescribed fees, the ‘fair and reasonable prices or rates prevailing in the construction industry’ at that time.12 The due date for payments under construction contracts will be 30 days from receipt of invoice.

Comparisons with Other International Adjudication Regimes

There are certain key differences between the Malaysian interim payment/adjudication regime and those which have been running for some time in the UK, Singapore and the various states in Australia. Practitioners familiar with other regimes may find some of these surprising:

- Unusually, when compared with other regimes, the payment provisions in the CIPAA do not impose a mandatory right to interim payments under a construction contract. Although a default interim payment regime is implied under the Act, it seems that the parties may still decide not to have an interim payment regime at all.

- Similarly, in the absence of the employer issuing a ‘Payment Response’ under any interim payment provisions the employer is deemed to have disputed the entire payment claim. This is potentially much more forgiving than the UK or Singapore regimes for failing to serve, for instance, a ‘Pay Less’ Notice under the UK Act.

- In contrast with the UK regime (but in accordance with the Singapore and various Australian regimes) only the receiving party may commence an adjudication – i.e. the sub-contractor may issue against the contractor, and the contractor against the employer, but not vice versa. This presents a definite strategic advantage to the receiving party.

- However, even the receiving party is not able to pick and choose as to the nature and timing of the reference to adjudication.

- For instance, any claims by the receiving party must be linked to interim or final account payments under the contract. The ability under the UK regime to refer “any dispute” is not available in Malaysia.

- The adjudicator does have the power to review and revise any certificate, decision, instruction or valuation issued or to be issued under a contract, and make declarations on any other matters.13 However these must be in the context of “a dispute arising from a payment claim” and cannot be ‘freestanding’ as they often are in the UK.

12 Article 36(2)
13 Under the ‘Powers of the adjudicator’ at Article 25
• Similarly, the receiving party cannot issue its adjudication “at any time” as it can under the UK regime. The receiving party has to wait for 10 days to pass following the time for service of the Payment Notice before the adjudication can be commenced.

• However, in contrast to the Singapore and Australian regimes there is no ‘window’ for commencement after which the right to bring an adjudication expires.

• Perhaps the most surprising feature is the relatively long period of time for a decision under the Malaysian adjudication regime. The UK regime would normally require a decision between 4 and 6 weeks of referral – the Singapore/Australian regimes provide for even shorter periods in some circumstances. However, the Malaysian regime will often not produce a decision for a period of 15 weeks (105 days).

• Even within this 15 week process, there is lots of scope for mischief by the responding party.

• Firstly, the parties must agree the terms and fees of the adjudicator’s appointment as an initial step, and there is no power of the nominating body or the Court to impose terms. The adjudicator may agree to be appointed under the KLRCA’s standard terms of appointment, and default fees and expenses will apply where the parties and the adjudicator fail to agree on fees. However, as time does not start running for the date of the Adjudication Response or the eventual decision until the Adjudicator is nominated, there is great potential for an uncooperative defendant to slow matters down.

• Secondly, in the normal timetable, the responding party will have up to 6 weeks to prepare its initial adjudication response. This would seem to be a luxury for practitioners in the UK, Singapore or Australian regimes who are used to having between 7 and 14 days to respond.

• Thirdly, there are no restrictions on what can be included in the Adjudication response. All other regimes exclude (for instance) the bringing of defences of set-off or counterclaims which have not been raised before. Under the Malaysian regime there is nothing to prevent a Defendant from using the 6 week period to raise entirely new contra-charges or other reasons for withholding.

• This leaves a potential for extremely strategic behavior by the respondent, particularly as the referring party has just 5 days from receipt of the Adjudication response to serve its Reply. The risk for a referring party to be overwhelmed by multiple lever arch files containing entirely new contra-charges, so that it is unable to properly reply, is huge.

• When the Adjudicator makes his decision within 45 days of the service of the Response, he is to order that the costs of the adjudication (presumably including the parties’ legal and other costs) will ‘follow the event’. i.e. the loser pays the winner’s costs. This is in contrast to the UK, Singapore and Australian regimes where the parties’ exposure is to the Adjudicator’s fees and expenses alone, a measure designed to encourage claims from weaker parties.

• Finally, under s.16, even where the referring party has been awarded money, enforcement can still be stayed by the High Court of Malaya where the subject matter of the dispute has been referred to arbitration/court proceedings. This is starkly in contrast to the UK, Singapore and Australian regimes where the Court may only stay enforcement in extreme circumstances (such as insolvency).

14 As per Rule 6 of the Construction Industry Payment and Adjudication Regulations 2014.
Conclusion

It is clear that the CIPAA will have a significant impact on construction and engineering projects in Malaysia. It has been broadly drafted to extend to the oil and gas and petrochemicals industries as well as utilities and infrastructure projects. Whether you are an owner/employer, contractor, subcontractor or consultant it will make good contract management even more important. In particular, it will be crucial to ensure that each and every payment application is properly assessed and dealt with, and that payments are made on time. It is likely that significant use will be made of the adjudication procedure, particularly by contractors and subcontractors, with it offering a cheaper and quicker means of bringing payment claims than via arbitration or the courts.

However, it is worth noting that the strategic advantages handed to a receiving party under comparable regimes elsewhere may not be of quite the same value in Malaysia.

Our team has experience of advising on adjudication in a number of jurisdictions around the world, and can offer bespoke training on the adjudication process and managing adjudicated disputes. If you would like to speak with us about the adjudication regime in Malaysia, or adjudication in the UK or another jurisdiction, and how we may be able to help you, please contact Simon Oats or Iain Black.

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