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Right of Set-Off on Unrelated Projects

Architects/Engineers Professional Network - Guest Essays

Right of Set-Off on Unrelated Projects

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Frequently, general contractors will work with the same subcontractor or supplier on two separate, unrelated projects. When that happens, the situation may arise that on the first project (Project A), the subcontractor defaults on its contract, resulting in a back-charge that exceeds the subcontractor's contract balance, i.e. the subcontractor owes the general contractor money. On the second project (Project B), the subcontractor satisfactorily completed its work and is due money from the general contractor. It may seem obvious that the general contractor would have a right of set-off, allowing the general contractor to deduct the amount due from the subcontractor on Project A from the amount that the general contractor otherwise owes the subcontractor on Project B. Seemingly, the general contractor should only have to pay the net difference or be able to avoid paying the subcontractor anything if the back-charge on Project A exceeds the amount due on Project B. However, as outlined in this article, that seemingly straight-forward right to "net out" the competing claims might not always be available.

There are several different factors that can frustrate the general contractor's right of set-off. In some jurisdictions, state statutes may prohibit the general contractor from withholding from the subcontractor the amounts received from the owner for the subcontractor's work, such statutes holding that those funds are held in trust for the benefit of the subcontractor. Some states might even find the withholding of funds received by the owner for the subcontractor's work to be statutorily criminal. On projects covered by a payment bond, courts in some jurisdictions have held that even if the general contractor has a contractual right to set-off, the Surety may not. As a result, in those jurisdictions, notwithstanding the contractor's contractual right of set-off, the subcontractor may be entitled to recover the full amount on Project B (from our scenario above) from the Surety without any deduction of the amounts the subcontractor owes on Project A. Given that the general contractor must almost always indemnify the Surety, such a result has the practical effect of eliminating the contractual benefit of a right of set-off. Additionally, in certain circumstances, by the discretion afforded to judges under the rules of civil procedure, courts have required the two competing claims to be handled by separate lawsuits independently and without regard to the general contractor's claim of set-off. This article discusses these scenarios and others that impact the right of set-off.

Projects Protected by Payment Bonds

Basic surety law holds that a surety assumes only the liability of its principal and generally has the same defenses against a subcontractor suing on a payment bond as the principal/ general contractor. So, it would seem that if a general contractor has a contractual right of set-off against amounts otherwise owed to a subcontractor on a bonded project, the surety's liability to the subcontractor on that bonded project should be reduced by the amount of the set-off. However, a federal district court in Virginia disagreed when addressing that situation on a federal project on which a federal Miller Act payment bond was issued. In *U.S. ex. rel. Acoustical Concepts, Inc. v. Travelers Casualty and Surety Company of America*, 635 F. S. 2nd 434 (E.D. Va. 2009), the court held that general principals of suretyship law that conflict with the Miller's Act's terms and purposes (i.e. ensuring that subcontractors are paid promptly for labor, materials and services furnished on federal construction projects) must give way to the Act.

In *Acoustical Concepts*, a subcontractor sued the surety on a Miller Act payment bond to recover amounts due on a federal project. The general contractor (the principal on the bond) had a claim against the same subcontractor on an unrelated non-federal private project. Accordingly, the general contractor and its surety set-off those claims against the amounts otherwise due on the federal project. In doing so, the general contractor and surety relied upon a provision in the subcontract on the federal project that expressly stated that the general contractor had the right to do so. Specifically, the contract provision stated:

Before paying any amount due to the Subcontractor as provided hereinabove, the Contractor is hereby authorized to deduct therefrom and offset an amount equal to any and all sums or obligations owing by the Subcontractor to the Contractor and ... any and all claims liquidated or unliquidated, by the Contractor against the Subcontractor, arising hereunder, under any other contract or agreement between the Subcontractor and the Contractor....

Again, the court rejected the surety and general contractor's argument, based in part on its determination that neither the Miller Act nor the subject payment bond made any reference to the contractual set-off provision or its effect. The court reasoned as follows:

Were defendants [general contractor and Surety] allowed to interpose a setoff defense involving facts and circumstances relating to a non-federal project, plaintiff subcontractor would be forced to litigate with defendant sureties a dispute that plaintiff has with its general contractor that is nowhere a part of the payment bond or the Miller Act. The result can only be the kind of delay and complexity the Miller Act was designed to avoid. By contrast, preventing sureties from asserting a setoff defense leads to the sensible result - contemplated by the Miller Act - that a subcontractor [on a federal construction project] receives timely payment for providing labor and materials to [that project]. Defendant sureties may then seek to recover from [its principal] the full amount paid to plaintiff [subcontractor], and [the general contractor/principal] may then litigate the unrelated, non-federal dispute with plaintiff. In other words, the result reached here maintains a sharp division between the Miller Act's remedy for subcontractors on federal construction projects and disputes between subcontractors and prime contractors arising from non-federal construction projects that are not governed by the Miller Act.

