Interim Certificates and the Common Law Remedy of Set Off

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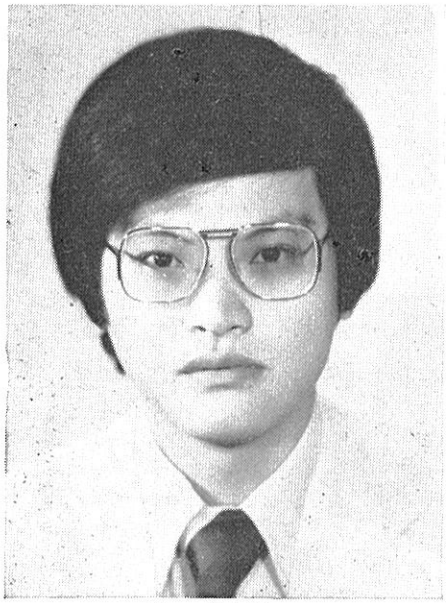
The expression "set off" in relation to building contracts is commonly encountered in the following situation. The architect, during the course of the works, issues a certificate stating that £X is due from the employer to the contractor. However, the employer considers that he has a claim against the contractor at the same time, and instead of paying the amount as certified, he deducts from the certified amount a sum which he considers to represent his claim against the contractor. In so doing, the employer is thus said to "set off" his claim against his debt to the contractor which arises from the issue of the architect's certificate.

The law on this subject (in the context of building contracts) has undergone considerable development within a short space of four years in the last decade. Starting with the Court of Appeal decision in the case of *Dawnays Ltd* v *F. G. Minter Ltd*[1] in 1971, the state of law took a sharp turn when it was considered by the House of Lords in the case of *Gilbert Ash (Northern) Ltd* v *Modern Engineering (Bristol) Ltd*[2] in 1973. A year later, in another House of Lords decision in the case of *Mottrams Consultants Ltd* v *Bernard Sunley & Sons Ltd*,[3] the principles were again re-stated, but in terms which appear to suggest that the principles are by no means as clear as the two earlier decisions made them out to be. The present paper examines the decisions of these cases which separately form three critical stages in the development of the law in this area and attempts to state the present position of this subject as a result of these decisions.

Prior to the seventies, it was thought that the principles relating to "set off" had been quite settled. As early as 1841, it was decided in the case of *Mondel* v *Steel*[4] that when a claim is made for the price of goods sold and delivered or of work performed, one of the courses of action open to the defendant (in the absence of any provision in the contract to the contrary) is to set off against the amount claimed, any damages which he has suffered as a result of the plaintiff's breach of the contract on the basis of which the claim was advanced. As Lord Diplock rightly observed,[5] this was no mere procedural rule, but a substantive defence to contractual claims at common law.

The effect of the decision in the case of *Dawnays Ltd* v *F. G. Minter Ltd*[6] was to prevent this common law rule from applying to the payment of sums specified in architects' certificates in a building contract. In *Dawnay's* case, sub-contractors issued a writ and applied for summary judgement against the main contractors to recover a sum of £27,870. This sum was included as



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part of the amount specified in an interim certificate issued by the architect and was stipulated as a sum due to the sub-contractors. The sum was duly received by the main contractors from the employers but they did not remit the same to the sub-contractors. The main contractors filed an affidavit in which they set up a cross claim for £61,000 damages for delays caused by the sub-contractors in breach of the sub-contract. Clause 13 of the sub-contract conditions had provided that ". . . the contractor shall notwithstanding anything in the sub-contract be entitled to deduct from or set off against any money due from him to the sub-contractor . . . any sum or sums which the sub-contractor is liable to pay to the contractors under this sub-contract." The Court of Appeal held that on the true construction of this clause, the only sums deductible thereunder were liquidated and ascertained sums established or admitted to be payable by the sub-contractors and that it was not, accordingly, permissible for the main contractors to deduct claims which were unliquidated and still in dispute.

