

**PROFILE OF SET-OFF CASES IN MALAYSIAN CONSTRUCTION  
INDUSTRY**

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**PROFILE OF SET-OFF CASES IN MALAYSIAN CONSTRUCTION  
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**A project report submitted in partial fulfillment of the  
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**DEDICATION**

*To my beloved family for giving me such a good start  
Thanks for support, guidance and everything.*

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## ABSTRACT

The problem of non-payment has long been lamented by the construction industry players. Payment default, as many in the industry know, poses potential undesirable consequences such as stifling the cash flow of industry participants, resulting in their insolvency, and affecting the entire project delivery chain. One of the reasons for non-payment is due to set-off. Set-off relates to the situation where an employer raises a counterclaim against the main contractor or where a main contractor raises a counterclaim against a sub-contractor's claim. This kind of action had caused the main contractor or sub-contractor to bring action against the employer in reclaiming the money due to them. This study focus on developing the profile of set-off cases in Malaysian construction industry and has been done based on the year, types of parties involved, types of construction project, nature of set-off, amount of money involved and court judgment. This study mainly carried out through documentary analysis of court cases using the online e-database via Lexis Malaysia website. This study covers the set-off cases in construction industry reported by Malayan Law Journal (MLJ) between years of 1961 to 2010 and related to building contract only while the methodology of this study is on the secondary data analysis. Research finding identified that the period between years of 1991 – 2000 had the most set-off cases and the most party involved in construction set-off is between the employer and the main contractor. The analysis also identified that the most types of construction project is private project. Besides that, this study also found that most of the set-off is due to defective works and late completion with the most amount of money involved is between RM100,001 – RM1 million. It also found that 16 out of 22 cases were held as wrongful set-off by the judge. These have proved that in reality, the industry players still lack of understanding on their right of set-off. By developing this profile, hopefully it will provide the relevant parties a better understanding on the set-off and helps to prevent or minimize the disputes in the construction industry.

## ABSTRAK

Masalah ketidakbayaran telah lama menghantui pihak industri pembinaan. Kemungkiran pembayaran, sepertimana kebanyakan pihak industri tahu, menimbulkan potensi akibat yang tidak diingini seperti menjejaskan aliran tunai, menyebabkan kemuflihan dan mempengaruhi keseluruhan rangkaian projek. Salah satu faktor ketidakbayaran adalah disebabkan penolakan bayaran. Tolakan berkaitan dengan situasi di mana majikan menuntut balas terhadap tuntutan kontraktor utama atau di mana kontraktor utama menuntut balas terhadap tuntutan sub-kontraktor. Tindakan ini telah menyebabkan kontraktor utama atau sub-kontraktor mengambil tindakan terhadap majikan untuk menuntut kembali wang yang sepatutnya dibayar kepada mereka. Kajian ini tertumpu kepada pembangunan profil tolakan kes dalam industry pembinaan di Malaysia dan telah dilakukan berdasarkan tahun, jenis pihak yang terlibat, jenis projek pembinaan, punca penolakan, jumlah wang yang terlibat dan keputusan penghakiman. Kajian ini dijalankan terutamanya melalui analisis dokumentari kes-kes mahkamah menggunakan e-pangkalan data melalui laman web Lexis Malaysia. Kajian ini merangkumi tolakan kes dalam industri pembinaan yang dilaporkan oleh Malayan Law Journal (MLJ) antara 1961 - 2010 dan yang berkaitan dengan kontrak pembinaan sahaja manakala metodologi kajian ini adalah berdasarkan kepada analisis data sekunder. Hasil kajian mendapati tempoh antara tahun 1991 - 2000 mempunyai tolakan kes yang tertinggi dan pihak yang paling banyak terlibat dalam tolakan adalah di antara majikan dan kontraktor utama. Analisis ini juga mengenal pasti bahawa kebanyakan jenis projek pembinaan adalah projek swasta. Selain itu, kajian ini juga mendapati bahawa punca tolakan berlaku adalah disebabkan oleh kecacatan dalam hasil kerja dan kegagalan menyempurnakan kerja di mana jumlah wang yang terlibat adalah di antara RM100, 001 - RM1 juta. Ia juga mendapati bahawa 16 daripada 22 kes yang telah berlaku telah dihakim sebagai salah tolakan. Ini telah membuktikan bahawa dalam realiti, pihak industri masih kekurangan pengertian mengenai hak tolakan. Dengan membangunkan profil ini, mudah-mudahan ia akan memberi pihak-pihak berkenaan pemahaman yang lebih baik mengenai tolakan dan membantu untuk mencegah atau meminimumkan pertikaian dalam industri pembinaan.

