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ADJUDICATION AND INSOLVENCY SET OFF: COMPATIBLE? IT'S A YES FROM THE SUPREME COURT

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SUMMARY

For some time we have been following with interest the case of Bresco Electrical Services Ltd (in liquidation) v Michael J Lonsdale (Electrical) Ltd as it progresses through the courts. Why? Because this concerns an important question which comes up time and time again: are the regimes of construction adjudication and insolvency set off compatible?

No, said Fraser J at first instance although he left the door a little ajar. Yes, but only in exceptional circumstances said Coulson LJ in the Court of Appeal. And now we have the final unanimous answer from the Supreme Court in Bresco Electrical Services Ltd (in liquidation) v Michael J Lonsdale (Electrical) Ltd– it's a definite and resounding yes.

Here, we take a look at Supreme Court judgment in more detail.

The facts – a quick recap

Bresco and Lonsdale were electrical contractors and in 2014 Lonsdale engaged Bresco to carry out some works. In 2016, Bresco went into insolvent liquidation. Both parties claimed they were owed money by the other. This culminated with Bresco's liquidator referring the dispute to adjudication.

First instance

Lonsdale objected to the adjudication arguing that the claim and cross-claim had cancelled each other out by the process of insolvency set-off. This meant there was no longer any claim, or any dispute under the contract, so adjudication was not available (the **jurisdiction point**). Lonsdale also claimed that the adjudicator's decision could not be enforced until the liquidator calculated the net balance. This meant the adjudication was pointless (the **futility point**).

At first instance, Fraser J granted an injunction preventing the adjudication. In a nutshell, the basis for this decision was that because the insolvency rules required an account of dealings between

the insolvent company and the relevant counterparty, such that the claims and cross-claims between the two would be merged into a single balance due in one direction, there was only one possible dispute remaining: being as to the net sum due to whichever party. The adjudicator had no jurisdiction to hear that dispute. All other specific claims under various contracts ceased to exist or, at least, be capable of separate enforcement.

Fraser J left the door ajar for parties to resolve their disputes of principle, but made clear that a liquidator could not use the statutory right to adjudication to obtain a financial decision in their favour.

We commented at the time that while this decision was legally unsurprising, it simply did not chime with the practice of liquidators regularly referring disputes to adjudication.

Bresco appealed.

Court of Appeal

In the Court of Appeal, Coulson LJ disagreed with Fraser J. He held that the adjudicator **did have** jurisdiction to consider the claim (the **jurisdiction point**). However, he upheld the first instance decision on the grounds that while a party who was in insolvent liquidation could commence an adjudication, to do so would generally be "an exercise in futility" since in the majority of cases, it would be unsuccessful if it applied to the court to enforce that decision by means of a summary judgment application (the **futility point**).

The court acknowledged the incompatibility of the two regimes and Coulson LJ rejected the view that the liquidator might find the adjudicator's decision helpful in terms of assessing the net balance, as required by the insolvency rules.

Bresco appealed to the Supreme Court and Lonsdale cross appealed on the jurisdiction point.

Supreme Court

With Briggs LJ giving the leading judgment, the Supreme Court was unanimous in its agreement with the Court of Appeal that the adjudicator did have jurisdiction to hear the dispute (the **jurisdiction point**) however, it disagreed that the adjudication and the insolvency rules were incompatible (the **futility point**).

Key points include:

- The insolvency set-off between the parties' claims does not mean that there is no longer a dispute under the construction contract or that the claims have melted away (and so are incapable of adjudication).

- The claims maintain their separate identity for many purposes. For example, a future or contingent claim may survive set-off and so be enforceable after the debt becomes due.
- The existence of insolvency set-off does not deprive the owner of the original claim of ancillary rights under the transaction which created it. Despite insolvency set-off, Bresco could have brought court proceedings to determine the value of its claim, or exercised a contractual right to go to arbitration. It follows that Bresco could also refer its claim to adjudication.
- Bresco had both a statutory and a contractual right to pursue adjudication, even though the dispute related to a claim affected by insolvency set-off. It would ordinarily be entirely inappropriate for the court to interfere with the exercise of that statutory and contractual right. Only in very exceptional circumstances would injunctive relief be appropriate to prevent the enforcement of those rights.
- Adjudication was designed to be a method of alternative dispute resolution in its own right and is not incompatible with the insolvency process. Where disputed cross-claims under a construction contract need to be resolved before a final arithmetical set-off, an adjudicator will be better placed than most liquidators to resolve them.
- On the question of futility, the Supreme Court accepted the possibility that the courts would not grant summary enforcement of an adjudicator's decision due to the insolvency process, but did not accept that this deprived adjudication of its potential usefulness to liquidators. The Supreme Court found that it is simply wrong to suggest that the only purpose of construction adjudication is to enable a party to obtain summary enforcement of a right to interim payment for the protection of its cash flow, although that is one important purpose.
- The Supreme Court considered that adjudication could be very useful to liquidators, given its features of speed, simplicity, proportionality and economy, with the added advantage of resolution by a professional construction expert. Therefore, even if a decision could not be enforced, the adjudication would not be an exercise in futility.
- An adjudicator will need to have regard to cross-claims which arise wholly outside the construction contract, and may need to simply make a declaration as to the value of the claim referred, leaving the unrelated cross-claim to be resolved by some other means. It will be interesting to see how responding parties rely on this as a defence to adjudication claims which seek an order for payment.
- In some cases, summary enforcement may be appropriate but, in any event, the proper answer to issues about enforcement is that they can be dealt with at the enforcement stage, if there is one.

Final thoughts

For those of us with a keen interest in construction law, the Supreme Court decision is well worth a read in full. It sets out some clear guidance on the purpose of adjudication, describing it as “a mainstream method of ADR, leading to the speedy, cost effective and final resolution of most of the many disputes that a referred to adjudication”.

I expect that the clear conclusion that a liquidator may commence adjudication on behalf of an insolvent company will be welcomed by insolvency practitioners..

Given the current economic climate, I expect that liquidators will take advantage of this clarity. However, the question of enforcement still remains and we may see a number of disputes about enforcement of such decisions in the TCC.

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