

What Is Set-Off Under Construction Contracts?

By the Entrusty Group

The Entrusty Group, a multi-disciplinary group of companies, of which, one of their specialisations is in project, commercial and contractual management, has been running a regular contractual question-and-answer section for MBAM members in the Master Builders Journal.

In this instalment of this series, the Entrusty Group will provide the answer to the frequently asked question above.

It is important to understand the mechanism of set-off under construction contracts in relation to issues of payment due to the Contractor. Set-off is a wide and complex topic, but in this article, the Writer will give an overview discussion on this aspect affecting payments under construction contracts.

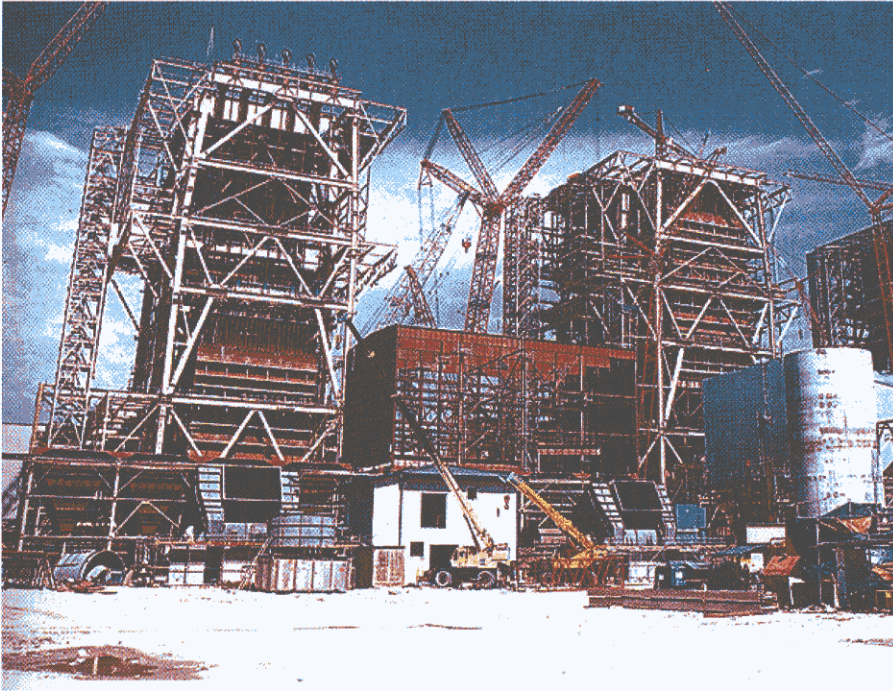
Set-off is normally used by the Employer in cross or counterclaiming against the Contractor for matters pertaining to delays and defective works. What it means is that the Employer will deduct his cross claim amount against the amount due to the Contractor in a particular certificate.

The Parties to construction contracts may agree by the wordings of their contract to preclude a party to it from exercising his rights of set-off and counterclaim. PAM 98 under clause 30(3)(i) is one such provision which states that *"Unless otherwise expressly provided in these Conditions, the Employer shall not be entitled to withhold or deduct any amount certified as due under any Architect's certificates by reason of any claims to set-off or counterclaims.....which he may purport to excuse him from making payments of the amount stated due in an interim certificate"*¹. This express provision has been introduced following the decision of the case

Pembinaan Leow Tuck Chui & Sons Sdn Bhd v Dr. Leela's Medical Centre Sdn Bhd [1995] 2 MLJ 57, SC where a modified PAM/ISM 69 contract was used. In the case, Edgar Joseph Jr FCJ stated *"...for all practical purposes, it conferred 'temporary finality' on the certificate and a right to immediate payment in full in the absence of any express contractual provision permitting deduction..."* This should be read that the issue of whether the right to set-off or counterclaim can be raised depends on each case upon the particular wording of the contract. It was also held that there are no special rules in building contract cases which ousts the common law right of set-off. It was further held that any express



¹ This clause seems to apply to interim certificates only and does not preclude the Employer from exercising his right to set-off at the final certificate stage.



provisions permitting set-offs in the building contract could imply that the Employer was limited to making deductions which must be strictly within the expressed provisions for set-offs based on the *expressio unius* principle. Therefore, it should be taken that in the absence of an express term, there is no general principle to state that an Architect's certificate must be honoured in full without the right to exercise the power to set-off and counterclaim.

