

Construction Contract and Management Issues

In this 3rd quarter issue of Master Builders Journal for 2018, BKAsiaPacific (Malaysia) Sdn Bhd (formerly known as BK Burns & Ong Sdn Bhd), a subsidiary of BK Asia Pacific, an international construction consultancy group providing project, commercial and contractual management services joins with Entrusty Group, a multi-disciplinary group, collectively named BK Entrusty, to present a new series of construction contract and management articles in areas related to project, commercial, contracts, risks, quality, value and the like on “Set-Offs - A Revisit and Update”

Introduction

The Malaysian construction industry is notorious for set-off practices, both at main and subcontract levels, often imposed unilaterally and unfairly by the Employer on the Contractor and/or the Contractor on its subcontractors, respectively.

Consequently disputes often arise when monetary claims are set-off by withholding any payment due or extinguished through counterclaim arising from unfinished defective / non-conformance works, thus resulting in lesser or negative amount due from the paying party to the receiving party.

Generally, set-off can only be practiced when the contract between the parties contains provision providing for set-off and/or withholding of monies. It is therefore pertinent for the contracting parties to know how and when the right of set-off can be exercised and do so, correctly.

In this article, BK Entrusty aims to provide a better understanding of set-off issues and implications by revisiting its past article on “What is Set-Off Under Construction Contracts” and updating with further description and discussion on “set-off and counterclaim” and the relevant case law, by the following article contents: -

- Introduction
- Set-off and its Types
- Relevant Set-off Provisions
- Pre-Conditions for Set-off
- Excess, Recoverable?
- Summary/Conclusion

Set-off and Its Types

Where an Employer has a cross claim against the monetary claim made by its Contractor, a right of set-off enables him to reduce or extinguish the Contractor’s monetary claim by such cross-claim to remedy both his breach and damages, such as recovering costs for rectifying defective works or any culpable delay by the Contractor.

Chow (2006) defined “set-off” as a cross claim against the claimant which either extinguish or diminish the claimant’s claim. Although a set-off is normally understood as a counter claim, not all counter claims are set-offs.

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The distinction between set-off and counter claim is as tabulated below: -

	Set-off	Counter Claim
1	A statutory defence against a monetary claim.	Substantially a cross action against a monetary claim.
2	A defence ground, it is a shield as well as sword.	A weapon of defence.
3	If established, affords an answer to the monetary claim.	Enables the Employer to enforce a claim against the Contractor as in an independent action.
4	If the Contractor’s monetary claim is stayed, set-off is discontinued or extinguishes.	If the Contractor’s monetary claim is stayed, counter claim may be proceeded with.
5	Must be an ascertained sum or arise out of the same transaction as the monetary claim.	Need not arise out of the same transaction.
6	The amount of set-off must be less than or equal to the amount of the monetary claim.	The amount in counter claim may be greater than the amount of monetary claim.

Table 1: The Distinction between Set-off and Counter Claim (Kumar, 2016)

Generally, there are various types of set-off exist under the law, save for contractual set-off, where it is expressly agreed by the contracting parties, the rest of the set-offs tabulated below are imposed by law and have their own characteristics;

Type of Set-off	Equitable	Legal	Insolvency
Self – help remedy?	✓		
Debts must be closely connected?	✓		✓
Debt must be liquidated?		✓	
Debt must be due and payable?	✓	✓	
Can be varied by contract?	✓	✓	

Table 2: Comparison of the Characteristics of Different Types of Set-Off (Rajah & Tam, 2001)

Equitable set-off is a self-help substantive remedy found in equity which allows a party to set-off or cross claim against another party’s monetary claim, provided that the two claims are ‘so closely connected’ and the relationship between them is such that it would be unjust to allow the claim without taking into consideration of such cross claim. It can only be used for closely connected claims, but does not necessarily means that they must be under the same contract. This was decided by the Court of Appeal in the case of *Geldof Metaalconstructie NV v Simon Carves Ltd*[2010] EWCA Civ 667. Most importantly, to qualify for an equitable set-off, the cross claim must be due and payable.

An example of a close connection between the claims which can be determined based on facts is a cross claim under a separate construction contract where both contracts relate to the connected works on the same

construction project may be the basis to exercise equitable set-off. The claims do not have to be liquidated but the loss must be reasonably assessed, made in good faith and can rightfully be set-off and exercised outside of the court, unlike legal set-off.

Legal set-off is a 'non-self-help remedy' procedural right of set-off that allows a court to render its judgment for the balance due between two parties for reciprocal claims which are unconnected to and independent of each other. However, this can only be available when both the claims are liquidated or capable of being ascertained with certainty. According to Geidel (2014), it is to be used as a shield and not a sword i.e. so it can be used only as a defence to a claim. Similar to equitable set-off, to qualify for legal set-off, both claims must be due and payable.

For insolvency set-off, which is a mandatory right of set-off, it cannot be restricted, extended or contracted out by the parties' agreement as it prevails over other forms of set-off exercised before one of the contracting party to the contract becomes insolvent.

