
Set Off

Notes on the impact upon
receivables financiers of the
law of solvent set-off

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s o l i c i t o r s

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Contents

1. Set Off.....	2
<i>What is It?</i>	2
<i>Does the Receivables Financier Like it?</i>	2
2. How Does it Work?	3
3. Set Off at Law.....	4
<i>When is it Available?</i>	4
4. Equitable Set Off.....	5
<i>When is it Available?</i>	5
<i>"Closely Connected"?</i>	6
5. Contractual Set Off	7
<i>When is it available?</i>	7
6. Contracting Out	8
7. Mutuality.....	10
8. Assignment.....	11
<i>Set-Off and Assignment</i>	11
9. Insulated Claims	12
<i>Freight</i>	12
<i>Negotiable Instruments and "the Cheque Rule"</i>	12
<i>Cancelled Direct Debit Mandates</i>	12
<i>"Construction Contracts" and the Housing Grants, Construction and Regeneration Act 1996</i>	12
10. Insolvent Set Off.....	14
<i>Importance?</i>	14
<i>Compared with Solvent set-off</i>	14
<i>Rule 4.90</i>	15
11. Abatement	16

Set Off

What is It?

Broadly, a monetary cross-claim adopted against a creditor's primary claim, and designed to defeat that primary claim by diminishing it or extinguishing it entirely by setting one against the other to arrive at a single account due from one party to another:

"It is difficult to give a comprehensive definition of set-off without reference to the various forms it can take, but on a general level it can be defined as the setting of money cross-claims against each other to produce a balance. It provides a defence to an action, although, depending on the form of set-off, the issue need not arise in that context. The essence of set-off, in this sense, is the existence of cross-demands¹"

The essentials for set-off to be available are:

- separate competing claims capable of being quantified in money;
- (usually) the claims must be "mutual";
- there must be a requirement for equity to be done between the competing claims

Does the Receivables Financier² Like it?

Yes and no. When dealing with the client, then invariably yes; the right to set off and create a consolidated account between mutual credits and debits to the account run between the client and the receivables financier has the benefit of ensuring that the receivables financier never pays out more to the client than any net credit balance standing to the account. When dealing with the client's customers, by contrast, the existence of cross-claims which diminish or extinguish the value of the assigned debts is one of, if not the, most common reason why the debt cannot be collected.

¹ Derham, **The Law of Set Off** (3rd ed. 2003, Oxford University Press) at pp1, para 1.01. Along with the massive (and now rather elderly) Wood, **English and International Set Off** (1989, Sweet & Maxwell), this probably contains the best analysis of the law.

² This term is used throughout to denote all those providing cashflow finance by way of an assignment of accounts receivable, including all forms of factoring and invoice discounting. Similarly, the term "client" denotes the party who discounts its receivables and "customer" is used to indicate the party by whom the debts are owed.

How Does it Work?

Wood³ in his book *English and International Set-Off* identified some seven types of set-off. There are three that interest us as regards dealings with the client's customer, namely:

- "Independent" or **Legal set off**
- "Transaction" or **Equitable set off**
- Set off "by Agreement" or **Contractual set off**

Whether any right of those rights of set off are available to the customer so as to defeat or diminish the receivables financier's claim to be paid the assigned debt depends on the facts from which, and the circumstances in which, the cross-claim arose. We must look, then, at each of the three types.

³ See footnote 1.

Set Off at Law

The terms "legal set-off", "statutory set off" and "independent set off" are all synonymous. A right to set off at law is rooted originally in the Statutes of Set-Off 1729 and 1735, when (unusually for lawyers) the common sense approach to reconciling cross-claims was reached by Acts of Parliament which expressly recognised the debtor's right to set-off a **mutual cross-claim** which is **due** from the Claimant at the date when he commenced proceedings.

When is it Available?

Legal set-off, as the alternative label "independent" set off suggests, is available to the defendant met with a claim for payment **regardless** of whether the claim and cross-claim are connected. This has obvious advantages for the customer as against the receivables financier, since he does not need to show that his cross-claim is linked to the debts pursued. However, certain conditions still need to be met:

- The claim must be for an **amount of money** or for a release based on non-payment of money;
- The claim must be for a liquidated debt;
- The claim to be set off must be **due** (but need not be **payable**) when the Claimant began proceedings, or (more probably) the debt to be deployed as a defence must be due when the customer files their defence;
- The claim and the cross-claim must be **mutual**;
- As against the receivables financier, there is the additional qualification that the cross-claim must be due (but need not be payable) prior to the customer receiving **notice of the assignment**.

