OPINION OF LORD DRUMMOND YOUNG, Outer House, Court of Session. 12th November 2004.

[1] On 2 January 2002 the parties entered into a Consortium Agreement. Under that agreement they associated themselves as a consortium for the purpose of tendering for and, if successful, completing the design, construction and commissioning of Newton Stewart Waste Water Treatment Works on behalf of West of Scotland Water (subsequently Scottish Water). The tender itself was made by the defenders, and was successful. The resulting contract with West of Scotland Water was accordingly in the defenders' name. So far as West of Scotland Water were concerned, therefore, the pursuers were in the position of a subcontractor. The relations between the pursuers and the defenders were governed by the Consortium Agreement, under which the defenders acted as lead contractor. Article 3.1 provided that the defenders as lead contractor should represent the interests of the Consortium in all dealings with West of Scotland Water. Article 6.1 provided that fulfilment of the obligations and responsibilities imposed upon the lead contractor under the contract with West of Scotland Water should be shared between the parties, each party's share being referred to as its Project Part. Article 6.2 then stated as follows: *"Each Party is fully responsible for the satisfactory performance of all obligations relating to the Project Parts undertaken by it as detailed in Appendix 1, and accordingly bears all commercial, technical and other risks arising therefrom or connected therewith and with any variations called for by the Engineer which may affect that Project Part, and in the manner and subject to the limits established in Article 8 hereof shall indemnify the other Party against the consequences of a failure to so perform such obligations".*

Appendix 1 provided in paragraph 1.1 that the defenders were to be responsible for the design, procurement, temporary works, construction and testing of all civil engineering, building works and landscaping elements of the contract. Paragraph 1.2 provided that the pursuers were to be responsible for the design, procurement, installation, testing and commissioning of all mechanical engineering, electrical engineering, instrumentation, control and automation elements of the contract. Paragraph 2.12 of Appendix 1 dealt with the consequences of design changes made by the pursuers to their Project Part. In short, the defenders were to include for "detailed" changes, which meant essentially minor changes. Otherwise, that paragraph provided that the cost of alterations or changes to elements of the civil engineering and building works caused by error or omission in information provided by the pursuers would be reimbursed to the defenders by the pursuers at demonstrable costs with no profit. Thus the overall contractual scheme was that the defenders alone were in a contractual relationship with the employer, West of Scotland Water. As between the parties, however, each was responsible for its own Project Part, and certain obligations of indemnity arose where the pursuers' Project Part had implications for the defenders' part of the works.

[2] Thereafter the parties undertook the design, construction and commissioning of the works. As work proceeded sums were certified as due under the construction contract and were duly paid to the defenders by West of Scotland Water. The obligations of the defenders as lead contractor in relation to such payments are set out in articles 4 and 7 of the Consortium Agreement. Article 4.2 provided as follows: *"Following the award of the Contract, the duties of the Leader shall comprise the following activities: ...*

f. arranging for the payment of funds payable to the Lead Contractor and for disbursing these monies to the Parties in accordance with the [Consortium] Agreement".

Article 7 of the Consortium Agreement dealt with management of the Consortium. Article 7.2.6 provided as follows: *"The Project Manager [nominated by the Lead Contractor] shall be responsible for the following functions...: ...*

g. Consolidating the payment requests of the Parties into a combined payment request for submission to the Engineer in accordance with Article 14 hereof. The Lead Contractor will pay any monies due to the other party within 5 days of receipt of monies under the Contract in accordance with the allocation of project parts established by the Project Manager".

Article 14 was not in fact included in the parties' contract. Nevertheless, the second sentence of article 7.2.6 g imposes a clear obligation on the defenders as lead contractor to make prompt payment of monies due to the pursuers following payment by West of Scotland Water.

