SHERIFF APPEAL COURT

[2024] SAC (Civ) 12
AIR-A140-22

Sheriff Principal N A Ross
Appeal Sheriff RDM Fife
Appeal Sheriff P A Hughes

OPINION OF THE COURT

delivered by SHERIFF PRINCIPAL ROSS

in appeal by

REALM CONSTRUCTION LIMITED

Pursuer and Appellant

against

ISG CONSTRUCTION LIMITED

Defender and Respondent

Pursuer and Appellant: Manson, advocate; Wright, Johnston & MacKenzie LLP
Defender and Respondent: Broome, advocate; Pinsent Masons LLP

08 April 2024

[1] In September 2021 the respondent subcontracted the appellant to carry out groundworks, drainage and other works in connection with construction works at the Talisker distillery site. The subcontract conditions contained, at clause 2(4), a provision that the appellant required to apply for interim payments not later than nine days prior to each scheduled date for payment. Clause 2(8) required the respondent to notify the appellant thereafter of the sum which it considered due. Clause 2(10) required the respondent, in the event that the respondent intended to pay less than the sum otherwise due under

clause 2(8), to issue a pay less notice. The pay less notice required to set out the lesser sum which the respondent considered to be due. These provisions met the requirements under the Housing Grants, Construction and Regeneration Act 1996 (the "1996 Act") for a scheme providing for interim payment.

[2] Interim payment number 11 was due on 13 May 2022. The appellant duly submitted application for payment on 4 May 2022, which valued the works to date and the sum claimed. The respondent thereafter notified the appellant on 18 May 2022 of its own valuation of the works, and that the sum due under application was £288,900.01. The respondent thereafter timeously, on 9 June 2022, issued a pay less notice. The pay less notice sought to deduct and retain £275,483.86 from interim payment number 11.

[3] The respondent sought to deduct this sum on the basis that it represented costs, fees, loss and expenses claimed by the respondent following the collapse of a wall of a warehouse at the Rosebank distillery site, Falkirk. That wall collapse and associated claimed costs relate to a separate and previous contract between the parties, and not the contract for the Talisker site. The appellant denies liability and the Rosebank distillery dispute has not been judicially determined. During submissions, it was confirmed that it had not been formally raised.

[4] The appellant disputed that, as a matter of contractual construction, an illiquid claim relating to a separate contract could be deducted from liquid sums due under the present contract. They raised the present action. The matter turns on the wording of clause 2(21) of the sub-contract, the relevant wording being:-

> "Subject to [the pay less notice clause], any sum of money recoverable from or payable by [the appellant] under or in connection with this Sub-Contract may be deducted from any sum then due or which may at any time thereafter become due to [the appellant] under this Sub-Contract or under any other agreement between [the appellant] and [the respondent] and/or a [respondent] group company…"

[5] The case went to debate. The sheriff dealt with matters which are no longer disputed but also held that clause 2(21) was apt to allow retention of illiquid claims against interim payments. The cause was continued for the purpose of probation on the claim itself. The appellant appealed, and submitted that the wording does not permit set off of illiquid claims. The respondent submitted that the wording is wide enough to cover illiquid claims made under separate contracts between the parties.

Submission for the appellant

[6] Counsel accepted that this was an unusual clause, in that it accepted deductions under unrelated contracts. The dispute was about how far the parties intended the right of set off to go. The parties were not in dispute about the principles to be applied. The sheriff failed to give any reasoning for favouring one construction over the other. He erred in choosing an extremely expansive interpretation, thereby allowing almost any conceivable basis for a claim, of uncertain merit, to prevent payment of a sum which was unquestionably due and payable. The natural and ordinary meaning of the words did not support that construction. The commercial effect would be at odds with the payment scheme. The legal context had not been recognised. The authorities supported the appellant's position.