Equitable Set Off

An equitable or “transaction” set off is a much more common form of defence for a customer to raise when pressed for payment by a receivables financier. It is permitted as a form of defence where there has been a breach of contract by the client which leads to a cross-claim which is so “inextricably bound up” with the debt otherwise owed that it would be “inequitable” for the Court to order the customer to pay the assigned debt without taking into account his cross-claim. It is often said that the cross-claim must “impeach the title to the debt” against which it is to be set.

Its roots go back to when there were separate Courts of Law and Equity. The Courts of Common Law would not recognise a cross-claim which did not fulfil the requirements of a legal set off (see above) and would order the debtor to pay and separately sue for on his cross-claim. The Courts of Equity, being more liberal (and possessing a good deal more common sense), *would* recognise the right to set the cross-claim against the debt owed at law. The situation developed where the customer, compelled to pay by the Common Law Courts, would obtain an injunction in Chancery (the courts of equity) pending the determination of his cross-claim. When the two legal systems were merged in the late 19th Century, the right to an equitable set off was recognised as a valid defence in all Courts, and lawyers everywhere lost out on a set of fees for evermore. Whilst the Courts’ systems were merged, the laws themselves (common law and equity) were not; hence the retention of the label “equitable set off”.

When is it Available?

The receivables financier faces this kind of cross-claim much more frequently for the following reasons:

- There is **no requirement for the cross-claim to be liquidated or due at any particular time**. A customer can thus raise all manner of cross-claims even if they do not come into being until **after** the notice of assignment is received and **after** the proceedings have been served (indeed, they can even be raised after he files his Defence, provided of course that he obtains permission to amend it); **but**
- **The following hurdles** still need to be overcome by the customer before he can rely on an equitable set off:
- The cross-claim must be **closely connected** with the primary claim so that it would be **inequitable** for the receivables financier to obtain judgment on the assigned debt without giving recognition to the cross-claim;
- The cross-claim must be **for an amount of money**. Although it need not be liquidated, it must be capable of being calculated with some degree of precision. For example, a claim to rescind a contract for misrepresentation cannot be set off against a claim for the money otherwise due under it; and

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- (Usually) the claim and cross-claim must be **mutual**, that is, they must be owed as between the same parties (or their assigns) in respect of the same rights.

"Closely Connected"?

This area of the law is in flux. The decision in *Esso Petroleum Co Limited -v- Milton* [1997] 1 WLR 938 is illuminating, and decided to the benefit of the receivables financier; the Court of Appeal refused to allow an equitable set-off of damages said to arise from a repudiation of an agreement against the price of deliveries made prior to the contract ending, since,

*"At the point when those deliveries were made, there was no cross-claim in existence and no loss yet suffered. No case has been cited to us in which payment of a debt presently due has been required to await the resolution of a cross-claim for future losses. The mere fact that both claim[s] arise out of a single trading relationship ... is ... wholly insufficient to supply the close link necessary to support an equitable set-off."*⁴

However, there are a raft of contradictory cases and there is no single application of the notion of "close connection". The question of whether the cross-claim is sufficiently closely connected is often a matter of impression. Like the elephant, the judiciary seem to often approach the criteria for deciding whether a debt is "closely connected" as being hard to describe, but they know it when they see it.

The easiest way to highlight the point is therefore by way of examples:

- Late delivery by the client leading to lost profit for the customer will amount to an equitable set off for the otherwise undisputed assigned debt;
- Defects in the quality of the goods sold are a paradigm matter for an equitable set off (and often form the basis of a contractual abatement also – see below).

⁴ Per Simon Brown LJ at 951

Contractual Set Off

It is fundamental to English contract law that parties are at liberty within reason to define, by agreement, their rights and obligations; they are "masters of their contractual fate". It is therefore possible for parties to agree that specified claims will be subject to rights of set-off which otherwise would not be available under general law or equity.

For example, say a holding company has two separate wholly-owned subsidiaries, A and B, each of whom in turn have entirely separate agreements for the factoring of debts with C, the receivables financier. In normal circumstances B would not be able to set off against an obligation to pay C such losses as might have arisen as between A and C under their separate agreement, since *"it is quite impossible ... to justify a mixture of claims and cross-claims and stir them up together like the ingredients of a Christmas pudding in order to arrive a settled account"*.⁵ Such an arrangement could only be achieved by an express agreement.

When is it available?

As its name suggests, contractual set-off is available when parties have previously agreed it would be. It should be borne in mind that it is not possible to contract out of the mandatory rules of set-off in insolvency, on which see further below.

