

Application and Regulation of Back-to-Back Clause in Construction Contract

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Abstract: As to the application and regulation of "back-to-back clause" in the construction project contract, it is necessary to analyze the dispute of its legal effect and application conditions from three aspects: The background of the clause, the focus of the dispute and the judicial practice. "The Back-to-Back Clause" is a contractual mechanism whereby the Main Contractor links its payment obligations to the Employer's payment, with the aim of sharing the risks in the complexity of the Works and high funding requirements, but may also prejudice the rights and interests of the Sub-Contractor. The core controversy over the terms is whether it is materially unfair, especially if the Subcontractor suffers the risk of indefinite delay or payment. By analyzing the principles of the Civil Code and the latest approval of the supreme law, we should consider the principles of freedom and fairness of contract. In judicial practice, the court usually balances the rights and obligations of each party to determine the payment period and the liability for breach of contract.

Keywords: Back-to-back Clause; Construction Project Contract; General Contractor with Terms

1. Introduction

The back-to-back clause was translated by Chinese scholars from "Pay-If-Paid" and "Pay-When-Paid" in Anglo-American law, which is not a strict legal term. In 1988, the American General Contractors Association first recognized the application of the "Pay-If-Paid" clause of the Construction Works Subcontract, which was formally established in Article 16.3. of the Conditions of Subcontract for Construction of Civil Works of FIDIC established by the International Federation of Consulting Engineers in 1994. After China joined FIDIC in 1996, the clause was widely used in various subcontracts. [1] In the field of construction projects, after the Employer contracts the project to the Contractor, the Contractor subcontracts the project to the Subcontractor, forming two contracts of three parties. The Employer signs the Contract with the General Contractor, and the General Contractor signs the Subcontract with the Subcontractor. In the Subcontract signed with the Subcontractor, the General Contractor agrees that after the Employer pays to the General Contractor, the General Contractor shall pay to the Subcontractor on XX day according to XX proportion. The Employer delays or refuses to pay the project payment, and the payment obligation of the General Contractor shall be delayed accordingly. Such contractual terms are often referred to in the industry as "back-to-back" terms. In view of the fact that the current legal system has not yet made clear and specific provisions on the validity and applicable conditions of the "back-to-back clause," both academic circles and practice circles believe that it is necessary to carry out in-depth analysis and discussion. This not only helps to clarify the legal status and scope of application of the clause, but also provides clearer and more accurate legal guidance for the formulation and implementation of relevant contracts [1-3].

2. Judicial Practice of "Back-to-back Clause"

Although on August 27, 2024, the Supreme People's Court formally issued and immediately implemented the Reply on the Effect and Subsequent Treatment of Terms and Conditions Precedent to Third Party Payment between Large Enterprises and Small and Medium-sized Enterprises (hereinafter referred to as "Reply"). The Reply provides a clear specification for determining the validity of "back-to-back" payment clauses in contracts between large enterprises and small and medium-sized enterprises, as well as the term of payment and the liability for breach of contract after the clauses are invalid. But before this, the judicial practice has been controversial about the validity of such clauses and their application conditions.

2.1. Background and Dispute Focus on "Back to Back" Clause

The "back-to-back" clause is widely used in construction engineering, procurement and service contracts, and its core mechanism is that the payments made by the Main Contractor to the Subcontractors are based on the payments made by the Employer or the Employer. Such terms are usually agreed in the form of

"conditions" or "time limit," for example, the General Contractor shall pay the relevant amount to the Subcontractor within several working days after the Employer pays the General Contractor. This mechanism stems from the complexity of the project and the high demand for funds. In the face of uncertain risks (such as the Owner's arrears, bad weather, policy changes, etc.), the Main Contractor shall transfer the part of fund pressure to the Subcontractor to relieve its own financial pressure and ensure the continuous advancement of the Project. However, this also brings significant capital recovery risk to the subcontractor. The core dispute of the back-to-back clause is its potential infringement of the rights and interests of the subcontractor. In practice, the court usually determines the payment term and the liability for breach of contract according to the specific circumstances of the case and the industry norms and transaction habits. Although the application of back-to-back clause has alleviated the capital pressure of the general contractor to a certain extent, due to its latent unfairness and legal disputes, it still needs to be carefully treated in the contract conclusion and legal practice to realize the balance of rights and obligations and protect the rights and interests of the vulnerable party [4].