The argument can be raised that courts would apply this same reasoning in cases involving the states' various Little Miller Acts on non-federal public projects or with respect to projects protected by statutory private payment bonds.

State "Trust Fund" Statutes

Several states have enacted statutes that hold that money received by the general contractor from the owner for the labor, materials, and services provided by subcontractors and suppliers (and lower-tiered subcontractors and suppliers) are held by the general contractor in trust for their benefit. The purpose of such legislation is to ensure that the subcontractors and suppliers that actually provide the work get paid. They may also potentially result in the frustration of the general contractor's right of set-off.

The New York Lien Law, Article 3A §§70-79 is an example of a state trust fund statute. Section §70, states as follows:

The funds ... received by a contractor under or in connection with a contract for an improvement of real property, or home improvement, or a contract for a public improvement in this state ... shall constitute assets of a trust.... (Emphasis added.)

The New York Lien Law then outlines a statutory cause of action to enforce such a trust.

This statute was addressed in the New York federal case of Universal Maintenance, Inc. v. Amherst Painting, Inc. 1997 WL 160157 (W.D.N.Y.). In that case, the subcontractor sued the general contractor for amounts due on Project A - amounts that the general contractor had already received from the owner for the work performed by the subcontractor. The subcontractor argued that the funds received by the general contractor were held in trust pursuant to the New York Lien Law. The general contractor filed a counterclaim and raised as a defense that it had a right of set-off for back-charges arising from that same Project A, as well as, a back-charge arising from an unrelated subcontract on Project B. The court ruled that the general contractor indeed had a right of set-off as it related to the back-charges arising from the same Project A, holding: "the relief available in a Lien Law trust action encompasses the contractor's right as trustee to offset against the trust fund amounts sums due from the subcontractor to the contractor with respect to the project." Id. at 7 (Emphasis added). However, the court struck the general contractor's counterclaim and defense of setoff for back-charges arising from the unrelated Project B, holding as follows: "The policy reasons for allowing the contractor to set off sums due from the subcontractor apply only to claims for sums due with respect to the project in question, not unrelated projects." The court reasoned that a set-off claim arising from the unrelated Project B was not a compulsory counterclaim (i.e. one that must be brought in the same lawsuit pursuant to the rules of civil procedure) and can be pursued in another forum.

New Jersey has a similar trust fund statute which applies to public projects ("The New Jersey Trust Fund Act") which states as follows:

All money paid by the State of New Jersey ... or by any county, municipality or school district in the state, to any person pursuant to the provisions of any contract for any public improvement ... shall constitute a trust fund in the hands of such person as such contractor, until all claims for labor, materials and other charges incurred in connection with the performance of such contract shall have been fully paid.

N.J.S.A. §2A:44-148.

The federal district court of New Jersey addressed that statute in the context of this article's two-project set-off scenario in a March 27, 2008 opinion and order granting a motion for partial summary judgment filed by the subcontractor in Atlantic City Associates, LLC v. Carter & Burgess Consultants, Inc. Civil Action No.: 05-3227. In that case, we again have the scenario of the general contractor having a back-charge claim against the subcontractor on Project A and, as a result, claiming a right of set-off against amounts the general contractor otherwise owes to the subcontractor on Project B. Also, the general contractor was paid in full by the public owner for the work performed by the subcontractor on Project B. Further, the following contractual provision was contained in the governing subcontracts that expressly granted the general contractor this right of set-off on unrelated projects:

The Subcontractor agrees ... that Contractor shall have the right to set off against any moneys due Subcontractor under this Subcontract any claim or claims against Subcontractor, whether arising under this Subcontract, or any other Subcontract or Subcontracts between the parties hereto.

Notwithstanding an express contractual right to do so, the federal district court rejected the general contractor's

claim to a right of set-off on unrelated projects as a matter of law. The court reasoned, in part, as follows: "The Trust Fund Act provides that '... the funds in the hands of the prime contractor constitute a trust fund to inhibit their diversion for purposes unconnected with the public project.'"

In an attempt to circumvent The New Jersey Trust Fund Act, the general contractor argued that the above-cited contractual right to set-off on unrelated projects constituted a waiver by the subcontractor of any rights otherwise bestowed by the Act. However, the court rejected that argument stating that the contract language was not "clear and unmistakable" evidence of the subcontractor's knowing waiver of its statutory rights, in part because the contractual provision did not reference the statutes. It should be noted, however, that the case holding suggests that, with more specific waiver language, a subcontractor can waive such statutory rights.