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Lord Denning, MR stated in his judgment that an interim certificate was to be regarded as cash and that unless deductions were specifically spelt out in the contract, the whole sum specified must be paid. He went on to hold that the language of clause 13 clearly shows that the provision in question was intended to apply only to liquidated and ascertained sums;

> ". . . the reason (being that) . . . it is only such a sum which is capable of being 'deducted'; it is only such a sum to which it can be said that the sub-contractor is 'liable to pay'; it is only such a sum as to which it can be said that the main contractor is 'entitled' . . ."[7]

His lordship stressed the fact that interim certificates serve to support the cash flow position of a contractor in the course of the contract, a premise which he elaborated at some length:—

> ". . . if the contention of the counsel for the main contractors is correct, it would mean that they would hold (the sub-contractor's) money . . . indefinitely. They would hold on to it until the end of the main contract, that is, until the whole work was completed. They would then hold on to it still longer whilst the dispute was referred to arbitration . . . That seems to me to run counter to the very purpose of interim certificates. Every businessman knows the reason why interim certificates are issued and why they have to be honoured. It is so that the sub-contractor can have the money in hand to get on with his work and the further work he has to do . . . An interim certificate is to be regarded virtually as cash, like a bill of exchange. It must be honoured. Payment must not be withheld on account of cross-claims, whether good or bad—except so far as the contract specifically provides . . ."[8]

On the facts, it is difficult to fault the reasoning of the Master of Rolls. The danger in permitting set offs during the course of the contract could, in extreme cases, vitiate entirely the effect and purpose of interim certificates. The possibility that a party who

is obliged to pay the sum set forth in an interim certificate may attempt to fabricate so called counterclaims as a means of staying payments cannot be imagined to be in any way remote. It would seem therefore that the Court of Appeal has argued very persuasively the case for deviating from the general rule as laid down in *Mondel* v *Steel*. The position taken in *Dawnays*' case was subsequently affirmed by the Court of Appeal in five other decisions decided by that tribunal; all in 1972. *Frederick Mark Ltd* v *Schield*[9]; *G.K.N. Foundations Ltd* v *Wandsworth London Borough Council*[10]; *John Thompson Horsley Bridge Ltd* v *Wellingborough Steel and Construction Co Ltd*[11]; *Token Construction Co Ltd* v *Naviewland Properties Ltd*[12] and *Carter Horsley (Engineers) Ltd* v *Dawnays Ltd*[13] all held that the amount stipulated in a certificate could not be the subject of set off or counterclaim, and that only ascertained sums could be deducted and that payment of the sum due under a certificate could not be held up for cross-claims.

It therefore came as some surprise that in the case of *Gilbert Ash (Northern) Ltd* v *Modern Engineering (Bristol) Ltd*,[14] three of their lordships in the House of Lords should hold that *Dawnays*' case was wrongly decided. The facts of that case were that main contractors carried out certain works for a statutory corporation under a contract fashioned after the RIBA standard form and which, by clause 27, provided that where the architect has certified certain sums as due to a nominated sub-contractor, the main contractors were required to pay them over to the sub-contractor less only the retention money, cash discounts and "any sum to which the (main) contractor might be entitled in respect of the sub-contractor's delays." The sub-contractors in question were engaged under a special sub-contract form which incorporated the principal contract save where its terms differed from the sub-contract. Clause 14 of the sub-contract form provided to the effect that the contractor shall be liable to pay only when he received the money from the employer. It also provided that if the sub-contractor fails to comply with any of the conditions of the sub-contract, the contractors were entitled to withhold or deduct from any payments certified, such amount of "any bona fide contra accounts and/or other claims" which the contractors might have against the sub-contractors. The House of Lords unanimously held that the main contractors were entitled, on the construction of the terms of the sub-contract, to set off "bona fide contra accounts . . . or claims" against the sums specified in the architect's interim certificates. Viscount Dilhorne, Lord Diplock and Lord Salmon felt compelled to rule that *Dawnays*' case was wrongly decided in order to arrive at this decision. On the other hand, Lord Reid was clearly of the opinion that the decision in *Dawnays*' case was right, but that the case before the House turned upon the construction of clause 14 of the sub-contract. The judgement of Lord Morris of Borth-y-Gest did not disapprove of the decision in *Dawnays*' case[15] and appeared to have followed a route similar to that taken by Lord Reid.

The decision in *Dawnays*' case was thus overruled by a bare majority in the House and Lord Diplock explained the views of the majority of their lordships in the following terms:—

> "... My Lords, I accept the importance of 'cash flow' in the building industry. In the vivid phrase of Lord Denning, MR: 'It is the very lifeblood of the enterprise . . .' But so it is of all commercial enterprises engaged in the business of selling goods or undertaking work or labour, and so it was in the first half of the 19th century when this common law remedy for breach of warranty was 'established' (in *Mondel* v *Steel*) . . .."[16]

The majority took the view that the common law right of set off emanating from the case of *Mondel* v *Steel*[17] must be presumed to apply to a given situation unless and until it is shown that the parties in question have agreed to abrogate this common law remedy of set off. Lord Diplock described this approach thus:—