⁵ per Mocatta J in *The Evelpidis Era* [1981] 1 Lloyd's Rep 54 at 65.

Contracting Out

Just as it is possible to widen the right of set off to embrace debts which would not otherwise be available, it is equally possible for the parties to narrow those rights so as to exclude set offs. However, as can be seen from the above, the right to set off arises by operation of law and therefore if the parties are to exclude it, they must use "clear and express words" which make it clear first that the indebted party must pay now and argue his cross-claim later; see the leading decision of the House of Lords in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689.

The parties may be "masters of their contractual fate" but where they exclude legal rights in a set of standard terms and conditions, they are subject to the intervention of the Unfair Contract Terms Act 1977. Section 13(1)(b) of the Act provides that clauses which "exclud[e] or restrict ... any right or remedy in respect of the liability ..." are subject to the test of reasonableness set out in section 11 of the Act. This is potentially important to the receivables financier for three reasons:

- Often the client's standard terms and conditions will exclude the customer's rights of set off;
- Almost invariably, the factoring or invoice discounting agreement will prohibit the client from setting off against any obligation to the factor;
- Similarly, an "on demand" personal guarantee taken from a director will often prohibit set offs.

The Court of Appeal held in *Stewart Gill Limited -v- Horatio Myer & Co Limited* [1992] 1 QB 600 that *prima facie* a written standard term which prevents payment or credit being set against the price claimed was unreasonable (and therefore void) under the Unfair Contract Terms Act. It was for the party relying on the term to provide a sufficient commercial justification for the exclusion.

Inevitably there are other cases which fall on the other side of the line. In *The Fedora* [1986] 2 Lloyds Rep 441 an earlier Court of Appeal held that a "no set off clause" was valid in a personal guarantee, since were it otherwise the commercial purpose of an "on demand" guarantee would be substantially defeated;

"The purpose [of this personal guarantee] ... was to ensure immediate payment if the principal debtor did not pay. Indeed the present cases make it the more necessary that the Court should not interfere ... It would defeat the whole commercial purposes of the transaction, would be out of touch with business realities and would keep the [beneficiary] waiting for a payment, which both the [principal debtor] and the guarantors intended that it should

*have, whilst protracted proceedings on the alleged counterclaims were litigated.*⁶

However, the Unfair Contract Terms Act 1977 does not appear to have been relied upon by Counsel for the guarantors. Similarly, a contractual prohibition against setting off was upheld in *Hong Kong & Shanghai Banking Corporation -v- Kloeckner & Co AG* [1990] 2 QB 514. However, as the case was in the context of international banking, and so the 1977 Act did not apply.

The upshot of the reams of case law on the validity of a “no set off” clause leads to the (tentative) conclusions that:

- The more sophisticated the parties and the more “commercial weight” they can throw around, the less likely the prohibition is likely to be found offensive;
- Smaller companies, and their personal guarantors, who have comparatively less bargaining power, are more likely to be successful in reliance on the Unfair Contract Terms Act 1977.

⁶ Per Parker LJ at 445.

Mutuality

We have already touched upon this above. In considering whether mutuality exists equity will look to the beneficial title of the competing interests and not merely to the bare legal title:

In *National Westminster Bank Plc -v- Halesowen Presswork And Assemblies Limited* [1972] AC 785 it was said that:

"it is necessary that the debts be between parties in the same right ..."

In this context "right" is referable to the capacity or interest of the party to set-off claim although in the context of equitable set-off the requirement for mutuality has been questioned. Accordingly, it is not possible for a person to set-off a debt due to a principal against a claim being made by that person in an agency capacity, or a debt due to a person in an individual capacity against a claim being made by that person as a trustee.

From the perspective of the receivables financier, this consideration can come into play where, for example, they have made a mistaken overpayment to the client's account (which the client is aware of, but the factor is not), or where the client receives cheques direct from debtors and fails to pay them over to the receivables financier. In such circumstances, the client will often hold those cheques or that mistaken overpayment on trust for the receivables financier; he will be trustee of the money. If (for example) the agreement were then to terminate, the client could not set off losses caused by the termination against his obligation to pay over those trust moneys. He would be obliged, as trustee in equity, to pay over the trust moneys to the beneficiary, the receivables financier, whilst his claim for damages would be a common law right. The distinction between the obligations of the parties arises under the distinctions between "law" and "equity" already referred to above. The obligations are therefore not mutual and thus no set off would arise.