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**LIST OF ABBREVIATIONS**

|             |   |
|-------------|---|
| AC          | Law Reports Appeal Cases                  |
| All ER      | All England Law Reports                   |
| Bing NC     | Bingham New Cases                         |
| BLR         | Building Law Reports                      |
| Ch D        | The Law reports, Chancery Division        |
| CIDB        | Construction Industry Development Board   |
| DLR         | Dominion Law Reports                      |
| Eq. Ca. Ab. | Equity Cases Abridged                     |
| EWCA        | England and Wales Court of Appeal         |
| EWHC        | High Court of England and Wales Decisions |
| Ex D        | Exchequer Division                        |
| Lloyd's Rep | Lloyd's List Reports                      |
| MLJ         | Malayan Law Journal                       |
| PAM         | Pertubuhan Arkitek Malaysia               |
| PWD         | Public Work Department                    |
| QBD         | Queen's Beach Division                    |
| SLR         | Singapore Law Reports                     |
| TCC         | Technical and Construction Court          |
| UK          | United Kingdom                            |
| WLR         | Weekly Law Reports                        |

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## CHAPTER 1

### INTRODUCTION

#### 1.1 Background of Study

A contract is a legally binding agreement made between two or more parties which rights are acquired by one or more to acts or forbearances on the part of the other or others'.<sup>1</sup> According to Contract Act 1950, contract is an agreement enforceable by law.<sup>2</sup> In brief, a contract is an agreement involving two or more parties that sets forth what the parties will or not to do which is enforceable by law. Once a party enters into a contract, he must perform his obligations strictly according to the terms of contract.<sup>3</sup>

Terms are promises, which form part of the contract, the breach of which will give rise to an action for damages for breach of contract or, in some cases, repudiation of the contract.<sup>4</sup> Therefore, the purpose of the terms is to amplify and

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<sup>1</sup> Ashworth, A. (2006). *Contractual Procedures in The Construction Industry*. 5<sup>th</sup> Ed. Malaysia: Pearson Education Limited. Pp. 17

<sup>2</sup> Section 2(h) of Contracts Act 1950

<sup>3</sup> Chow, K.F. (1988). *An Outline of the Law and Practice of Construction Contract Claims*. Singapore: Longman Singapore Publishers Pte. Ltd.

<sup>4</sup> Oughton, D. & Davis, M. (2000). *Sourcebook on Contract Law*. 2<sup>nd</sup> Edition

explain the basic obligations of the parties and to provide administrative mechanisms for ensuring that the correct procedures are observed.<sup>5</sup>

In construction industry, the contractor is expected to deliver the project entirely that fulfil the objectives set out according to employer's requirement. On the other hand, the employer function is basically to pay for the works in accordance with payment terms of the contract. The primary obligation upon the employer is to give the contractor the sum of money, which forms the consideration for the contract. However, the consideration given by the employer to the contractor is not always a fixed amount of money i.e. certain amount of money being deducted or set-off.<sup>6</sup>

Set-off is a familiar concept in the construction industry. It is often used between main contractor and sub-contractors, but it is equally capable of being used at all contractual levels. There is no statute setting out the basis on which one party can make a set-off against another and standard form of contracts are often unclear about set-off. Construction set-off, therefore, tends to be ruled by the law of the jungle. This is because if, say, a sub-contractor has his monthly payment reduced by a set-off, there is little that he can do about it other than take the main contractor to law.

Traditionally, the idea known as Dawnays principle as emphasised by Lord Denning in the case of *Dawnay Ltd. v. FG Minter Ltd. and others*<sup>7</sup> does not permit any set-off, taking the view that there should not be any interruption of cash flow in the building industry, which itself the life blood of the industry. Because of dynamic risks in construction especially dealing with large capital and long period to complete, money itself is the motivation factor. Money must be paid promptly and fully unless there are specific reasons for withholding it.

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<sup>5</sup> Murdoch, J. and Hughes, W. (2008). *Construction Contracts: Law and Management*. 4<sup>th</sup> Ed. UK: The Cromwell Press

<sup>6</sup> Ibid

<sup>7</sup> [1971] 2 All ER 1389

Contractors who carry out construction work using standard form of construction contracts often rely on the interim certificates as a condition precedent for payment during the progress of the work. Interim certificates (which are estimated valuations of work done and may include materials and plants) are normally issued by architects who are engaged by the employers. Persistent attempts by employers to rely on the rights of set-off, especially on nebulous grounds with a view to delay payments, may cause undue financial stress on the contractors.