2.2. The Latest Approval on the Supreme Law of the "Back to Back" Clause

Large enterprises often have strong bargaining power, while small and medium-sized enterprises are at a disadvantage and are forced to accept harsh terms to gain business opportunities. Increase the capital turnover pressure of small and medium-sized enterprises: The payment prerequisite clause transfers the payment obligation to a third party, which may lead to the small and medium-sized enterprises facing uncontrollable delay or even bad debt risk, and further worsen their business environment. According to Article 520 of the Civil Code, the contract terms violating the mandatory provisions of the law are invalid. This reply clarifies the illegality of the clause "based on the third-party payment" through judicial interpretation, and invalidates it directly, which helps to unify the judicial standard [5].

2.3. Divergence of Judgment between Local and Practice

Freedom of contract is not absolute. 《The principle of fairness in Article 6 and the principle of good faith in Article 7 of the Civil Code exert an important constraint on the validity of the provisions, in particular, the court shall balance the rights and obligations of both parties in cases where the interests of one party may be obviously unfair. However, the disputed view of "back-to-back" clause in practice is legal and valid. The judge who supports this view holds that the "back-to-back" clause conforms to the principle of freedom of contract, and does not touch the invalid provisions of Article 153 of the Civil Code on mandatory provisions of laws and administrative regulations. According to Article 509 of the Civil Code (Debt Performance Rules) and Article 11 of the Interpretation of the Supreme People's Court on the Applicable Law of the Construction Contract Dispute Cases (I), the Contractor shall have the obligation to reasonably collect the payment from the Owner, and its negligence in performing the collection responsibility may constitute a malicious act. On a legal and valid basis, the court should focus on whether the drawee (contractor) has fulfilled the obligation to call on the owner. If he neglects to claim his rights, he shall be deemed to infringe upon the interests of the Subcontractor, thus limiting the application of the clauses [6,7].

3. The Basic Problem of "Back to Back" Clause

3.1. Legal Effect of Back-to-back Clauses

The legal effect of back-to-back clause directly affects the arrangement of rights and obligations between the parties. These terms usually occur between the main contract and the sub-contract to ensure that the terms of the sub-contract are consistent with the main contract to reduce uncertainty in the risk transfer. However, its effectiveness may be bound by the basic principles of contract law, especially the conflict between the principle of autonomy of will and the principle of fairness.

The main dispute is whether the parties to the sub-contract are obliged to accept terms not expressly disclosed in the main contract. For example, if the conditions of performance, liabilities for breach of contract, or terms of payment in a sub-contract are set out entirely in the main contract and are not set out in detail in the sub-contract, a challenge to the validity of the terms may arise. Some judicial practice shows that the back-to-back clause can not exempt the parties from the obligation of reasonable disclosure, otherwise it may

violate the principle of fair transaction in the Contract Law. Therefore, back-to-back clauses have legal effect only when they meet the requirements of clarity and reasonableness, not natural validity.

3.2. Application scope of "back-to-back" Clause

Back-to-back clauses are widely used in supply chains and subcontracts, but their scope of application is controversial. The main question is whether such clauses can cover all contract clauses, especially those that are unfair to subcontractors or subcontractors. For example, the Master Contract may set out extremely demanding terms of performance and liability and pass them entirely "back-to-back" to the Subcontractor, which may impair the Subcontractor's interests or even render it unenforceable. Secondly, the parties' status and rights and obligations in different contracts often have asymmetry. For example, Party A of the main contract may have a strong bargaining power, while the subcontractor may have a weak position in the sub-contract. Therefore, mechanically applying all the terms of the main contract to the sub-contract may lead to the sub-contract violating the principle of equality in contract law. In judicial review, the court will generally consider the applicability of the clause and the actual performance ability of the parties to avoid unreasonable transfer of rights. Therefore, the scope of application of the back-to-back clause should be defined according to the nature of the contract and the content of the specific clause [8].