However, mutuality does not require that the claims should arise at the same time, nor that there should be any connection between them. Moreover, it is irrelevant that the claims may be of a different nature. The requirement of mutuality will operate to exclude set-off in various situations:

- Different legal persons
- Joint creditors or debtors (e.g. A and B jointly liable to X, X owes monies to A alone)
- Trustees (e.g. *Quistclose* trust arrangement)
- Beneficiaries
- Interveners (e.g. assignees, garnishees)

Assignment

This is relevant not only where a claim is brought by a receivables financier, but also where there is:

- A claim is brought by an administrative receiver in respect of recovery of a pre-appointment debt;
- There is any situation where a right to payment has been sold.

Set-Off and Assignment

An assignee owes no positive duty to a debtor; he "takes subject to equities but is not subjected to them" (see Salinger, *Factoring: The Law and Practice of Invoice Finance* (3rd ed., 1999, at pp211, paragraph 9-37). So far as we can tell, the legal expression "taking subject to equities" (which is the rule for both equitable, and also legal assignments; see section 136(1) of the Law of Property Act 1925) means that legitimate defences that were available to the debtor against the assignor, either because they were in existence at the date that the debtor received notice of the assignment (legal set off) or because they arose afterwards but are sufficiently closely connected (equitable set off) are equally available as against the assignee.

The leading case is *Business Computers Limited -v- Anglo African Leasing Limited* [1977] 1 WLR 578 where Templeman J analysed the relevant authorities and concluded:

"The result of the relevant authorities is that a debt which neither accrues due before notice of an assignment is received, whether or not it is payable before that date, or a debt which arises out of the same contract as that which gives rise to the assigned debt, or is closely connected with that contract, may be set-off against the assignee. But a debt which is neither accrued nor connected may not be set-off even though it arises from a contract made before the assignment"

Insulated Claims

Set-Off is not available, or its operation is limited, against certain kinds of claim.

Freight

Set-Off is not available against a claim for freight, at least where the claim relates to voyage charter party (*Aries Tanker Corporation v Total Transport Ltd* [1977] 1 WLR 185 and *The Brede* [1974] 1 QB 233). The justification for this historical anomaly is now lost in the mists of time, but it is clear that it extends to domestic carriage of goods by land (*United Carriers Limited -v- Heritage Food Group (UK) Limited* [1995] 2 Lloyd's Rep 269).

Negotiable Instruments and "the Cheque Rule"

Set-off is not available in relation to claims by the first holder of a negotiable instrument, such as a cheque. This is because, for commercial reasons, the Court treats the order from the drawer of the cheque as an autonomous contract separate from the underlying contract, and therefore the instrument should be treated as cash. If the cheque is dishonoured, the holder can proceed on the cheque and obtain summary judgment.

Cancelled Direct Debit Mandates

The recent case of *Esso Petroleum Co Ltd -v- Milton* [1997] 1 WLR 938 supports the argument that a cancelled direct debit mandate ought to be treated the same as a claim on a dishonoured cheque and no right of set off will be allowed against a claim for the non-payment of the direct debit.

As a word of caution, simply because a set-off is not available, it does not mean that the cross-claim disappears and cannot be pursued (as against the client - albeit in separate proceedings if Third Party proceedings have not been issued).

"Construction Contracts" and the Housing Grants, Construction and Regeneration Act 1996

This Act provides limits the rights of parties to a "construction contract" (defined by the Act in fairly broad terms) which is made "in writing" (again, a wide definition is employed) to set off against sums otherwise due. The Act and "the Scheme" (a Statutory Instrument which, in the absence of the parties' drafting a contract compliant with the Act will imply a set of statutory terms) provides that a "Notice of Withholding" must be given by the party intending to set off at least 7 days prior to the "final date for payment" of a sum due under the terms of the contract. If no proper "Notice of Withholding" is given, then the right of set off is disallowed; the paying party must "pay now and argue later".

To be effective, a "Notice of Withholding" must set out, amongst other things, all the grounds on which the set off arises and the amounts attributable to each.

Insolvent Set Off

This is a huge topic. It is developing all the time - not least from the various BCCI cases (still, more than 10 years later) going through the Courts. So far as a receivables financier's dealings with the customer is concerned, insolvent set-off is rarely applicable as the assignment of the debts to the factor destroy the required mutuality.

Importance?

The existence of a right of set-off becomes crucial whenever an insolvent and its creditor have had prior dealings giving rise to cross-dealings. In the absence of a set-off, the creditor would have to pay the full amount of his debt to the liquidator and would be restricted to proving in the liquidation of the unsecured debtor for his claim. The unsecured creditor will only receive a dividend of pence in the pound (if anything!). If, however, set-off is allowed, the creditor will be able to set off the two claims against each other and thereby receive payment in full. The balance, if any, owing to the receivables financier will remain provable, or *vice versa*, in which case the company liquidator will be able to proceed for the balance.

