A Primer On The English Law Of Set-Off

Foreword

Set-off[1] is the process by which a claim is reduced or eliminated upon account being taken of a cross-claim. It has the reputation of being an obscure and intimidating subject. It is also a profoundly important one, given its insolvency implications and the role it has to play in the workings of the financial markets. The integrity of the various financial markets, and of the netting agreements designed to offset the multiplicity of transactions cancelling each other out, was important enough in the United Kingdom economy to be the subject of Part VII of the Companies Act 1989. This created a type of mini-insolvency process, designed to allow the rules of set-off to operate unimpeded by insolvency. Otherwise, the insolvency of one market player could have a domino effect on other players, triggering a wave of defaults and further insolvencies. At one stage, the Companies Bill contained a clause modifying the statutory rule governing set-off in insolvency.[2] Earlier, the Insolvency Acts of 1985 and 1986 had made provision for the unified treatment of set-off in both corporate and individual insolvency. The clause in the Companies Bill, which was dropped at a late stage

[1] R. Derham, *Set-off* (Oxford, 2nd ed, 1996), P.R. Wood, *English and International Set-Off* (Sweet & Maxwell, 1989); R.M. Goode, *Legal Problems of Credit and Security* (Sweet & Maxwell, 2nd ed. 1988); Shea, "Statutory Set-Off" (1986) 3 JIBL 152; Derham, "Set-Off and Netting of Foreign Exchange Contracts in the Liquidation of a Counterparty I,II" [1991] JBL 463, 536; *ibid.*, "Some Aspects of Mutual Credits and Mutual Dealings" (1992) 108 LQR 99. The law is stated as of 1 July 1997.

[2] Clause 193 of the 1989 Bill.

in the passage of the bill, was designed to resolve a difficulty that first crept into the language of the statutory provision when it was revised in the Insolvency Act 1985, as well as to make certain other adjustments.

I. NON-INSOLVENCY SET-OFF

(a) Introduction

There are a number of versions of set-off and various rules whose effect is similar to set-off. It commonly makes an appearance without explicit mention as such. Outside insolvency, the principal categories of set-off are common law (or legal or statutory) set-off and equitable set-off. They are not always clearly distinguished in practice and those invoking it as a defence do not consistently point to the correct form. Briefly, equitable set-off is broader in scope than common law set-off, subject to one important exception that will be discussed below, and comes close for practical purposes to superseding it.

In its early stages, the common law was not sympathetic to the combination of a claim and cross-claim in a single action. The normal procedure was for the defendant, having been sued to judgment, to launch a separate cross-action against the successful plaintiff. This was obviously time-consuming and wasteful. From 1705 onwards, a number of statutes were passed to allow set-off and thus to avoid circuity of actions. They were repealed in due course in 1879, but it was explicitly provided that the repeal should not affect any 'jurisdiction or principle or rule of law or equity established or confirmed, or right or privilege acquired'.[3] Since the jurisdiction originally conferred by statute has now been shorn from its statutory base, it is perhaps more accurate, if a little pedantic, to speak of common law (rather than statutory) set-off.

[3]Civil Procedure Acts Repeal Act, s4(1). See now Supreme Court Act 1981, s49(2); *Hanak* v *Green* [1958] 2 QB 9, 22 (CA); *Henriksens Rederei A/S* v *PHZ Rolimpex* [1974] 1 QB 233, 246, 252 (CA).

Common law set-off is restricted in its scope. It does not observe the division between legal and beneficial ownership. It is also confined to cases where both claim and cross-claim are for 'debts', though this expression is liberally interpreted to encompass liquidated damages. Moreover, both claim and cross-claim have to be due and payable at the date of the action, thus excluding debts that are contingent or payable at a future date. In the words of Lord Hoffmann:

> Legal set-off is confined to debts which at the time when the defence of set-off is filed were due and payable and either liquidated or in sums capable of ascertainment without valuation or estimation.[4]

Yet, in one important respect, the common law rule goes beyond anything developed in equity. Common law set-off operates where the claim and cross-claim are both debts, even if there is no connection at all between them or anything in the way of justice pressing for their joint treatment. A concern with the avoidance of circuity of actions is a purely pragmatic matter, not bound up at all with fairness and justice. In the words of Lord Hoffmann again: 'Legal set-off does not affect the substantive rights of the parties against each other ... It addresses questions of procedure and cash flow.'[5] Since only this feature of common law set-off prevents its merger with equitable set-off, much of the discussion of the subject of set-off may be conveniently located under the equitable rubric. For example, the requirement of mutuality of the parties applies equally to common law and equitable set-off. The differences between the two forms of set-off will be noted in the following treatment of what is, for the most part, equitable set-off. In particular, there will be a detailed reference to common law set-off when the subject of assignment is taken into consideration.

