

## Can the Contractor on the ground of “back-to-back” contracts, defer payments of the Sub-Contractor in perpetuity?

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### INTRODUCTION

Can a main contractor delay in clearing the invoices of the sub-contractor, forever, for the reason that the contract was executed on a ‘back-to back’ basis with the principal employer and therefore, until the principal employer makes payment to the main contractor, he is not required to make payment to the sub-contractor?

The Delhi High Court, recently, had the opportunity to clarify the position of law in relation to back-to-back contracts in *Gannon Dunkerley and Co Ltd v M/s Zillion Infraprojects Pvt. Ltd.* [2023 SCC Online DEL 4815]. The judgement is hereinafter referred to as the “**Gannon Dunkerley case**”. While dealing with a petition under Section 34 of the Arbitration and Conciliation Act, 1996, the Delhi High Court interpreted the extent of defense of back-to-back obligations in deferring payments to a sub-Contractor by the main Contractor.

Back-to-back agreements are a common feature of infrastructure construction projects. The principal employer may prefer to have a single party responsible for the project and will thus,

execute a contract with the main contractor. By virtue of a back-to-back agreement, the main contractor will pass its obligations and liabilities to the sub-contractors, for effective completion of the contract. Thus, “back-to-back” contracts involve at least three parties, i.e. a principal employer (who floats the tender), a main contractor (who is awarded the tender), and a sub-contractor (who is engaged by the main contractor for the whole or part of the work) who put together their resources at different levels for the execution of the same or connected project..

### FACTUAL BACKGROUND OF THE GANNON DUNKERLEY CASE

In the case at hand, the Petitioner/main contractor was awarded civil and structural work in a thermal project at Nasik, by the principal employer. Subsequently, the Petitioner sub-contracted the work of steel fabrication and erection work to the Respondent by execution of a memorandum of understanding (“**MoU**”). Post execution of the MoU, a tri-partite agreement was executed between the principal employer, the main contractor and the sub-contractor.

Disputes arose between the parties and the sub-contractor alleged that the main contractor despite receiving payments from the principal employer, had not made payments to the sub-Contractor. However, the main contractor denied the said assertion and contended that since the sub-contract was executed on a 'back-to-back' basis, until the bills raised by the sub-contractor are paid by the principal employer, the same don't become due for payment by the main contractor. The dispute was referred to the Arbitral Tribunal which observed that the Petitioner/main contractor cannot contend that the sub-contractor's entitlement to the disputed running bills amount was dependent on the main contractor receiving the said amount from the Principal Employer. The Arbitral Tribunal further observed with respect to refund of retention money that the amount ought to have been released to the Sub-Contractor after the satisfactory completion of the defect liability period of 12 months from the date of completion of the work. The Petitioner/main Contractor challenged the Award on the grounds of perversity before the Delhi High Court.

### **Judicial Precedents with respect to “back-to-back” obligations**

The legal position of back-to-back contracts and obligations has been discussed at length by the Supreme Court in *Zonal General Manager, Ircon International v Vinay Heavy Equipment* [2015

(7) SCJ 320]. In this case, the contractor had cancelled the sub-contract executed with the sub-contractor and was resisting the sub-contractor's remainder payments on the ground that the sub-contract was wholly of a "back-to-back" nature. Therefore, it was the contention of the contractor that the liability of the contractor would be restricted to and co-extensive of that which the employer had acknowledged. In other words, the acceptability and tenability of any claim made by the sub-contractor against the contractor will depend first upon that claim's acceptability and tenability by the employer. The Supreme Court rejected this assertion of the contractor and observed that the High Court had rightly upheld the Arbitrator's repudiation of the applicability of "back-to-back" principle to the issue of liability of payment, thereby affirming that the contractor was primarily liable to the sub-contractor. The Supreme Court further held that:

*“the question of primary liability therein is concerned, the law on subcontracts and employer liability is amply clear. In the absence of covenant in the main contract to the contrary, the rules in relation to privity of contract will mean that the jural relationship between the employer and the main contractor on the one hand and between the sub-contractor and the main contractor on the other will be quite distinct and separate.”*

Similarly in *Sharma & Associates Contractors (P) Ltd v Progressive Constructions Ltd*, [AIR 2017 SC 847] the Supreme Court held that in the absence of a price escalation clause in the contract between the contractor and the sub-contractor, the benefit of price escalation received by the contractor from the principal employer cannot be passed on to the sub-contractor.

### **Findings of the Delhi High Court in the Gannon Dunkerley case**

The Ld. Single Judge of the Delhi High Court interpreted the clauses pertaining to back-to-back payments in the principal contract and the sub-contract. Clause 5 of the sub-contract between the contractor/Petitioner and the sub-contractor/Respondent stipulated that the invoices raised by the Respondent are subject to the certification of the bills by the principal employer. The Petitioner relied on this clause to defer the payments to the Respondent. It was argued by the Petitioner pending the reconciliation between the Petitioner and the principal employer, the claims of the Respondent could not be determined. The High Court in adjudicating the Section 34 Petition observed that back-to-back obligations would mean that what has been incorporated by reference from the contract between the Petitioner and the principal employer would be applicable to the contract between the Petitioner and the Respondent. The Delhi High Court

while rejecting the defence of the Petitioner that pending the reconciliation between the Petitioner and the Principal Employer (PE), the bills of the Respondent/sub-contractor cannot be cleared, held that:

*“43. Pendency of the bills with the PE for certification could be a ground for Contractor to defer payments to Sub-contractor, until certification is complete. This is a mechanism to be followed in the regular course during the execution of the works. However, once the parties are in a dispute, in relation to the bills claimed by the Subcontractor, Contractor cannot defer payments in perpetuity on the ground of the pendency of certification, when it has not otherwise disputed the correctness of the bills.”*

The Delhi High Court further observed that –

*“45..... As per record, the work was stopped in June, 2012. There is neither any allegation nor any claim made by the Contractor that Sub-contractor had failed to rectify the defects found in its work, in the 12 months defect liability period. In the absence of any claim, Contractor cannot justify withholding of retention money that became due and payable to the Sub-contractor upon completion of*

*defect liability period, in terms of Clause of LOA which period expired in June 2013.”*

Therefore, from the above, it can be noted that the Delhi High Court has laid down the following thumb rule which is to be followed in back-to-back obligations:

i. In the course of execution of the works, pendency of the bills with the Principal Employer for certification could be a ground for the Contractor to defer payments to the Sub-Contractor until certification is complete.

ii. However, the payments to the Sub-Contractor cannot be deferred in perpetuity once the parties are in dispute and the Contractor has not disputed the correctness of the bills of the Sub-Contractor. The fact that the Principal Employer and the Contractor are in a dispute also cannot be used as a ground to defer payments.

The Delhi High Court also emphasized that, in a

petition filed under Section 34 of the Arbitration Act, the Court is not expected to act as an appellate court and re-appreciate the evidence. Furthermore, the Arbitral Tribunal is the master of both quality and quantity of evidence that it may rely upon to evaluate claims. Since the Indian Evidence Act does not apply to the arbitral proceedings, it cannot be insisted that the evidence produced by the parties must be tested on the rigorous rules of evidence laid down in the Indian Evidence Act.

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