Submission for the respondent

[7] Counsel for the respondent agreed that the principles were not in dispute. The question was what a reasonable person who had all the background knowledge would have understood the parties to have meant. It was an error to focus on the legal concept of illiquidity. Rather, the focus should be on the words used, which were plainly wide and

inclusive. "Recoverable" was not a restrictive concept, and contemplated prospective, future claims. There was no question of the respondent operating non-contractual or equitable retention. For that reason, *Inveresk plc* v *Tullis Russell* 2010 SC (UKSC) 106 was not engaged in this case. Further, the fact that a contractual arrangement had worked out badly was not a reason to depart from the natural language used (*Scanmudring AS* v *James Fisher MFE Ltd* 2019 SLT 295).

Decision

[8] The sheriff's decision amounted to no more than preferring the submissions of the respondent, without further reasoning. The sheriff's decision does not meet the criteria for a judgment (see <u>Macphail</u>: Sheriff Court Practice (4th ed) para 17.10). It leaves the reader in a real and substantial doubt as to what the reasons for the decision were. The matter requires to be assessed of new.

[9] The canons of construction were not in dispute and were summarised by parties under reference to *Scanmudring AS* per the Lord President (Carloway) at [47], and *Ardmair Bay Holdings Ltd* v *Craig* 2020 SLT 549 at paragraphs [47] to [49]. These were summarised in four stages. First, the correct approach to the interpretation of commercial contracts is a unitary one which seeks to objectively determine what a reasonable person with all the background knowledge reasonably available to both parties at the time of contracting would have understood the parties to have meant by the words they have used. Second, the court should be concerned to give effect to the natural and ordinary meaning of the words used by the parties. Third, in circumstances where there are ambiguities or rival meanings, the court is entitled to test the competing constructions with reference to business common sense. Fourth, the internal and legal context of the contract at issue should be considered in seeking

to construe a particular term. The court should therefore be concerned to read the contract as a whole in a coherent and consistent way in its relevant legal context with the result that these complement rather than contradict one another.

[10] The starting point is the natural and ordinary meaning of the words. The pivotal phrase is: "any sum of money recoverable by ISG…or payable to ISG…under or in connection with any other agreement may be deducted".

[11] The appellant's submissions identified that the significant words on which the meaning hinges are "sum", "recoverable" and "payable". The appellant sought to contrast *Modern Engineering* v *Gilbert-Ash* [1974] AC 689. We have not found *Modern Engineering* to be of assistance. In that case the contractor reserved the right to make deductions from payments for, amongst other things, "claims". It was held that this term contemplated retention pending a cross-claim for unliquidated damages. In the present case, however, parties do not refer to claims, and the clauses are not similar. Had the parties truly intended wide powers of set off, they could have put the matter beyond doubt by use of clear terminology, such as claims, unliquidated claims, or damages. They did not do so.

[12] Parties agreed that considerations of non-contractual or equitable retention do not arise. Accordingly, *Inveresk plc* (above) is not engaged. The matter turns on the wording alone. Parties did not seek to refer to any other wording of the contract, and no further assistance appears to arise from the wider contract terms. No specialist or trade meaning was suggested, so background knowledge, at least of factual matters, is not a source of assistance either.

[13] In our view, consideration of the plain meaning of the words tends to slant the meaning towards the respondent's position, but not sufficiently to allow the parties' intention to be identified. "Sum" may or may not be read as contrasted to "claim", but there

is no indication either way, and it can be read as a description of what is to be deducted, which would always be described as a sum. It therefore does not assist. "Recoverable" may be read as anticipating future developments, which assists the respondent, or present debts, which assists the appellant. "Payable" can only be a present, identified, sum, but that does not assist the appellant, because both recoverable and payable sums may be deducted. If the matter rested simply on those words, we would find on the balance of probabilities that the word "recoverable" anticipated future, unascertained sums, and was wide enough to cover illiquid sums.

[14] That, however, is not the exercise that the foregoing principles require. The exercise is more than a free-standing assessment of definitions. In our view the matter is put beyond doubt by two further considerations, namely the commercial purpose of the contract, and the legal context.