> "So when one is concerned with a building contract one starts with the presumption that each party is to be entitled to all those remedies for its breach as would arise by operation of law, including the remedy of setting up a breach of warranty in diminution or extinction of the price of materials supplied or work executed under the contract. To rebut that presumption one must be able to find in the contract clear unequivocal words in which the parties have expressed their agreement that his remedy shall not be available in respect of breaches of that particular contract . . .."[18]

With the greatest respect, it is difficult to see how the views taken by the majority of their lordships could adequately deal with the situation where a contractor attempts to delay paying out sums stipulated in interim certificates as being due to a sub-contractor by purporting to set off so called "counterclaims" against these certified sums. In such an event the principles laid down by the majority of their lordships will clearly work injustice towards the unfortunate sub-contractor. It is submitted that such a result could have been prevented had *Dawnays*' case been left intact as a general rule while allowing for situations which could qualify as exceptions to this rule. It is respectfully suggested that the points advanced by Lord Diplock did not address completely the reasons raised by the Master of Rolls for his decision in *Dawnays*' case. The building industry is characterised by the fact that a contractor has to bear tightly stretched cash flow profiles between commencing and completing the process of constructing the end product. Except for industries such as ship-building, such a state of affairs can hardly be said to have the slightest resemblance to that confronted by the common commercial retailer or even wholesaler. The time taken for the performance of a sales contract in the latter instances, will in nearly all cases be of a very much shorter order than that for the performance of a building contract. A building contract is thus designed to cater for a fairly protracted course of dealings, and in so doing it necessarily incorporates a number of variations to the usual form of contractual relationships. Provisions relating to the powers to order additional work and omissions, the powers to grant extensions of time and the very question of certifying interim payments, are all clearly related to the special nature of building contracts. It would follow therefore that the common law doctrine of set off could likewise be permitted to take on a different mould in the case of building contracts, and the form as laid down by the principles in *Dawnays*' case must, it is submitted, seem the most logical one to take.

It is suggested that the route taken by Lords Reid and Morris is to be preferred in the situation as posed by the facts in *Gilbert Ash*. The decision of both their lordships turns upon the special wording of what has been referred to in their judgments as "the fourth sentence" in clause 14. The material portion of clause 14 reads as follows:—

> "... The Contractor also reserves the right to deduct from any payments certified as due to the sub-contractor . . . the amount of any bona fide contra accounts and/or other claims which he, the contractor may have against the sub-contractor in connection with this or any other contract."

In the absence of the fourth sentence, Lord Reid remarked that the provision would have been unenforceable since it would have entitled the contractor to withhold sums which may be far in excess of any fair estimate of the value of his claims. In his lordship's opinion, the wording of the fourth sentence had the effect of restricting the contractor's claims to those which were genuine, but not necessarily sums which have been found to be due or agreed,[19] and that in this form the right of set off provided by clause 14 is enforceable. Lord Morris of Borth-y-Gest summed up the position taken by both their lordships in the following passage from his judgement:

> ". . . There may be a deduction of the amount of any bona fide claim which the contractor may have against the sub-contractor. Such claim may be in connection with the contract which has occasioned the certified payments or in connection with any other contract. As applied to the facts now before us the position is that the appellants have claims against the respondents in connection with the sub-contract. Those claims have both been particularised and quantified. Their amount is known. Whether or not they can be substantiated it is accepted that as "claims" they have been made in good faith. Whether it is wise for a sub-contractor to agree to a provision which may delay his receipt for money certified by an architect as being payable is not for us to decide. I can see no escape however from the conclusion that the *respondents agreed with the appellants* that there could be a deduction of the amount of any bona fide claims . . .."[20]

The crux of their lordships' judgement therefore is that, in the case before them, the remedy of set off was expressly agreed between the parties to the dispute and thus enforceable. The remedy of set off was thus

not something which applies to architects' certificates until there is some provision in the conditions of contract providing otherwise. On the contrary, the payer is presumed to have no right of set off as against the payee (following *Dawnays*' case) unless some provision exists which permits the remedy of set off to come into operation.