[3] The parties are in agreement that the value of the pursuers' work to date, as certified by West of Scotland Water, is £1,371,389.41, and that of that sum the defenders have disbursed £985,795.40 to the pursuers. The pursuers aver that the defenders are accordingly withholding £385,594.01 from them. The defenders accept that they have withheld payments of that amount. They assert, however, that they are entitled to withhold such payments, both in terms of the contract and by exercising the common-law power of retention in a mutual contract. In their defences, they aver that the pursuers' designs for various parts of the works were defective, or required to be changed during construction. As a result the defenders claim to have incurred substantial loss through having to construct additional works or through having to alter the designs for their own part of the works. The alleged defects in the pursuers' design of the works are set out in some detail. They may be summarized as follows. First, it is said that the pursuers changed the design of the their Project Part within the administration building by adding an additional motor control cubicle panel and by altering the cabling in such a way that it went through the floor slab rather than the top of the building. As a result it is said that the size of the building had to be substantially increased and the floor slab required to be materially altered. That had implications for the defenders' Project Part, and put them to additional expense. The cost of the relevant changes is alleged to be £43,262 and £28,817 respectively. Secondly, it is said that the pursuers' original design of the inlet pump station was defective as a result of errors in calculating the hydraulic gradient of the plant. As a result the design of the inlet pump station itself required to be altered, first through the removal of a balancing tank and secondly through detailed design changes. The cost of the relevant changes is alleged to be £80,853 and £149,442 respectively. Thirdly, it is said that the pursuers' original design of their Project Part provided for a motor control cubicle to be installed in an existing building. During construction this was changed, and a new enclosure had to be constructed for the motor control cubicle. That meant that the defenders required to construct a reinforced concrete slab for the enclosure, putting them to additional expense. That expense is said to amount to £18,874. Fourthly, it is said that the pursuers' original design of their Project Part provided for a particular design of the final settling tanks. That design, it is said, was defective owing to errors in the hydraulic gradient, which meant that the tanks required to be deeper than had originally been provided. The design was changed during construction, and the changes put the defenders to additional expense. Their resulting loss is said to amount to £11,831. Fifthly, it is said that as a result of the defects in the pursuers' original design of their Project Part the defenders required to spend additional time on site and to incur additional supervision and overheads costs. Their resulting loss is estimated at £50,000. The total loss that the defenders claim to have suffered a result of design changes by the pursuers is £383,079. Their counsel indicated that their claim for that sum was based, at least in part, on paragraph 2.12 of Appendix 1 to the Consortium Agreement.

[4] Against that background the pursuers have raised the present action. They conclude first for declarator that the defenders are not entitled to withhold payment of or retain the sum of £385,594.01 from the pursuers, that sum having been received by the defenders in respect of work certified as carried out by the pursuers. Secondly, the pursuers conclude for an order under section 47(2) of the Court of Session Act 1988 for payment by the defenders of the sum of £385,594.01, with interest at the judicial rate. A motion for such an order under section 47(2) came before me. Counsel for the pursuers submitted that the pursuers were entitled to payment of a certified sum under the parties' contractual arrangements. The defenders had received payment from Scottish Water of the balance certified as due to the pursuers, but were not observing their duty under article 7.2.6g of the Consortium Agreement to disburse those monies. Counsel submitted that the scheme of the Consortium Agreement was that all such monies should be paid expeditiously to the pursuers. Moreover, the provisions of the Consortium Agreement, in particular clause 7.2.6, were inconsistent with any common-law right of retention. He made reference to my decision in ***VA Tech Wabag UK Ltd.*** **v** ***Morgan Est (Scotland) Ltd.,*** 2002 SLT 1290, in which I granted an order under section 47(2).

[5] Counsel for the defenders submitted that article 7.2.6g imposed an obligation on the defenders to pay "any monies due" to the pursuers. The critical question was accordingly whether any sum was in fact due by the defenders. Article 6.2 imposed responsibility on each of the parties for its own Project Part. The pursuers were in breach of that provision, in that the performance of their Project Part had been