The right of set-off, generally, is derived from common law based on the principle stated authoritatively in *Mondel v Steel*<sup>8</sup> and statute.<sup>9</sup> The right of set-off is subjected to an express provision in the contract that permits such right to be exercised. Although, normally, standard forms of contract does contain an express provision for deduction of payment but some of the new provisions could undermine the employer's right of set-off.<sup>10</sup>

Therefore, a set-off is in essence a defence rather than a cross-action. The set-off must be in monetary terms (whether of an ascertained amount or not).<sup>11</sup> The principle that derived is that when the defendant, in the absence of a contrary provision in the contract, is allowed to defend himself by setting-off against the amount claimed, any damage which he has sustained as a result of the plaintiff's breach of the contract under which the goods were sold and delivered or the work and labour done and thus showing the diminution of value of the subject matter.<sup>12</sup>

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<sup>8</sup> [1841] 8 M & W 858; [1835-42] All ER Rep 511

<sup>9</sup> Courts of Judicature Act 1964 (Malaysia) s 25(2) Sch s 13

<sup>10</sup> Clause 30.4 and Clause 30.6(a) PAM 2006

<sup>11</sup> Rules of the High Court 1980 (Malaysia) O 18 r 17

<sup>12</sup> *Pembinaan Leow Tuck Chui & Sons Sdn Bhd v Dr Leela's Medical Centre Sdn Bhd* [1995] 2 MLJ 57 at p 74. In Britain, in so far as it applies to contracts for work and labour, it still rests on the common law: *Gilbert Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1973] 3 All ER 195 per Lord Diplock at p 215c

## 1.2 Problem Statement

One of the most important components that are of major concern to the players in the construction industry is the aspects of payment. Payment has been said to be the lifeblood of the construction industry. Yet, there remains a chronic problem of non-payment affecting the entire delivery chain.<sup>13</sup> The dissatisfaction on payment has created many disputes among the contractual parties especially the employers and the contractors. This lead each party to reject the certificate of payment issued by an architect or withhold a payment follow by set-off.

If one party to a construction contract does work that turns out to be defective, the other party is allowed by law to set-off or deduct a sum required to make good that defect. This happens frequently in construction contracts and regularly involves large sums of money, disputes and litigation. It is a complex area of the law with a number of cases, as well as the contractual provisions themselves, which prescribe a party's right of set-off.<sup>14</sup>

Generally, not all the standard form of contracts contains provision with the term of 'set-off' except PAM 2006 (clause 30.4) and JKR 203N (clause 37). Even so, these provisions give effect that a right of set-off cannot be exercised unless certain specified conditions have been met.<sup>15</sup> On the other hand, some of the standard form such as PWD 203 and CIDB 2000 was not properly mentioned the 'set-off' term but certain provisions in the contract were found to give employer entitlement to deduct money from the contractor. It can be seen in *Token v Charlton*<sup>16</sup> where the court held that deductions can be made from Interim Certificates if the contract expressly

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<sup>13</sup> Ameer Ali, N.A.N. (2005). Construction Industry Payment and Adjudication Act – Reducing Payment Default and Increasing Dispute Resolution Efficiency. *International Forum Construction Industry Payment Act and Adjudication*. Kuala Lumpur Convention Centre, 13-14 September

<sup>14</sup> Jones, N.F. (1999). *Set-off in the Construction Industry*. 2<sup>nd</sup> Ed. UK: John Wiley & Sons

<sup>15</sup> Murdoch, J. and Hughes, W. (2008). *Construction Contracts: Law and Management*. 4<sup>th</sup> Ed. UK: The Cromwell Press

<sup>16</sup> [1973] 1 BLR 50

gives that right and there seems little doubt that phrases such as “from any moneys due” will be taken to confer it.

Undoubtedly, a study on the causes of set-off had been carried out but these are the general findings and some others elements have to be determined. This is because construction is a unique and specialization process involving many activities, myriads of individual, different company or firms, different size, part of country with different skills and capabilities and always subject to changing environment. Set-off can have serious implication in construction project. The project may suffer cost and time overrun, the owner may suffer significant loss and profit and worst still the project may be abandoned or failed.

The issues are which period of years involved most set-off cases? Who are the parties involved? What types of the construction project? What is the nature of the set-off? What is the amount of money involved? And what are the court judgments?

The right to set-off depends on the nature of set-off and in accordance with the provisions of the contract as well as general law and statute. Even though in standard form of contract, the conditions to set-off had been clearly stated but many cases reported at court still found that the parties had exercised the wrongful set-off. These have proved that in reality, many parties in the construction industry still lack of understanding in relation to set-off.