Unfortunately the majority of their lordships considered it necessary to undo the effect of *Dawnays*' case in the course of deciding for the appellants. As it stands therefore, *Gilbert Ash* ruled that a payer is presumed to be entitled to all remedies for breach of contract which would arise by operation of law including the remedy of setting up a breach of warranty in diminution or extinction of the price of materials supplied or work executed under the contract in question, and such a presumption can only be rebutted by clear and unequivocal evidence showing the existence of an expressed agreement between the parties to the effect that the remedy called in question shall not apply.[21]

The difficulties arising from the opinions held by the majority of their lordships in *Gilbert Ash* were felt immediately in the following year when the case of *Mottram Consultants Ltd* v *Bernard Sunley & Sons Ltd*[22] came before the House of Lords. The contractors in that case entered into a "cost plus" contract for the construction of a supermarket in Zaire for the appellants. The contract provided that the architect was to issue interim certificates for the amount due in respect of the total prime cost every week for local expenditure and every month for other expenditure eg. money spent in the purchase of materials outside Zaire. Condition 28(d) of the contract stated that on the presentation of such certificates by the contractors, the appellants should pay the amounts certified therein within seven days, less only the retention money and the sums previously paid. During the course of the contract, the parties agreed that the weekly imprest accounts, which were prepared by the contractors to show the amounts they had paid to their sub-contractors, should be deemed to be the architect's weekly certificates, being subject to adjustment if necessary in the monthly certificates. The parties then discovered that the contractors had wrongly paid considerable sums of money to certain sub-contractors and the appellants contended that these wrongful payments were made as a result of the contractors' negligence and that accordingly they were entitled to set off these amounts from those stated in the architect's certificates. The contractors, on the other hand, contended that the imprest accounts took the place of the architect's weekly certificates and that the appellants could have no greater right of deduction than they would have had if the architect had issued a certificate for the same sum. The House of Lords, by a bare majority, held that the appellants were not entitled to withhold payment of any part of the sum appearing in a weekly imprest account merely because they thought that some of the expenditure included in a former account or that account had not been properly incurred; and that accordingly it was for the architect to put that right if need be in the monthly certificates.

Lord Cross of Chelsea in delivering judgement on behalf of the majority directed his attention to the construction of condition 28(d) of the contract and observed that under this provision the only sums which are permitted to be deducted from the amount stated to be due in an interim certificate are (i) retention money and (ii) any sums previously paid. Accordingly he ruled that in the absence of any suggestion of fraud on the part of the architect or the contractor, it cannot be argued that any other sums could be deducted. In the course of his judgement, his lordship noted that as a result of the decision of the House in the *Gilbert Ash* case, "the position is now once more what it was before *Dawnays*' case was decided—namely, that one should approach each case without any 'parti pris' in favour or against the existence of a right of set off, though one must bear in mind the principle established in *Mondel* v *Steel* . . .."[23] With due respect, it is submitted that this dictum runs counter to what has been expressed by the majority of their lordships in the *Gilbert Ash* case. The majority of their lordships in that case ruled that the common law right of set off is a presumption in favour of the payer unless it is unequivocally shown that this right has been excluded by the terms of the contract called in question. The language used by both Lords Diplock and Salmon in *Gilbert Ash* could not be read as maintaining the position that the Court should only "approach each case without any 'parti pris' in favour of or against the existence of set off . . .." To quote Lord Diplock again, the approach adopted in *Gilbert Ash* began with "the presumption that each party is to be entitled to all those remedies for its breach as would arise by operation of law, including the remedy of setting up a breach of warranty in diminution or extinction of the price of materials supplied or work executed under the contract . . .."[24] Such language can only be construed as saying that the right of set off must be presumed until proven to have been excluded. In his powerful dissenting judgement, Lord Salmon recognised the difficulty of reconciling the decision of the majority in *Mottrams*' case with the decision in *Gilbert Ash*. His lordship having sat in both cases, observed:—

> ". . . If, as this House ruled in the *Gilbert Ash* case the law and practice now stand exactly where they did before *Dawnays*' case was decided, I think that this appeal presents no difficulty at all. It should be allowed . . . Indeed, the only hope which the respondents (contractors) had . . . was to persuade this House to uphold what has been called "the rule in *Dawnays*' case" namely, that whenever a claim is brought on an architect's certificate, the defendant must pay up first and arbitrate afterwards . . .."[25]

In his Lordship's judgement therefore, the appellants were entitled to the set off in question; but this judgement failed to prevail against the majority in the House.[26]

The situation is not assisted by the reference of Lord Cross to the case of *Mondel* v *Steel*. With respect, it seems contradictory to suggest that while an inquirer ought not to presume the existence or otherwise of the common law remedy of set off, he must nevertheless have regard to the rule laid down in *Mondel* v *Steel*, a case whose primary relevance is to serve as an authority for the remedy of set off. A possible interpretation of this portion of the judgement of Lord Cross is that the Court will lean towards the construction that a right of set off exists but not in a fashion as strong as would be the case had there been, instead, a presumption as to the existence of the remedy of set off.