In later decided building contract cases [DMCD Museum Associates Sdn Bhd v Shademaker (M) Sdn Bhd [1998] 364 MLJU 1, Mahkota Technologies Sdn Bhd v BS Civil Engineering Sdn Bhd [2000] 6 MLJ 505 and BMC Construction Sdn Bhd v Dataran Rentas Sdn Bhd [2001] 1 MLJ 356], the High Court has confirmed the position of *Pembinaan Leow Tuck Chui* where the Employer/Main Contractor are still entitled to the right to set-off against payments due to the Main Contractor/Sub-Contractor under Interim Certificates subject to the express terms of the particular contract. In BMC Construction, the learned judge citing from *Problems in Construction Claims*, p 127 (Vincent Powell-Smith) stated that 'Where a building contract or sub-contract contains a set-off clause, it

entitles the Employer of Sub-Contractor (within the permitted set-offs) to set-off claims certified as due to the Contractor or Sub-Contractor'. In an earlier decided Singapore case of *Tropicon Contractors Pte Ltd v Lojan Properties Pte Ltd* [1989] 3 MLJ 216, it was held that 'In so far as any sum claimed by the Employer is concerned, only the amounts expressly deductible under the contract may be set-off against the amount due under the interim certificate'.

In practice, Contractors often seek to enforce a claim for payment by applying for summary judgement under High Court Rules Order 14. Where this is done, a mere counterclaim will not operate to defeat the claim. However, the Contractor's claim will be defeated by a cross-claim which satisfied the more limited definition of set-off. Whether a cross-claim will do this depends largely upon whether it satisfies the test laid down by the English Court of Appeal in *Hanak v Green* [1958] 2 QB 9. This requires the two claims to be so closely linked that it would be manifestly unjust to insist on one of the claims without taking the other into account.

The facts of *Hanak v Green* provide a good illustration of the doctrine of set-off. The contract there was for

refurbishment work in the Employer's house, the Employer and the Contractor were at war throughout the contract period. When the work was completed, the Employer sued the Contractor, alleging various defects in the works. In answer to this action, the Contractor raised claims for extra work disruption caused by the Employer's refusal to allow one of the workmen into the house, and the loss of certain tools which the Employer had disposed of! It was held that all these claims could properly be raised as defences, since they arose directly under and affected the contract on which the Employer relied.

In the light of *Hanak v Green*, it can safely be said that cross-claims which arise out of the same contract as the primary claim may be relied on to provide a defence of set-off.

In theory, the same principle may apply to claims under separate contracts, provided that there is a sufficiently close link between them. In practice, however, the courts have proved extremely reluctant to permit a set-off in such circumstances. One example is provided by *B. Hargreaves Ltd v Action 2000 Ltd* (1992) 62 BLR 72, where the parties had signed nine virtually identical sub-contracts (relating to different sites) on the same day. When the Sub-Contractors claimed payment under one of these contracts, the main Contractors were not permitted to raise a set-off based on breaches of some of the other contracts. Needless to say, where the two contracts are not even between the same parties, the likelihood of successfully claiming a set-off is even more remote. Thus, an Employer cannot refuse to pay the main Contractor in respect of work done by a Nominated Sub-Contractor, on the ground that the Employer has a claim against that Sub-Contractor under a direct warranty agreement for defective works.

The *Hargreaves* case raised another point of importance in this context by recognising the existence of another type of set-off. This is common law set-