One of the deficiencies of common law set-off, as we have seen, was its failure to recognise equitable interests, such as that of a trust beneficiary. This did not mean that common law set-off could operate

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[4]In *Stein* v *Blake* [1995] 2 All ER 961,964.

[5]*Ibid.*

unimpeded by equitable considerations. Prior to the fusion of common law and equity, equitable intervention to repair the deficiencies of the common law took the classical form of an injunction to restrain the plaintiff from proceeding further in a court of common law or from enforcing a judgment already obtained there, unless due credit were given for the defendant's cross-claim. No such injunctive power, of course, is necessary today with law and equity being administered together within a fused system. It remains the case, of course, that common law set-off must obey the distinction between legal and equitable title.

As in other areas of law, this administrative fusion has created difficulties in defining just what is the modern equitable position, and inevitably one is drawn to define the equitable rule as what was established or recognised by a pre-fusion court of equity. Now, courts of Equity would certainly by following the law have recognised common law set-off. In that limited sense, equitable set-off prior to fusion might be said to have swallowed whole its less expansive common law equivalent. While it is commonly asserted today that equitable set-off and common law set-off are distinctive, the question must be asked why the two may not simply be collapsed into a single category. One response to this is to stress the discretionary element that infuses equitable set-off and to reiterate that common law set-off ventures into one important area not penetrated by the equitable doctrine, namely, the setting off of unconnected liquidated claims and cross-claims.

It is usual to break up the demands of equitable set-off into three categories. First of all, the claim against which the set-off is to be made must be for a money sum or be based upon a claim for money. Secondly, the cross-claim must, in the eyes of a court of Equity, be effective to 'impeach' the plaintiff's legal title to the claim. This means, in short, that cross-claim and claim must be so intimately connected as to make it inequitable for judgment to be enforced against the defendant on the claim, with the defendant then having to launch a separate action against the plaintiff. Thirdly, there must be a sufficient degree of mutuality between claimant and cross-claimant to justify offsetting their respective claims. These requirements will be addressed in order.

(b) A Money Claim

Obviously, this requirement is satisfied when the plaintiff's claim is for a debt or a liquidated sum. It is also satisfied when the plaintiff claims an unliquidated amount. In *Hanak* v *Green*,[6] the plaintiff owner sought damages from the defendant builder for breach of a building contract and the defendant cross-claimed, *inter alia*, a *quantum meruit* sum for additional work performed. This was allowed. If it had been the builder suing the owner, the latter would on the facts have been given a set-off. It would have been anomalous to deny set-off just because the party with the debt entitlement was the defendant and not the plaintiff. Besides direct claims for a money sum, equitable set-off has been applied where the claim is for specific performance of an agreement founded upon the defendant's obligation to pay a money sum. *BICC Plc* v *Burndy Corporation*[7] was incorrectly dealt with as a case of common law set-off, but the court saw no difference in this regard between common law and equitable set-off. It involved an application for specific performance of an agreement to execute a transfer of certain patent rights, which agreement was triggered by the defendant's failure to pay agreed sums under another contract. A number of related agreements had been concluded in the course of dissolving a close trading relationship. Against this claim for specific performance, the defendant sought a set-off of liabilities of the plaintiff arising under another of these related agreements. The Court of Appeal, by a majority, gave the defendant company its set-off. An earlier decision[8] had granted set-off against both a claim for unpaid rent and a claim to forfeit the lease in question. The majority in the *BICC* case, pointing to this decision, saw no reason why the claim for specific performance had to be coupled with a money claim in the alternative for set-off by the

[6] [1958] 2 QB 9(CA).