Compared with Solvent set-off

- Insolvency set-off is mandatory and automatic on the winding up of the company. It occurs under Rule 4.90 of the Insolvency Rules 1986 independent of any act of the parties. Similar provisions apply in bankruptcy for individuals.
- It does not matter if the debt to be set off against the liquidator's claim has not been proved for. The party possessing the cross-claim can wait and raise it as a defence if and when the liquidator issues proceedings. The subsequent litigation over the cross claims is treated as working out the account as between the parties; see *Stein v Blake* [1996] AC 243.
- Insolvency set-off cannot be extended by agreement.
- The claims available for insolvency set-off are wider. There is no need for the claims to be "closely connected" or for the cross-demand to have arisen at any particular time, as with equitable and legal set off respectively.
- Insulated claims (e.g. for freight) may be available for set-off.
- Insolvency set-off excludes certain claims obtained without prior notice.
- The claims must still however be "mutual"; the rights to be set off against one another must be owed by the respective parties in respect of the same right.

Rule 4.90

Rule 4.90 of the Insolvency Rules 1986 provides:

1. *This Rule applies where, before the company goes into liquidation there have been mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.*
2. *An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set-off against the sums due from the other.*
3. *Sums due from the company to another party shall not be included in the account taken under the paragraph (2) if that other party had notice at the time they became due that a meeting of creditors had been summoned under s.98 or (as the case may be) a petition for the winding up of the company was pending.*
4. *Only the balance (if any) of any account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets."*

Abatement

It would not be right to leave the topic of set off without a brief note on its common law counterpart, abatement. As noted above, prior to the Acts of Set Off in the early 18th Century, the Common Law Courts would not allow a cross-claim as a defence to the action; a duplicate action in the Courts of Equity was necessary to obtain an injunction restraining enforcement pending the cross-claim being resolved.

Instead, and in an act of seemingly unnecessary duplication, the Common Law Courts would allow a right of “abatement”, first recognised clearly in the decision of the Court of Exchequer in *Mondel v Steel* (1831⁷) where Parke B said:

"Formerly, it was the practice, where an action was brought for an agreed price of a specific chattel ... to allow the plaintiff to recover the stipulated sum, leaving the defendant to a cross-action for breach of warranty or contract; in which action, as well the difference between the price contracted for and the real value of the articles of the work done, any consequential damage, might have been recovered ... But after the case of Basten v Butter, a different practice ... began to prevail, and being attended with much practical convenience, has been since generally followed; and the defendant is now permitted to show that the chattel by reason of the non-compliance with the warranty in the one case, and the work in consequence of the non-performance of the contract in the other, were diminished in value ..."

Abatement is still today recognised defence and is often pleaded in relation to defective works and goods (particularly, for example, in construction contracts). Moreover, it is a substantive defence, unlike legal set off, the latter being merely procedural; an abatement extinguishes the liability of the debtor to the value of the defects.

The point does not arise in relation to dealings between the receivables financier and the client, as there can be no abatement of a contract of services, only those for goods or the carrying out of physical works (see *Mondel v Steel*).

As against a customer defending a claim for an assigned debt, does it matter whether he claims to set off or whether he claims an abatement of the contract price? Usually no, but the point sometimes arises in relation to clauses in the contract with the client prohibiting set off. As we have seen above, the parties must use “clear and express words” if they want to exclude their legal rights – one of which is abatement. A contract clause which prohibits a party from *setting off* cross-claims would not, unless it expressly said so, also exclude his right to *abate* that contract price, so the customer may be able to defend by reference to defects even if he cannot set them off; see *Acism v Danish Contracting* (1987) 39 Build LR 59.

⁷ The decision is reported in the English Reports at (1841) 8 M & W 858, 151 ER 1288, but is more conveniently reproduced in the modern, and more easily accessible, Building Law Reports at (1976) 1 BLR 106.

Finally, the “Notices of Withholding” regime in the Housing Grants Act, Construction and Regeneration Act 1996 must be followed if a party is to withhold for defects, regardless of whether for an abatement or a set off; see HHJ Bowsher in *Whiteways Contractors (Services) Impresa Castelli Contractors (Services) Limited* (9 August 2001, unrep.).

Note: this paper is intended only as a general statement of the law and no action should be taken in reliance upon its contents.

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