defective in the manner averred by the defenders, as summarized in paragraph [3] above. As a result loss had been caused to the defenders, and the defenders were entitled to recover the amount of that loss from the pursuers. On that basis, no sum was currently due to the pursuers, for two reasons. First, the scheme of the Consortium Agreement was such that only the net balance would be due by the defenders to the pursuers, after offsetting any sum due by the pursuers to the defenders in respect of the defective performance of the pursuers' Project Part. Counsel relied in particular on article 6.2 and paragraph 2.12 of Appendix 1 in advancing this contention. Secondly, counsel submitted that the right of retention at common law applied to the parties' contract. On that basis, he argued, the defenders were entitled to withhold payment of any sum due to the pursuers until such time as it could be set off against the payment of compensation due by the pursuers to the defenders. Counsel referred to ***Scottish Power Generation Ltd.*** **v** ***British Energy Generation (UK) Ltd,*** 2002 SC 517, as indicating the general principles to be followed by the court in an application under section 47(2). Counsel submitted that the decision in ***VA Tech Wabag UK Ltd.*** **v** ***Morgan Est (Scotland) Ltd,*** *supra,* should be distinguished; the contractual provisions under consideration there, although related to those in the present case, contained an additional clause, article 14.1, which provided that the only adjustments to be made to sums due as between the parties were to be those provided for in their agreement. That prevented the parties from relying on any defences available at common law, and in particular from relying on the common-law principle of retention.

[6] Section 47(2) is in the following terms: *"In any cause in dependence before the Court, the Court may, on the motion of any party to the cause, make such order regarding the interim possession of any property to which the cause relates, or regarding the subject matter of the cause, as the Court may think fit".*

It is not in dispute that the order sought by the pursuers, which is for a payment due under a contract, related to the subject matter of the cause. The general approach to section 47(2) is set out in the cases referred to by counsel, ***Scottish Power Generation Ltd*** **v** ***British Energy Generation (UK) Ltd*** and ***VA Tech Wabag UK Ltd*** **v** ***Morgan Est (Scotland) Ltd.*** First, the party who seeks the order must make out a prima facie case, and in particular must make out a prima facie case for the existence of the obligation that he seeks to enforce. Secondly, the balance of convenience must favour the making of such an order. In this connection, three matters are likely to be relevant. The first is the respective strengths of the cases put forward by the parties. The second is the likelihood that harm may be suffered by either party as a result of the granting or refusal of the order. The third, in a case involving enforcement of a contract, is the need to maintain the integrity of the parties' contractual arrangements; in effect, the contractual status quo must be maintained.

[7] In the present case I consider that the pursuers have stated a clear prima facie case for an order under section 47(2). They claim payment of a sum that has been certified as due under the construction contract with Scottish Water. It is not disputed by the defenders that the sum claimed has been duly certified. Moreover, it is clear from the terms of the Consortium Agreement, in particular articles 4.2f and 7.2.6g, that the defenders are obliged to secure the payment of sums due to the pursuers. Article 4.2f obliges them to disburse funds payable to the pursuers, and article 7.2.6g obliges them to pay any monies due to the pursuers within five days of receipt. That gives the pursuers a clear right to payment. The response by the defenders, however, is that they are entitled to withhold payment of the sum that would otherwise be due to the pursuers in consequence of claims that they have against the pursuers. If that is correct, it would give the defenders a valid reason for asserting that no sum was presently due to the pursuers. In these circumstances it is necessary to consider whether the balance of convenience favours the making of an order under section 47(2).

[8] The first issue that is relevant is the strengths of the parties' respective cases. The pursuers' case is quite straightforward: sums have been certified as due to them, and the defenders are obliged to make payment of those sums by virtue of articles 4.2f and 7.2.6g of the Consortium Agreement. It must be noted, however, that the latter provision applies to any monies that are "due to the other party". In view of the general structure of the payment provisions in the Consortium Agreement, it seems clear that that refers to monies due by the defenders as lead contractor. The defenders' response is that the sum claimed by the pursuers is not due because the pursuers are in breach of provisions of the

Consortium Agreement; the result of those breaches is that the defenders have financial claims against the pursuers. I am satisfied that the defenders' averments on this matter, which are summarized in paragraph [3], are sufficient to disclose a relevant claim against the pursuers. The alleged instances of defective performance are particularized, and enough is said to indicate the nature of the claim that is being made. Thereafter the defenders' argument proceeded on two alternative bases. First, it was said that the scheme of the Consortium Agreement, as disclosed in particular by article 6.2 and paragraph 2.12 of Appendix 1, was that the sum due to the pursuers under article 7.2.6g was only the net balance after offsetting the defenders' claims against the pursuers for defective performance of the pursuers' Project Part. Secondly, the defenders argued that, because of their claims against the pursuers for defective performance of the pursuers' Project Part, the defenders were entitled to exercise a right of retention at common law over the monies due to the pursuers.