The paradox presented in *Mottrams*' case is therefore this: notwithstanding the disapproval of *Dawnays*' case expressed in the majority's judgement delivered by Lord Cross, the result of *Mottrams*' case could only be reconciled with the position adopted by the Court of Appeal in the *Dawnays*' case. As noted by Lord Salmon in his dissenting opinion, the majority's decision is not reconcilable with the principles upon which *Gilbert Ash* was decided before the House only a few months earlier. The state of affairs is thus such that no clear statement of law could be easily adduced, and until the matter is finally cleared once again before the House, it is submitted that the following represents a plausible description of the law as it stands at present:—

(a) Firstly it is clear that the portion of the so called rule in *Dawnays*' case which purports to lay down that the remedy of set off does not apply to interim certificates in building contracts is no longer law. Instead the extent of set off permissible in a given set of circumstances is determined solely by the terms set forth in the building contract or otherwise agreed between the parties thereto.

(b) Secondly, if the approach taken by Lord Cross on behalf of the majority in *Mottrams*' case is accepted as correct, then one should approach each case without any "parti pris" in favour or against the existence of a right of set off. This reaffirms the corollary to the previous proposition that primary consideration should be directed towards the terms as set out in the building contract or to terms otherwise shown to have been agreed to by the parties in contention.

(c) Finally, it might be possible to suggest that the court will lean towards a construction that the right of set off will exist in a given state of circumstances but the effect of this is not to impute a presumption in favour of the remedy of set off. On the other hand, and this is where the full measure of the difficulties arising from the judgements in *Gilbert Ash* and *Mottrams*' are felt, in order that a party may be absolutely certain that the operation of the common law remedy of set off is excluded, clear and unequivocal words to this effect must be present in terms of the agreement in question. In this connection it is useful to note that Lord Diplock in the *Gilbert Ash* case had expressly ruled that there is "no

provision in a main contract in the standard RIBA form which excludes the common law remedy of (set off) . . .."[27] Presumably, since the relevant provisions in question are similar to those contained in both the existing and the proposed 1980 editions of the JCT standard form, this opinion will apply with equal force for some time to come.

References:

1. Reported as *Dawnays Ltd* v *F. G. Minter Ltd and Trollope and Colls Ltd* (1971) 1 WLR 1205; (1971) 2 AllER 1389 CA.
2. (1974) AC 689; (1973) 3 WLR (HL).
3. (1975) 2 Lloyd's Rep 197; (1974) 118 SJ 808 (HL).
4. (1841) 8 M & W 858.
5. *Gilbert Ash (Northern) Ltd* v *Modern Engineering (Bristol) Ltd* (1974) AC 689, at p 717. This is quite independent of the doctrine of "equitable set off"; of which an account can be found in the judgement of Morris, LJ. (as he then was) in *Hanak* v *Green* (1958) 2 QB 9.
6. (1971) 1 WLR 1205; (1971) 2 AllER 1389 (CA).
7. (1971) 2 AllER 1389 at 1392.
8. (1971) 2 AllER 1389 at p 1392, 1393.
9. (1972) 1 Lloyd's Rep 9.
10. (1972) 1 Lloyd's Rep 528.
11. (Unreported) Bar Library Transcript No 41A of 1972.
12. (Unreported) Bar Library Transcript No 170 of 1972.
13. (Unreported) Bar Library Transcript No 208 of 1972.
14. (1974) AC 689; (1973) 3 WLR (HL).
15. Lord Morris, however, in the subsequent case of *Mottram Consultants Ltd* v *Bernard Sunley Ltd* (1975) 2 Lloyd's Rep. 197 at p 204, did affirm that there is no longer the so called rule in *Dawnays'* case.
16. (1974) AC 689 at p 718.
17. (1841) 8 M & W 858.
18. (1974) AC 689 at p 718.
19. (1974) AC 689 at p 698.
20. (1974) AC 689 at p 704.
21. Lord Diplock in (1974) AC 689 at p 718; *supra.*
22. (1975) 2 Lloyd's Rep 197; (1974) 118 SJ 808 (HL).
23. (1975) 2 Lloyd's Rep 197 at p 205.
24. (1974) AC 689 at p 718; *supra.*
25. (1975) 2 Lloyd's Rep 197 at p 212.
26. See also article by Adrian Julian (1976) *New Law Journal* 141.
27. (1974) AC 689 at p 720.