Lastly, in contractual set-off, which is broadly used in construction industry, the contracting parties are allowed due to related contractual provision in their construction contract. This is to give clarity and certainty as to what, when and how specific remedies of set-off are available to the parties. It allows the parties to extend or limit the general rights of set-off available to them under the precise circumstances in which set-off can be exercised before any dispute arises.

Contractual set-off provisions may also expressly empower a party to set-off a claim under an unconnected contract between the same contracting parties. It can also account for or specifically discount future or contingent claims that are not yet due and payable such as future payment of liquidated damages. It is important that the parties set-out clearly what rights exist between them at an early stage in order to avoid confusion and disputes later on.

In the case of *Pembinaan Leow Tuck Chui & Sons Sdn Bhd v Dr. Leela's Medical Centre Sdn Bhd* [1995] 2 MLJ57, the Court held that the Employer was limited to making deductions strictly within the expressed provision for set-offs based on *unius* principle. Meaning, in the absence of an express term, there is no general principle to state that a payment certificate must be honoured in full without any right to exercise the power to set-off and counterclaim.

It must be noted that in abatement or common law set-off, it is distinguished from contractual set-off, for which the Court in the case of *Thorton v Place* [1832] 1 M&R 218 had developed to allow a contracting party to obtain a diminished amount payable for goods or services rendered under a contract in the event of any breach of contract by the other contracting party, e.g. build-up size being slightly smaller than what it was intended for.

Relevant Set-off Provisions

Under the Malaysian Standard Forms of Construction Contract, the relevant set-off provisions are;

PAM 1998 & 2006 Forms of Building Contract

The Employer can only set-off any amount from the Contractor's payment, if there are express provisions in the contract, such as Clause 30.3 of PAM 1998. However, there is no provision available for resolving dispute in set-off amount during construction stage.

Under Clause 30.4 of PAM 2006, it expressly identified all the set-off clauses in the contract and provided procedures to be followed before any amount can be set-off. Further, contractual adjudication may be referred, in the event of set-off amount is disputed by the Contractor.

JKR/PWD Form of Contract (DB/T and 203A – Rev 10/83, Rev 1/2010)

Clause 33 expressly provides set-off rights by the Government against the Contractor, both in relation to or any other contracts to which the Contractor had contracted with the Government.

IEM Form of Contract 2011 Edition

Similarly, Clause 50 of the IEM Form of Contract expressly provides for the set-off rights by the Employer against the Contractor, but only for those in relation to the contract by the parties concern.

CIDB Standard Form of Contract for Building Works 2000 Edition

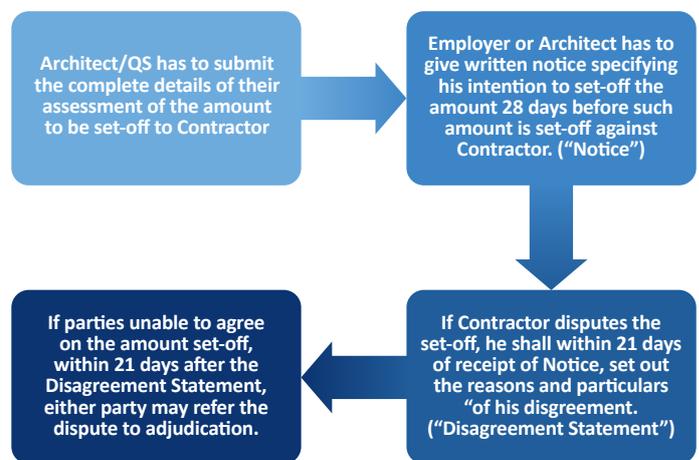
Clause 42.11 uses "Deemed Payment" term instead of set-off. It allows the Employer to recover or deduct any payment due to the Contractor in accordance with Clause 42 (Payment).

AIAC Standard Form of Contract 2018 Edition

The Employer, under Clause 30.4, is not allowed to withhold or deduct any certified due amount by reason of any set-off or counterclaim unless provided by the contract conditions such as Clause 2.5 (Contractor fails to comply with Architect's Instruction), Clause 30A.1 (Employer made direct payment to subcontractors as per CIPAA decision), Clause 15.2(b)(ii) (Contractor fails to rectify the instructed defects) and several other provisions.

Pre-Conditions for Set-off

The right of set-off amongst the Malaysian Standard Forms, under PAM 2006 Clause 30.4, the contractual set-off procedure is, as follows: -



The above set-off procedure clearly illustrates that PAM 2006 expressly prohibits the Employer from exercising any set-off even when it is expressly provided for in the contract, unless and until the Employer satisfies two preconditions contained in the said provision.

The first precondition requires the Architect (or the Quantity Surveyor or the Contract Administrator) to submit to the Contractor a complete detail assessment of any set-off. Rajoo (2010) commented that the wording 'complete detail' used in this provision seemed ambiguous and sweeping, thus can be a basis for disputes. Even if any such detailed assessment was properly given, the Contractor may still reject such submission and insist its incompleteness, therefore not satisfying the first precondition, thus frustrating the subsequent stage or precondition.