[7] [1985] Ch 232 (CA).

[8] *British Anzani (Felixstowe) Ltd* v *International Marine Management (UK) Ltd* [1980] 1 QB 137.

defendant to be permissible. In a partial dissent, Kerr LJ would not have allowed an equitable set-off as such,[9] but he would have been prepared to look at the cross-claim, along with all other relevant circumstances, in determining whether to exercise the Court's discretion to award specific performance. Not too much should be made of this disagreement. The different approaches would yield the same result in the great bulk of cases. Equitable set-off itself, it should not be forgotten, contains a substantial discretionary element.

Not all money claims, even if otherwise they satisfy the requirements set-off, are susceptible to a set-off defence. Where a claim is brought on a cheque or bill of exchange, no equitable cross-claim will be admitted by way of defence. This was firmly laid down by the House of Lords in *Nova (Jersey) Knit Ltd* v *Kammgarn Spinnerei GmbH*,[10] where the German purchaser of machinery under a partnership agreement with the English seller was not permitted to raise a cross-claim for fraud when the seller brought an action on bills of exchange accepted by the purchaser. Negotiable instruments are as good as cash: had payment already been made in cash, it would of course have been far too late for fraud to be raised by way of defence to the seller's claim. For the same reason, the Court of Appeal in *Esso Petroleum Co Ltd* v *Milton*[11] refused to allow equitable set-off where payment for fuel oil supplied to the defendant garage was made by means of direct debit. On the instant occasion, the garage had cancelled the debit after deliveries had been made but before payment had reached the plaintiff supplier. A supplier accepting payment by direct debit should be no worse off than one insisting upon a bill of exchange.

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[9] And see Halsbury's Laws of England (4th ed), Vol 42 ("Set Off and Counterclaim") (paras 406, 440).

[10] [1977] 1 WLR 713 (HL).

[11] [1997] 2 All ER 593 (CA).

(c) The Cross-Claim Impeaches the Plaintiff's Claim

This aspect of equitable set-off is expressed in classical, if somewhat outmoded, form by Lord Cottenham in *Rawson* v *Samuel*:[12]

> Equitable set off exists in cases where the party seeking the benefit of it can shew some equitable ground for being protected against his adversary's demand. The mere existence of cross demands is not sufficient. [Previous decisions have allowed it where] the equity of the bill impeached the title to the legal demand.

Equitable discretion has never submitted to water-tight definition and this requirement of impeachment is no exception. One therefore has to proceed by examples. The Court in *Rawson* v *Samuel* itself provided the following two instances of close factual connection: the coupling of a landlord's claim for rent with a tenant's cross-claim for damage caused by the landlord in cutting down some timber,[13] and of a solicitor's claim for unpaid fees with a client's cross-claim for damage caused by the solicitor's negligence.[14]

In *Rawson* v *Samuel*, the defendant failed to establish the equitable ground necessary to secure an injunction to restrain the plaintiff from taking further common law proceedings. The parties had a trading relationship under which the defendant consigned goods to a trading house in India in which the plaintiff had an interest. The trading house acted as the defendant's commission agents. Various breaches of contract by the defendant were alleged by the plaintiff: the invoicing of goods above cost price, instructing the commission agents not to sell the goods at certain times and failing to renew certain bills of exchange as had been agreed. Under the contract, the plaintiff had agreed to honour certain bills of exchange drawn for the goods consigned to the commission agents. The plaintiff anticipated financing his acceptance of these bills from the proceeds of sale of the goods

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[12] (1841) Cr & Ph 161.

[13] *Beasley* v *D'Arcy* (1800) 2 Sch & Lef 403n.

[14] *Piggott* v *Williams* (1821) 6 Madd 95.

in India. When these proceeds dried up as a result of the defendant's instructions, the plaintiff began to dishonour the defendant's bills. It was this behaviour that prompted the defendant to seek a set-off against the plaintiff's demands. Even though the claim and the cross-claim arose out of the same contract, the court refused the defendant the injunction he sought, largely because of the inordinate delay that would have resulted from the defendant's attempts to establish the losses caused by the plaintiff's dishonour of the bills. The defendant was nowhere near establishing what these losses were.