[15] As to commercial purpose, the practical effect of the contract is relevant. The issue of set off only arises following presentation of a liquid, ascertained claim by the appellant. The sum is both fixed and explained. The respondent has the opportunity to make its own assessment of that claim, and to present the appellant with its own valuation. Only then does the question of the pay less notice arise. The respondent knows the sum claimed, and knows its own valuation of that claim. There can be no clearer indication of entitlement to payment than that the respondent has made its own calculation of the sum which, in the absence of a pay less notice, is payable. If the respondent's position were correct, then the reasonable person with the relevant background knowledge would require to accept that the parties intended that a certain and justified claim could be defeated, in the respondent's unfettered discretion, by a future and unspecified claim. That future claim might be speculative, over-valued, slow to the point of deliberately obstructive, or made in error. The

appellant would be deprived of its rightful payment until the matter was resolved, a process over which it had no control. The potential for misuse of this clause is clear. It tends to demonstrate that the respondent's proposed interpretation is not one which would have accepted by the said reasonable person. It does not make business sense, at least to one party. It is a strong indication that the parties did not intend such a result, and that set-off of illiquid claims is not contractually available to the respondent.

[16] There is a further issue of business common sense. We agree with the appellant's submission on the practical absurdity created by the respondent's position. Faced with an unjustified pay less notice, the appellant would require to raise an adjudication in order to be paid. The subject of that adjudication would not be its own claim, which is defined, explained and accepted by the respondent as otherwise payable. The subject would instead be the respondent's pay less notice, about which the appellant may know next to nothing. Against a time frame of 28 days (1996 Act, section 108) the appellant would serve a notice, working more or less blind, on the respondent, who would then respond. Only once the response was received would the appellant be able to properly understand, for the first time, the reasons, specification and quantification of the claim, and mount a defence by amending its own claim. The pay less notice could found on any historic contract, potentially long forgotten, and on a recent loss which was un-investigated by the appellant. The appellant may only have a few days left in which to investigate and assess the defence, to plead a detailed rebuttal, and prepare affidavits, contract documents and other evidence about a hitherto unconsidered dispute. The obvious procedural and substantive unfairness thereby created is a strong indication that the parties could not possibly have intended such a result. Further, there is merit in the appellant's submission that this would only set a trap for the appellant – upon issue, the arbitrator's decision will convert an illiquid claim into a liquid

ascertained debt. Again, the reasonable person would not consider the parties to have intended such a result. It is a further strong indication that set-off of illiquid claims is not contractually available to the respondent.

[17] It is also necessary to consider the legal context, both under the 1996 Act and at common law. That also supports the appellant's position. Under the 1996 Act the statutory scheme was based on a clear policy. That policy was to tackle the concern that main contractors were abusing their position to wrongfully withhold payment from sub-contractors who were unable to challenge their actions (Keating; Construction Contracts (11th ed) at para 18-120). The 1996 Act is a relevant aid to construction of contracts in this context (*Grove Developments Ltd* v *S&T (UK) Ltd* [2019] Bus LR 1847 (CA) at para [41]). The respondent's construction is the antithesis of this, potentially clearing the way for extensively-delayed retention for spurious reasons. It would require the clearest wording to justify such a position. As set out above, the wording does not achieve that.

[18] At common law, the legal context is one where a liquid claim cannot be met by an illiquid claim. At common law this claim of set off would be unenforceable (*Inveresk plc*, above). While parties can contract out of that, and the respondent claims that they did so, it would take clear wording to demonstrate that the parties intended this departure from the common law, and that a legally unenforceable claim should become enforceable. The wording does not achieve that.

[19] The respondent's position was that clause 2(21) did not differentiate between liquid and illiquid claims, and that the 1996 Act, and *Inveresk plc*, above, allowed parties freedom of contract. The Rosebank claim was specified and would be available to the appellant. The pay less notice had been validly served. *Modern Engineering* v *Gilbert-Ash*, above, required to be read in context of pre-1996 Act law, and in any event dealt with the English law of set off.

The respondent relied on the well-understood rules of contractual interpretation. None of these points, however, meet the difficulties discussed above, and the rules of contractual interpretation do not, for the reasons set out, assist the respondent.

Disposal

[20]	We will allow the appeal, recall the sheriff's interlocutor of 13 September 2023, sustain the appellant's first and second pleas-in-law, repel the respondent's pleas-in-law and grant decree as craved. Parties should attempt to agree expenses, failing which within 21 days the clerk will fix further procedure, whether oral or written.