Upon the satisfaction of first precondition, the Employer or Architect then issues a written notice to the Contractor, by hand or registered post, indicating his intention to set-off the amount and the grounds on which such set-off is to be made. The Employer can only take into account of such set-off in its payment to be made after 28 days of the said notice, provided if no objection has been raised by the Contractor for such set-off in the first instance.

Only after these two preconditions have been satisfied, that the Contractor is given choice either to accept the amount of set-off or dispute the amount in writing within 21 days of receipt of the notice issued under second precondition and then proceed with contractual adjudication to resolve the set-off dispute.

The Court in the case of *Tan Wai Kok (formerly trading as TWK Skills Engineering Works) v Hart Engineering (Pte) Ltd* [2005] SCHC 215 held that, the failure by the plaintiff in objecting to the deductions made against progress payments whenever the payments were made by the defendant, gave rise to an estoppel. It would be inequitable for the plaintiff to recover the deducted money since the plaintiff had accepted these payments without protest.

It must be noted that the Employer under PAM 2006 is only entitled to set-off the undisputed amount against the Contractor. This is similar to the Housing Grants, Construction and Regeneration Act 1996 (2009 Amendment) of the

United Kingdom, whereby a paying party cannot legitimately withhold any monies unless they have issued a complaint, namely, the “withholding notice” or a “notice to pay less”. Without such notice, any attempt to exercise a right of set-off is likely to fail. This had been decided in the case of *Northern Development (Cumbria) Ltd v J&J Nochol* [2000] EWHC Technology 176 and *VHE Construction plc v RBSTB Trust Co Ltd* [2000] EWHC Technology 181.

Excess, Recoverable?

It is often a concern that the set-off amount is greater than the amount in monetary claim and that the excess cannot be recoverable. One needs to appreciate and understand the related provisions contained in the contract as a whole to establish the contractual set-off position, if any.

Generally, most construction contracts contain a provision for Final Certificate to be issued to the Contractor after the issuance of Certificate of Making Good of Defects. In the Final Account, the total amount due is net of the total sums certified in previous payment certificates, whether these have been paid or not to the Contractor, the balance from the deduction, should it be positive, will constitute the balance due to the Contractor by the Employer. Otherwise, it will be a balance due from the Contractor to the Employer, which then becomes a debt payable.

In the event that the Contractor is the net debtor, he shall conversely pay the balance due to the Employer within the similar time period i.e. Period of Honouring Certificate provided for under the Appendix to the Contract. This period is provided for in most of the standard forms of contract in Malaysia (Clause 33 of the JKR Forms 203 and 203A (Rev 1/2010), Clause 56.0 of the PWD Form DB (Rev 1/2010), Clause 48.1 of the CIDB Form (2000) etc.

Under these contracts, one must also note that set-off by the Employer cannot be included in the Final Account, as it is to be dealt separately by the contracting parties. The set-off by the Employer, if it is not disputed or has already been decided vide the contractual adjudication, shall be taken into consideration in payment to be made to the Contractor by the Employer under the Final Certificate.

Such sum may be recovered from any performance security, provided its still valid and/or through liquidated demand vide legal action, as decided by the Court in the case of *Bukit Cerakah Development Sdn Bhd v L'Grande Development Sdn Bhd* [2008] 2 AMR 597.

Summary/Conclusion

When a contracting party has a cross claim against the other party's monetary claim, the former can exercise a right of set-off to reduce or extinguish the monetary claim. Amongst the four types of set-off namely equitable, legal, insolvency and contractual, contractual provision of set-off in standard forms of contract aims to provide clarity and certainty to the contracting parties in limiting their general rights of set-off to be exercise before any dispute occurs.

In the Malaysian standard forms of construction contracts, the pre-conditions for set-off in PAM 2006 are essential for the Employer (and its project consultants) to adhere strictly, in order for the right of set-off to be exercised, accordingly. These pre-conditions seem to be quite onerous on the Employer to do so unilaterally, without the professional consultant or independent certifier and/or a third party adjudicator to assess and/or adjudicate the set-off. Otherwise set-off dispute can only be dealt with via arbitration and/or litigation upon the completion of the Works, leaving the Contractor having to finance the set-off, until its resolution, in due course.

In conclusion, the Malaysian construction industry is still notorious in set-off practices, mostly unilaterally and unfairly by the contracting parties. It is high time that better express and equitable contractual provisions be incorporated in construction contracts to ensure proper procedures and independent professional certifier to assess any set-offs under the contract.

In the next issue of the MBAM Journal, BK Entrusty article will deal with another pertinent contractual issue affecting the Malaysian construction industry, on “PAM Contract 2018 – Changes and Implications”

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 - JKR PWD/Standard Form of Design & Build/Turkey Contract (PWD Form DB/T)(2002 Edition)
 - AIAC Standard Forms of Contract 2018

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