[9] I am not persuaded that the scheme of the Consortium Agreement, by itself, is sufficient to achieve the result that only a net balance is due under article 7.2.6g. The latter provision is very specific in requiring payment within five days of receipt of the monies. The obligations in article 6.2 and paragraph 2.12, however, are clearly distinct. They are not expressly related to the defenders' obligation to pay sums received to the pursuers, and they do not include any time limit. That is irrelevant, however, if the common law right of retention is applicable. The right of retention is a defence to a claim for enforcement of a contract, and arises if the party seeking enforcement is itself in material breach of contract. In such a case, the party who is not in breach of contract may withhold performance of its own contractual obligations until such time as the other party performs its obligations. The right of retention applies generally to mutual contracts containing interdependent obligations: see Gloag, Contract, 592-596 and 626-627; McBryde, The Law of Contracts in Scotland, 2nd edition, 20-62 - 20-67.

[10] Four features of the right of retention call for comment. First, the right only arises if the two obligations are themselves interdependent or, as is sometimes said, are the counterparts of each other: Gloag, Contract, 592-596. The presumption is that every stipulation on one side of a mutual contract is the counterpart of every stipulation on the other side: *ibid*. at 595-596. Nevertheless, in some cases a contractual provision incumbent on one party may appear to be independent of the other party's obligations, and in that event a failure to perform the obligation will not prevent enforcement of other obligations under the contract: *ibid*. at 593-595. Secondly, the right only arises when one party is in material breach of contract: see ***Turnbull* v *McLean & Co***, 1874, 1 R 730 at 738 per LJC Moncreiff. Thirdly, the function of the right is to provide a party to a contract with a form of security for performance by the other party of its outstanding obligations: see Gloag, *op. cit.*, 626-627. The question of whether a breach is material must in my opinion be determined in the light of that function. Thus if the breach threatens the future performance of the contract, as with a straightforward refusal to perform, it will normally be material for the purposes of the right of retention. Likewise, if the breach is of such a nature that it threatens to deprive the innocent party of a substantial part of the benefits of the contract, it will normally be material for the purposes of retention. In this connection I think that a distinction should be drawn between breaches that consist of non-performance, a refusal or failure to perform, and breaches that consist of misperformance, or defective performance. Non-performance, at least if it relates to a substantial obligation, is obviously a threat to future performance. Misperformance, on the other hand, will not always threaten future performance. In some cases, the defects in performance may be capable of remedy, either directly, as by a process of snagging, or indirectly through the payment of compensation. In such cases the breach will not normally be material for the purposes of the right of retention. In other cases, however, the defects in one party's performance may be so great as to threaten to deprive the other party of the practical benefits of the contract. Where, for example, the cost of rectifying defects is said, on the basis of averments that appear to have a reasonable basis, to be large in relation to the total value of the contract, there is a significant risk that the innocent party will be deprived of a substantial part, at least, of the benefits of the contract. In such a case I think that the breach of contract can be considered material for the purposes of the right of retention. Fourthly, in spite of a suggestion to the contrary by Lord Benholme in ***Field & Allan* v *Gordon***, 1872, 11 M. 132, at 136, that the right of retention might not apply to

building contracts, it is now accepted that building contracts of all sorts are in no different a position from other contracts: McBryde, op.cit., 20-67.

[11] In the present case it was argued by counsel for the pursuers that the obligations relied on by the defenders, those in article 6.2 and paragraph 2.12 of Appendix 1, were distinct from the principal obligation relied on by the pursuers, that in article 7.2.6g, in that the latter obligation included a time limit whereas the former obligations did not. Counsel's argument did not, however, go so far as to suggest that the obligations in question were not mutually interdependent. In my view it could not have been argued that the relevant obligations were not the counterparts of each other. In the first place, it is presumed that all of the obligations on one side of a mutual contract are the counterparts of all of the obligations on the other, unless the contract indicates the contrary. In the second place, in the present case it is clear that the pursuers' obligations as to the performance of their Project Part and the defenders' obligations as to payment are fundamental to the contract; the basic contractual scheme is that the pursuers perform the works comprised in their Project Part and the defenders pay them for those works. It is obviously unlikely that stipulations of that nature will be independent of each other. The existence of a time limit in one obligation and its absence in another does not in my opinion preclude reliance upon the right of retention. As mentioned in the last paragraph, the basis of that right is to provide security for future performance, and the need for such security is not affected by the presence or absence of a time limit.

