CONSTRUCTION CONTRACTOR
DECEMBER 2000 VOL 15 NO 11 P. 36

OPINION

Principals still can set off their costs

by DOUG JONES

CONSTRUCTION contracts frequently set out a variety of ways for principals to withhold part of their payments to contractors to set off the costs of rectifying defective work, or to seek damages for defective work from the contractor and resist payment on this basis.

They also frequently set out a variety of procedures when disputes about progress payments and counterclaims arise.

But what is the situation when the contract does not expressly provide for the setting off of payments? Can set offs still be made?

Quite often, the answer is yes.

According to a series of UK and recent Victorian court decisions, an equitable right of set off is available unless this right has been expressly or by clear implication displaced by the parties ó and the courts have been quite willing to allow equitable set offs in a number of situations, for both liquidated and unliquidated damages.

To go further, does it make any difference if the progress payments are being made to a construction manager merely supervising the work of the building contractors responsible for the defective work, and not building anything itself?

The answer this time, it seems, is no. The same presumption that equitable set off is available will apply ó even though the damages the principal may ultimately obtain from the construction manager may be uncertain and (through joint and several liability statutes) may well be less than the cost of rectification.

This, at least, was the decision reached by the Victorian Supreme Court in February 2000 in Leighton Contractors Pty Ltd v East Gippsland Catchment Management Authority.

Leighton had been engaged by the Authority as construction manager to supervise other contractors in a flood response program. It did not perform any construction work itself. It charged the Authority through progress claims based on an agreed hourly rate.

The Authority withheld some $350,000 from three progress payments because of allegedly defective work by the contractors. Leighton sued.

The court accepted that there were triable issues about the quality of the construction work, which it assumed would cost $400,000 to $450,000 to rectify, and the adequacy of Leightons supervision. It said the Authority was iundoubtedly entitled to lodge a counterclaim to Leightons claim for payment in full.

So the question then was: was the Authority entitled to set off the $350,000?

Although the Authority attempted to argue several express provisions in the contract gave it this right, the court was not persuaded on this score.

For example, a clause requiring the Authority to pay Leighton only that amount which it does not dispute if it disputed the whole or any portion of the amount claimed in an account was held to be limited to disputes about the hours charged, rates applied, arithmetic calculations and so on.

Similarly, a clause permitting the Authority to set off any monies which become due by [Leighton] to the Authority at any time was held to be limited to amounts that had become due, resolved and quantified, and not some future iunquantified and disputed claim.

So there was nothing in the contract which expressly gave the Authority the right to withhold the $350,000.

But when it came to the question of whether the Authority had an equitable right to set off, and could defend itself against Leightons claim on this basis, the Authority was more successful: the court said it iundoubtedly did, and could.

The threshold issue for the court to consider was whether the claim and counter-claim were sufficiently related to entitle the Authority to raise an equitable set off. In this case, they both arose out of the same agreement, and the test was easily satisfied.

Leighton argued that because the contract contained express but limited rights to make deductions from payments, it had impliedly excluded the wider-ranging equitable right to set off.

The court decided, however, that the removal of the Authoritys right to raise the defence of equitable set off would have required something more explicit than an inference of this kind.

Excluded equitable right

This decision was consistent with guidelines laid down by two earlier Victorian Supreme Court decisions, LU Simon Builders v H D Fowles (1992) and Melbourne Glass v Coby Construction (1997).

In the Simon Builders case, the court decided the standard form JCC B 1985 contract did, by clear implication, exclude the right to rely on the defence of equitable set off.

The features of the contract influencing that decision included:

❑ The appointment of an architect as an assessor, valuer and certifier.

❑ A requirement for payments to be made within five days of the certification of progress payments.

❑ The right of the builder to terminate if certified progress payments were not made. As the court said, if equitable set off were available in these circumstances, the builder would not know whether it could terminate until the dispute was resolved.

❑ An arbitration clause providing for disputes, including the progress payment disputes, to be referred to arbitration, but importantly for the works to continue in the meantime. The court said it followed that the viability of the contract depended on the builders being paid, even though there was a dispute: The entitlement to progress payments is the quid pro quo for the obligation to continue working while the parties are in dispute.

❑ Provisions in the contract relating to defects, delays, security and the adjustment of the final certificate, enabling the proprietor to retain any amount in dispute and clearly protecting it against any risk of loss.

In contrast, in the Leighton and Melbourne Glass cases, where the equitable right to set off was found not to be impliedly excluded by the contracts,

❑ There was no third party certifier

❑ There were no express terms about what was to happen on the final payment

❑ There was no obligation to continue the works if a dispute were referred to a dispute resolution procedure, and

❑ The principal was not given the right to retain money at some point for delays, and indeed there were no provisions for any form of security.

In Melbourne Glass the court pointed to two factors which have strongly influenced the courts in this country to exclude the defence of set-off:

❑ A complete and detailed scheme allowing for deductions from all progress payments or on final payment, and

❑ An obligation to continue work even when the parties have commenced some form of dispute resolution.

So if there is a detailed mechanism in the contract dealing with liquidated damages and unliquidated damages, the principal must rely on this if it wants to reduce payments to its contractors, and cannot seek equitable set off instead.

In Melbourne Glass it was held that even when the equitable right to set off still exists, the party relying on it as a defence must satisfy the court on the likely quantum of its damage. Even if the defendant had an arguable case, if a court were left to speculate on the range of damages it would have to decide in favour of the plaintiff instead.

In Leighton, however, the court adopted a more relaxed approach.

It hinted that in accordance with legislation apportioning damages between defendants found jointly and severally liable, it was unlikely that the Authority would be entitled to keep all of the amount it had withheld from Leighton, which had not performed the defective work itself.

Despite this uncertainty, the court still allowed the Authority to raise equitable set off as a defence to resist summary judgment, and was happy to leave the matter of the quantum to be awarded against Leighton, large or small, to the trial. ■

Ed: Doug Jones is a construction partner in national law firm Clayton Utz.

PEOPLE

❑ **Jeff Brundell** has been appointed gm of Potain Australia, Potain being the largest manufacturer of tower cranes in the world. Brundell was gm of Terex Cranes in Australia for 18 years. He is a past president of the Crane Industry Council of Australia and has been **the US and Africa, mainly in offshore engineering construction.**

❑ **Gary Punch**, a former federal member of parliament and Minister for Defence, Science and Personnel, has joined Phillips Fox **Mary Jo Adams** and **Russell Blackford** signing on in the legal eagles' Melbourne office.

❑ For those who fly ... an insider's view of the Qantas safety strategy will be revealed, we are told, when **Ken Lewis**, the airline's gm safety and environment - an air safety investigator and meteorologist - *than 33 years of management and technical experience in the public sector. His main roads experience spans both field and specialist areas as well as executive management.*

❑ Described by the Royal Australian Institute of Architects as "one of Australia's rising architectural stars", **Richard Francis-**