Since set-off have been one of the major factors causing non-payment, it is necessary to determine the nature or the general background or the profile of the set-off itself. It is essential in construction contract management to adopt an anticipative approach to management. By having thorough knowledge and information, it will definitely help the employer or the contractor in anticipate the potential disputes when exercising their rights to set-off payment. Besides as a tool in contract

management, this profile definitely helps to prevent or minimize the non-payment issues in Malaysian construction industry as well as potential disputes.

### **1.3 Objective of Study**

The objective of the study is to develop the profile of construction set-off cases in terms of year of cases, types of parties involved, types of construction, nature of set-off, amount of money involved and the court's judgment.

### **1.4 Scope and Limitation of Study**

The followings are the scopes of the study:

- Only building and construction cases will be discussed in the study.
- Only examines the construction set-off reported by Malayan Law Journal between years 1961 - 2010.
- Malaysia legal cases reported in Lexis Malaysia in relation to the issue will be used for discussion in this study.

## **1.5 Significance of Study**

This profile is very important where it addresses the current problem in relation to non-payment due to set-off encountered by main contractors, sub-contractors and suppliers in the local construction industry. This study will act as a tool in construction industry for all the players to get information regarding the characteristics of set-off. This study should be able to increase the awareness of both employers and main contractors in relation to the set-off issues.

From the findings, it will provide the relevant parties in the construction industry with a better understanding of their rights of set-off and more clarified with the nature of set-off and influenced them to be more aware before they exercised their rights in set-off. Any attempt to set-off payment must be done with greatest care and in accordance with the condition required in the contract. Hence, the profile could assist the players in the construction industry in avoiding unnecessary disputes while assuring project success and better relationship among the contractual parties.

## **1.6 Research Methodology**

Research methodology is one of the crucial parts that are needed to ensure the study can be carried out methodically in order to achieve the proposed objective of the study due to the systematic arrangement of the research procedures. The research methodology that had been outlined comprised of four major stages, which involved initial study, data collection, data analysis and conclusion and recommendations.

### **1.6.1 Stage 1 : Initial Study**

Early literature review is the primary step in doing this study in order to identify the study issue. The issue arises from intensive reading on various sources of published materials such as books, journals, articles, seminar papers, cases and electronic resources as well as World Wide Web and online e-databases from UTM library's website. This had lead to the establishment of the objective of the study, the scope and limitations for the study as well as the study title.

### **1.6.2 Stage 2 : Data and Information Collection**

Collection of relevant data and information through documentary analysis were carried out in this stage. All collected data were recorded systematically. Secondary data collection is from Lexis-Malaysia legal database by using keywords of "set-off, construction, payment, certificate" and reading materials in printing form like books, journals, research paper, magazines, reports, proceedings, seminar paper as well as information from internet. It is important to support and strengthen the study as well as to gain general state of knowledge concerning the subject area of the research such as background, definition, procedures, relevant events, etc. before proceed to other stages.



### **1.6.3 Stage 3: Data Analysis**

All the collected data, information, ideas, opinions and comments were arranged, analysed and also interpreted. The cases that found by using the keywords as stated above were being read through and only cases that discussed set-off payment will be selected to be sample of analysis. Arrangement of data tends to streamline the process of writing of the paper.

### **1.6.4 Stage 4 : Conclusion And Recommendations**

In this stage, reviews on the whole process of the study will be carried out with the intention to identify whether the study objective has been achieved. After presenting the findings, recommendations and limitations of the study, topics for further study emerge. The conclusion and recommendations were made based on the findings during the analysis stage.