Set-off as a Felony Crime?

It would be difficult to be more severe than Florida which makes the misapplication of construction funds a statutory felony. Florida Statute §713.345(1)(a) states as follows:

(1)(a) A person, firm, or corporation, or an agent, officer, or employee thereof, who receives any payment on account of improving real property must apply such portion of any payment to the payment of all amounts then due and owing for services and labor which were performed on, or materials which were furnished for, such improvement prior to receipt of the payment. This paragraph does not prevent any person from withholding any payment, or any part of a payment, in accordance with the terms of a contract for services, labor, or materials, or pursuant to a bona fide dispute regarding the amount due, if any, for such services, labor, or materials.

(b) Any person who knowingly and intentionally fails to comply with paragraph (a) is guilty of misapplication of construction funds, punishable as follows: 1. If the amount of payments misapplied has an aggregate value of \$100,000 or more, the violator is guilty of a felony of the first degree, punishable as provided in s. 775.082 [i.e. by a term of imprisonment not exceeding 30 years].

This provision arguably limits a general contractor's right to withhold payment for a back-charge (i.e. a bona fide dispute regarding the amount due) to only the project on which that back-charge arose. This is because the statute limits bona fide disputes to "disputes regarding the amount due, if any, for such services, labor, or materials". A strong argument can be made that this language could be interpreted to mean "such" services, labor, or materials provided on that project only. If so, there would not be any right to set-off on unrelated projects if the contractor has received payment for the work by the subcontractor on the unrelated project on which the subcontractor performed satisfactorily; it would be criminal to withhold such payment because of a claim on an unrelated project. A general contractor could try to argue otherwise, but at the risk of committing a statutory felony crime punishable by jail time.

Rules of Civil Procedure - Court's Discretion to Require Separate Trials

The rules of civil procedure might also assist a subcontractor to avoid a general contractor's right of set-off on unrelated projects. If the subcontractor sues a general contractor for amounts owed on a project, and the general contractor has a back-charge arising from that same project, the general contractor must assert the back-charge through a counterclaim in that same lawsuit; it is deemed a compulsory counterclaim. However, the same is not true for a back-charge arising from a separate contract. In such instances, the general contractor's counterclaim is deemed a permissive counterclaim. It is within the court's discretion whether a permissive counterclaim is to be addressed in the same lawsuit or separately.

This scenario was addressed in *Turner Construction Co. v. E&F Contractors, Inc.*, 939 So. 2d 1108 (Fla. 3rd DCA 2006). In that case, the general contractor conceded that the subcontractor was due the amounts sought, *but for* the general contractor's claim to a right of set-off for back-charges arising from three other unrelated projects. Importantly, the subcontractor had filed four separate lawsuits - one for each of the projects. In the lawsuit at hand, the general contractor claimed that its back-charges on the other three projects exceeded the amount that the subcontractor was owed on the subject project. Accordingly, the general contractor filed a counterclaim and affirmative defense in the subject lawsuit, asserting a claim of set-off arising from its back-charges on the other projects.

The trial court struck the general contractor's defense of set-off and entered a final summary judgment in favor of the subcontractor. The appellate court affirmed that decision holding as follows:

The affirmative defense of set-off in the instant case is in the nature of a permissive counterclaim, and is the subject of other pending suits between the parties.... It is within a trial judge's discretion to sever a permissive counterclaim from the main claim if there is no evidence of prejudice.... Here, the trial court's order does not prejudice [the general contractor] because [the general contractor] still has the opportunity to fully litigate its set-off claims in the pending lawsuits arising out of its other subcontracts with [the subcontractor].... Furthermore, the trial court's order striking the set-off claim promotes the interests of judicial economy, and avoids the potential of inconsistent rulings.

Based upon the results of this case, legal counsel for subcontractors facing this scenario may want to consider filing separate lawsuits. The lawsuit concerning the project on which the back-charge arose may take years to litigate given the likelihood of numerous contested factual issues that must be investigated through discovery. Conversely,

the lawsuit concerning the project on which the amount due is undisputed (but for the set-off claim arising from the other project) could be won through summary judgment much sooner. The subcontractor might be able to collect quickly on the undisputed project, allowing it to build its legal war chest to fight the battle on the disputed project.

Conclusion

While it may seem absurd to require Party A to pay Party B when Party B owes Party A, the courts may nonetheless require it depending upon which states' law governs, whether the job is bonded, or other circumstances. Accordingly, when there are set-off claims arising from separate and unrelated projects, it is strongly recommended that parties consult and retain local counsel.

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