[12] The right of retention will only arise if the pursuers are in material breach of their contractual obligations, materiality being determined in the manner discussed in paragraph [9] above. In the present case, I am of opinion that the breaches of contract averred by the defenders are material for the purposes of the right of retention. The sum claimed in respect of those breaches is £385,594. The breaches alleged, which I have summarized at paragraph [3] above, are clearly substantial, on the assumption that they are made out. Individual sums are claimed in respect of each breach of contract that is alleged. I am unable to hold that the sums claimed by the defenders for the breaches of contract are unreasonable, either individually or collectively, and it was not in fact argued that any of those sums was unreasonable. The total sum claimed, £385,594, must be contrasted with the total amount that has been certified under the contract, £1,371,000, and with a price in the original order of £1,269,000; the amount claimed is thus approximately 28% of the amount certified. In my opinion the inability to retain a sum of that magnitude would clearly threaten to a substantial degree the benefit that the defenders might reasonably expect to obtain from the parties' contract.

[13] The result is that the defenders have pled a relevant defence of retention. The claims on which it is based, however, can only be established following proof. It is not possible at present for me to reach any view on whether they are well founded. In these circumstances I must, I think, conclude that the respective strengths of the parties' claims are equal; each has stated a claim that is prima facie relevant, and no reason has been advanced to support the view that either claim is improbable or manifestly ill founded.

[14] The next aspect of the balance of convenience is the possible harm that might result to either party as a result of the granting or refusal of a section 47(2) order. Once again, I am of opinion that this is a consideration that is equally balanced. If an order is refused the pursuers will fail to receive payment of monies that have been certified as due to them. That has obvious consequences for their cash flow, which is clearly a matter of considerable importance to almost any commercial concern. I should note in this connection that the provisions of Part II of the Housing Grants, Construction and Regeneration Act 1996 do not apply to the present contract as a result of section 105(2)(c) of the Act. If an order is granted, on the other hand, the defenders will lose the security for contractual performance provided by their right of retention. That too is a serious matter, because the security conferred by a right of retention is of practical commercial importance. That is especially so in a legal system such as Scots law where parties' contractual rights are normally wholly personal in nature, with nothing akin to the English equitable interest unless the relatively strict requirements of a trust are met. Thus retention is the main security for future performance of a contract. These considerations are sufficient in my

opinion to balance the pursuers' interest in maintaining cash flow, especially in view of the size of the sum retained in relation to the total sum due under the contract.

[15] That leaves the integrity of the parties' contractual arrangements. In my opinion this is the decisive consideration in the present case. The pursuers' claim is based primarily on article 7.2.6g of the Consortium Agreement, which relates to any monies that are ***"due to the other party".*** The defenders rely upon the common-law right of retention, which is a right implied into every mutual contract that contains interdependent obligations. The defence conferred by that right is applicable to every sort of contractual obligation, provided that the requirement of interdependence is met. As indicated in paragraph [11] above, I am of opinion that it is irrelevant that the obligation performance of which is withheld is subject to a time limit. The critical point of the defence is that performance can be withheld by one side until the other side performs its obligations, regardless of any time limits in the contract. In effect, the defence involves the suspension of the innocent party's contractual obligations, and that must supersede any time limit. It follows in my opinion that the integrity of the parties' contractual arrangements requires that the right of retention should prevail over any obligation to pay. For that reason I consider that the pursuers' motion for payment under section 47(2) must be refused.