3.3. Risk Sharing of "Back-to-back" Clause

In essence, the back-to-back clause is a risk sharing mechanism, and the core problem lies in how to reasonably transfer and distribute risks in the supply chain. Such clauses attempt to reduce disagreements and uncertainties by being consistent with the main contract, but in practice may be controversial due to the different capacities of the parties to bear risks. The typical problem is whether the force majeure clause or liquidated damages clause in the main contract can be directly applied to the sub-contract. For example, an agreement in the Master Contract that the Supplier is exempt from a Force Majeure event and the Subcontractor is not expressly granted the same exemption rights in the Subcontract may result in additional performance risks for the Subcontractor. In addition, in the main contract, Party A usually has a strong negotiating position, which can transfer excessive performance risks to suppliers and subcontractors, resulting in imbalance of risk sharing mechanism of back-to-back clauses. In the legal review, the court often emphasizes the reasonableness of risk sharing and avoids the excessively harsh clauses from harming the interests of the vulnerable parties. Reasonable risk sharing should be considered based on the comprehensive factors such as the performance ability, fairness principle and purpose of the contract.

4. Perfection of Effective Application of Back-to-Back Clause

4.1. Comprehensive Application of Basic Principles of Contract Law

Even if the back-to-back clause indicates that the contents of the sub-contract are directly subordinate to the main contract, the important clauses in the main contract shall be notified to the parties to the sub-contract by express means when the sub-contract is concluded, otherwise it may be invalid due to information asymmetry. For example, if the conditions of performance or the liability for breach of contract of the main contract impose a higher obligation on the parties to the sub-contract, but do not inform the other party in a reasonable manner, the clause may be considered unfair and void. To solve this problem, it is suggested that the drafting and performance process of the contract should pay attention to the full disclosure of information, especially for the important clauses involving the performance cost, risk allocation and liability for breach of contract, the written express method should be adopted and the parties of the sub-contract should be aware of and agree. Therefore, in order to guarantee the validity of the back-to-back clause, it is suggested to strengthen the communication between the parties before the conclusion of the contract, clarify the expectations of both parties through negotiation, and attach explanatory documents or notes if necessary [9].

4.2. Application of Clauses from the Perspective of Ternary

It is suggested to classify key clauses in the main contract: For general clauses (such as technical standards and delivery period), they can be directly applied in the subcontract; For clauses involving significant risk allocation or limitation of liability (such as compensation clause and liability for breach of

contract clause), the adjustment mechanism shall be renegotiated and specified in the subcontract based on reasonableness. In particular, the Subcontractor shall be expressly exempted from the corresponding responsibilities for matters that the Subcontractor cannot control (such as delay or force majeure events caused by Party A). In addition, mediation mechanism or risk sharing clause can be included in the contract design to provide the parties with dispute resolution and risk mitigation approaches [10].

4.3. Clarify the Rules for Connection of Primary and Secondary Contracts

A "reasonable exception" clause may be introduced into the contract, for example, to stipulate that the liability of a sub-contract is limited to the portion of it that is relevant to the scope of its control in the event that the sub-contract is beyond the capacity of the sub-contractor, and to allow the sub-contract to be adjusted simultaneously and reasonably in order to dynamically maintain the balance of risk sharing in the contract when the terms of the main contract are adjusted. In addition, to prevent overly demanding terms, consider establishing an independent third-party assessment mechanism or introducing industry standards to review the compliance and reasonableness of the terms of the contract to ensure that the design of the terms is in line with the expectations of both parties and to avoid excessive accountability to the vulnerable. In the judicial practice, the rationality review of risk sharing by the court also provides reference for the guidance of practice. The parties to the contract can reduce the possible subsequent dispute cost by specifying the dispute resolution method and the specific rules of risk sharing in advance [11,12].

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