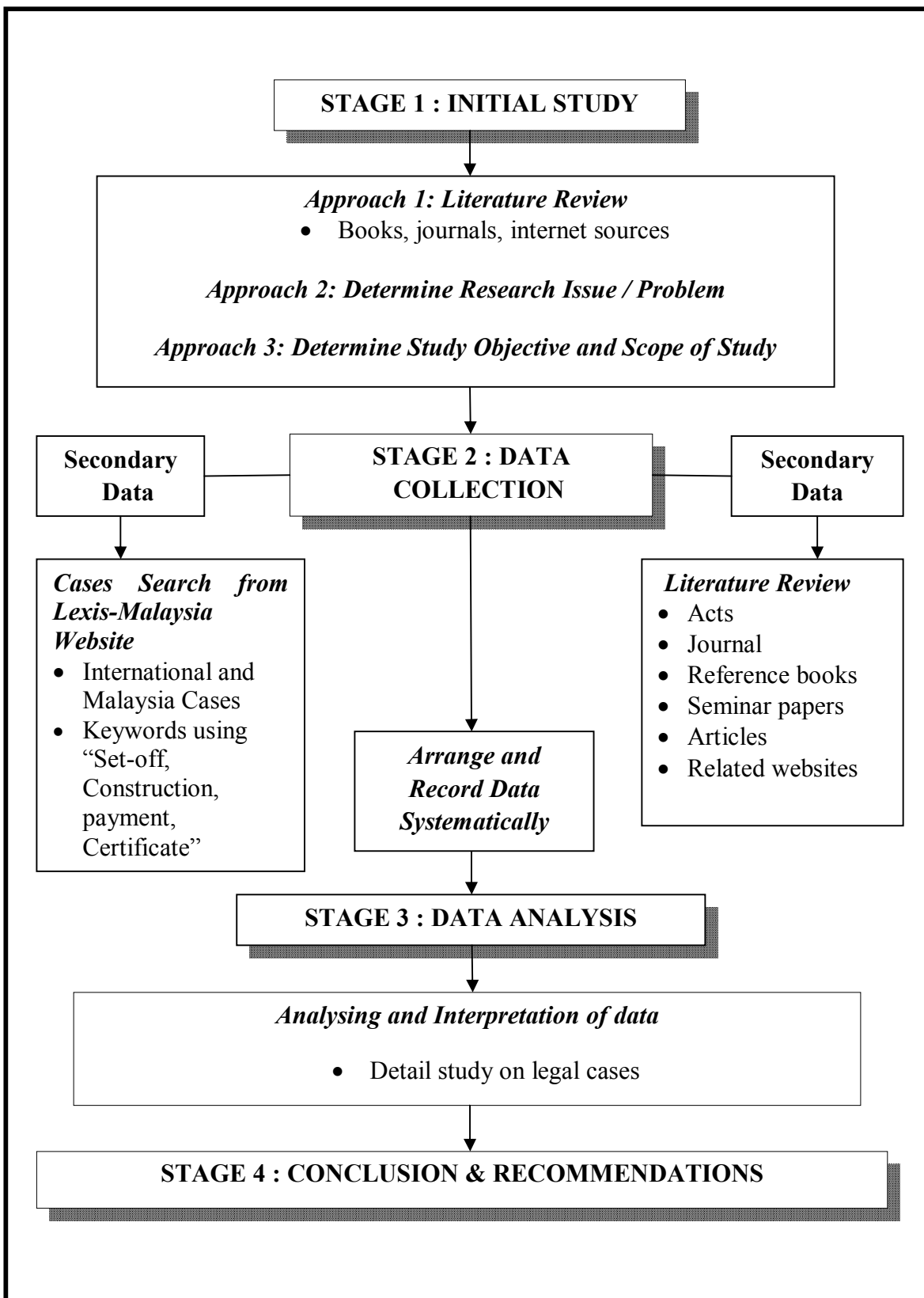


Figure 1.1: Research Methodology

## **1.7 Organisation of the Study**

This study covers five (5) segments as follows:-

### **1.7.1. Chapter 1 : Introduction**

This chapter consists of a brief introduction to the study topic and the problems that triggered this study to be conducted. It also established the key objective that expected to be achieved at the end of this study. In addition, it also presents the scope and limitations; significance of the study; as well as the methodology and the outline of this study.

### **1.7.2. Chapter 2 : Set-off**

This chapter covered the definition of set-off; principles of set-off in construction contract; types of set-off; distinction between set-off, counterclaim and abatement according to relevant cases; and the topic expand to discuss the provision of set-off available in various standard forms as in PAM 2006, JKR 203A (Rev 1/2010), CIDB 2000 which includes contractual procedure to set-off payment and also in Limitation Act 1953. This will determine the right of the employer to set-off or withhold payment which available in the contract.

### **1.7.3. Chapter 3 : Profiling Methodology**

This chapter discusses the concept or theoretical background of profiling such as the meaning and its importance to the construction industry. This chapter also discusses on the elements of profiling such as year of cases, types of parties involved, types of construction, the nature of set-off, the amount of money involved and court judgment. It also discusses the data collection method and data analysis.

### **1.7.4. Chapter 4 : The Profile of Construction Set-off Cases**

This chapter presents the data and analysed the result from the legal cases to address the objective, which has been formulated. Here, the analysis determines the year of cases, types of parties involved, types of construction, nature of set-off, amount of money involved and the court judgment.

### **1.7.5. Chapter 5 : Conclusion and Recommendations**

This chapter is the final part of the whole report and is a conclusion chapter. It consolidates the results and findings of the study, which is relating to the objective of the study. It also gives recommendations and conclusions besides highlighting the problem encountered during the course of the study.

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