

Construction Law

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The Right to Set Off

It's not uncommon for commercial entities with an established track record of doing business together to be party to a number of contracts at the same time, for different projects or even different elements of the same project. When matters are progressing properly, this arrangement can work well. But if something goes wrong on one of those contracts, a question that frequently arises is whether a sum claimed under that contract can be set off against a sum due on another.

For example, employer A enters into two contracts with contractor B; (1) for the supply of radiators and (2) for the installation of a new bathroom. If the cost of contract (1) is £100, but damage caused by faulty workmanship under contract (2) is £75, can the employer set one off against the other, only paying the contractor £25? There are two different ways in which a right to set off between different contracts can be claimed: a contractual right or an equitable right (this should not be confused with abatement, which is where sums are set off within the same contract).

Under contract law the position is clear. Set-off between different contracts is only allowed where a clause in the contract specifically allows it to be done. So in our earlier example, unless the contract (1) contained a set-off clause, the employer would have to pay the contractor £100 under contract (1), and then claim £75 for the damage under contract (2) separately. However, suppose the radiators supplied under contract (1) were actually installed in the bathroom under contract (2). Where circumstances allow, it may be possible to claim an equitable right of set-off if you can show that the two contracts are connected in some way. As Keating on Construction Contracts says: *'An employer cannot set off a claim arising under another unconnected contract with the same contractor unless he*

has been given express power by the contract upon which the contractor claims, or there are special circumstances sufficiently connecting the two claims to sustain an equitable set-off. [1]

In the absence of a specific set off clause, the question of what circumstances in fact are sufficiently special to sustain an equitable right to set off has produced some interesting, and sometimes confusing case law. However, the recent case of [Geldof Metaalconstructie NV v Simon Carves Ltd](#)[2] has set out some useful guidance on the subject.

The facts

Simon Carves was the main contractor for the building of a bioethanol plant in Teeside. Two elements of the works it put out to tender to sub-contractors were (1) the supply of pressure vessels for the plant, and (2) the installation of storage tanks on the site. Geldof tendered successfully for both elements of work, and were awarded the two sub-contract packages.

The supply contract contained clause no.24 that said the contractor was entitled to set off against the purchase order price any amounts 'lawfully due from the sub-contractor to the main contractor, whether under the purchase order or otherwise'.

The installation contract did not go to plan. Simon Carves alleged that Geldof was in breach of the (second) installation contract. It issued a default notice and refused to pay the sums due under the (first) supply contract. Geldof in turn refused to continue with the installation work unless its invoices on both the installation and supply contracts were paid. Simon Carves issued a notice of termination under the installation contract.

The court case

Geldof commenced proceedings to recover the sums due under the supply contract for the pressure vessels supplied. Simon Carves counterclaimed for damages arising out of Geldof's breach of the installation contract. It admitted that the two contracts were separate but argued that they were connected by the course of dealings and transactions.

In the first instance the Technology and Construction Court held that the contractor was not entitled to set off its counterclaim. Clause 24 was not sufficiently wide to allow set-off of provisionally quantified but unliquidated damages. The judge also found that there was not an inseparable connection between the contracts that would give rise to an equitable right. The main contractor appealed, resulting in the recent decision of the Court of Appeal.

The decision

In the Court of Appeal, Lord Justice Kay examined the case law on equitable set-off and set out some useful conclusions on it as guidance we can follow:

- There is a formal requirement of close connection between the contracts
- An 'inseparable connection' is one formulation of the close connection test, but not the only one
- There is also a functional requirement that it must be unjust to enforce the claim without taking into account the cross-claim
- Although the test required consideration of both a formal and a functional requirement, this should not be treated as a 2-stage test.
- **The best restatement of the test was whether the cross-claims were so closely connected with a claimant's demands that it would be manifestly unjust to allow him to enforce payment without taking into account the cross-claim.**

The appeal was allowed. Geldof, by insisting on payment of the supply contract and a pre-condition of continuing work on the installation contract had brought the contracts into a close relationship with each other, and when Simon Carves brought the installation contract to an end it did so based on both Geldof's poor performance under the installation contract and also its insistence on prior payment under both contracts. That brought the two contracts into an inseparable connection, so that it would be manifestly unfair to enforce

payment under the supply contract without taking into account the cross-claim under the installation contract.

LJ Kay also found that the commercial meaning of clause 24 was sufficiently wide to allow amounts to be claimed that were recognisable at law, so Simon Carves was entitled to set off under the contract terms in any event.

Although this case provides useful guidance on the test for equitable set-off, for certainty the best practice for paying parties who are in a number of different contracts is always to insert set-off provisions allowing balancing exercises to be carried out.

Notes:

[1] Para 18-054

[2] Court of Appeal, 11 June 2010

If you have any questions about set-off, please contact the writer of this article, Rebecca Shorter, or the head of the construction team, Jane Ryland.



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