[16] ***VA Tech Wabag UK Ltd*** **v** ***Morgan Est (Scotland) Ltd*** must in my opinion be distinguished on its facts from the present case. While the contract in issue in that case bore certain similarities to the present contract, it was different in two important respects. The first such difference was that the contract contained one critical additional clause, article 14.1. This was in the following terms: *"All monies held by the construction consortium... shall be treated as, and are hereby declared to be, funds held in trust for the benefit of the Parties. Monies received as payments under the Contract... shall be promptly distributed to the Parties, subject only to such adjustments as are provided for in this Agreement".*

Two important points emerge from this clause. First, the parties in that case had opened and maintained a joint bank account to hold monies paid by the employer to the consortium. Monies were disbursed to the parties from that account. In these circumstances the trust referred to in the first sentence of article 14.1 might well have been effective, in that a separate account had been constituted to hold the monies in question. Even if that is not correct, it is clear that a segregated fund had been set up, and that the monies held in that fund were to be used for the specific purpose of making distributions to the parties. In these circumstances neither party could assert a right of retention over the monies paid into the joint bank account, because those monies were held either on trust or for special purposes, and that is normally inconsistent with the exercise of a right of retention. In the event, it was not argued in that case that the defenders were entitled to assert a right of retention. Secondly, the second sentence of article 14.1 provided that monies were to be distributed to the parties subject only to "such adjustments as are provided for in this Agreement". The main argument in the case centred upon this provision: see paragraphs [14]-[18]. The defenders argued that the expression "adjustments" was wide enough to cover sums due by one party to the consortium to the other party. It was held, however, that the expression was only apt to cover variations in the contract price payable by the employer, and did not extend to sums due by one consortium party to the other. Thus the terms of the contract itself were inconsistent with any right of retention based on sums due by one party to the contract to the other. In the present case, by contrast, there is nothing similar to article 14.1, and no trust or segregated fund has been set up to hold monies received from the employer. In these circumstances there is nothing to exclude the normal application of the common-law right of retention.

[17] The second crucial difference between ***VA Tech Wabag*** and the present case is that the general scheme of the contractual arrangements between the consortium and the employer is different in each case. *In* ***VA Tech Wabag*** the construction contract with the employer was entered into on the contractor's side by both parties to the consortium. Thus the payments received under that contract were, in effect, for their joint benefit, although they were apportioned according to the parties' project parts. The mechanisms set up under article 14.1 were obviously designed to reflect the contractual arrangements with the employer. In the present case, on the other hand, the construction contract was concluded on the contractor's side solely by the defenders (see paragraph [1] above). Consequently the relationship

between the defenders and the pursuers is akin to that between a main contractor and a subcontractor. Thus the payments received by the defenders under their contract with West of Scotland Water were received on their own account, and the obligations incumbent on the defenders under articles 4.2f and 7.2.6g are simple obligations to make payment to the pursuers. In ***VA Tech Wabag***, by contrast, the obligation on the defenders was to distribute monies that had been received for behoof of both parties. Thus the obligations relied on by the pursuers in each of the two cases are distinct in nature. Before I leave ***VA Tech Wabag***, I should mention one statement in the case that I do not now think is correct. At page 1296H I stated that, in an application under section 47(2), payment of a liquid debt that has fallen due should generally be enforced without regard to any illiquid claims or rights of retention or set off or counterclaim based on illiquid claims that may be asserted to resist such payment. I now think that that is too widely expressed, and should not apply to rights of retention. The critical point about a right of retention is that it is based on the mutuality of contractual obligations, and is thus an essential part of the contract that the pursuer seeks to enforce. Any right of the pursuer to enforce the contract must accordingly be subject to that right of retention. For this purpose I do not think that it matters that the sum claimed by the pursuer is a liquid debt, whereas the claim by the defender on which retention is based is illiquid in nature. It is clearly established that the right of retention can be based on an illiquid claim: Gloag, op. cit., 623-627; McBryde, op. cit., 20-64. It should not make any difference to this rule that the pursuer is seeking enforcement of a debt by means of an order under section 47(2); that subsection is procedural in nature, and should not affect the parties' substantive rights.

[18] For the foregoing reasons I will refuse the pursuers' motion for an order for payment in terms of section 47(2).

Act: Davidson, Q.C.; MacRoberts
Alt: Stewart; Shepherd & Wedderburn