The impeachment requirement, a matter of close connection, is essentially based upon impressionistic judgement. It was satisfied in *Hanak* v *Green* where, it will be recalled, the claim was in respect of defective building work and the cross-claim, *inter alia*, for extra work done by the builder. Whereas *Rawson* v *Samuel* shows that set-off can possibly be refused where only one contract is involved, *Hanak* v *Green* is an example of it being allowed where there are separate but connected contracts. The requirement of impeachment was also met in *Government of Newfoundland* v *Newfoundland Railway Co.*[15] The claim against the colonial government was for failing to pay a number of subsidies that fell due as sections of a railway line were completed. The cross-claim was for damages for the railway company's failure to complete the line as required by the same contract. Again, there was no difficulty with impeachment in *Bankes* v *Jarvis*[16] where a claim for the balance of the price due on the sale of a veterinary surgeon's practice was extinguished by a cross-claim for damages based on the plaintiff's failure to pay rent to the landlord and on breaches by him of his covenant to repair.

In any discretionary area, there will be difficulties in reconciling certain cases. To take recent cases as examples, in *The Aditya Vaibhav*[17] the owners of a ship chartered on Shelltime 3 terms failed to clean its hold with the result that the ship was delayed for fourteen days at

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[15] (1888) 13 App Cas 199 (PC).

[16] [1903] 1 KB 549.

[17] *Century Textiles and Industry Ltd* v *Tomoe Shipping Co (Singapore) Pte Ltd* [1991] 1 Lloyd's Rep. 173.

Jeddah. The charterers sought to deduct their losses from hire due, not just in the period the ship was off hire, but also in a period when the ship was back on hire. The court held that the necessary close connection with the charterer's cross claim existed only for the hire falling due while the ship was off hire. Summary judgment was therefore allowed for further hire claimed by the owner. The result does appear to give a narrow reading to equitable set-off. On the other hand, in *Dole Dried Fruit* v *Trustin Kerwood*,[18] the plaintiffs, producers of prunes in California, engaged the defendants as their exclusive English distributors. In summary judgment proceedings under R.S.C. Order 14, they claimed the price of goods supplied and the defendants sought to set off against this a cross-claim for unliquidated damages for unlawful repudiation of the distributorship agreement. Summary judgment was denied because of the defendants' arguable defence. The close connection needed for equitable set-off was such that 'manifest injustice' would be caused if the claim and cross-claim were not taken together. There was clearly an intimate connection in the instant case between the two. A further point was the difficulty facing the defendants in having to launch separate proceedings against a foreign party.

(d) There Must Be Mutuality Between Claimant And Cross-Claimant

This means that the two claims must be due from the same parties in the same right. In *Middleton* v *Pollock, ex p. Nugee*,[19] Nugee was personally indebted to the claimant for certain sums secured by a mortgage. The claimant represented a deceased insolvent who had advanced the mortgage sums to Nugee. The deceased insolvent, for his part, was personally liable to trustees of a residuary estate to account for certain rents received from properties that fell within that residue. Nugee was one of the trustees of the residuary estate. Nugee petitioned

[18] *The Times*, 1 June 1990.

[19] (1875) LR 20 Eq 29.

to set off the outstanding rents against the mortgage debt, but the court refused to mix the two claims. Nugee owed money as mortgagor in his personal capacity and was owed money, not in his personal capacity, but in his capacity as trustee of the residuary estate. There could be no equitable set-off.

The intervention of a trustee does not necessarily mean that mutuality of parties is absent. In *Bankes* v *Jarvis*,[20] an action was brought by the plaintiff, acting as trustee for her son, to recover an instalment outstanding from the sale to the defendant of a veterinary surgeon's practice. The defendant, however, had a personal cross-claim against the son, both liquidated and unliquidated, and, despite the plaintiff's objections, equitable set-off was allowed. The court was 'unable to understand how a person, by creating a trustee to sue for him, can be entitled to any greater rights than he would be if he sued in his own name'. The trustee had no personal claim or liability. Both claim and cross-claim were personal to the son; neither was representative.

The issue of mutuality can cause problems when one of the two claimants has granted a floating charge to a third party. In *Rother Ironworks Ltd* v *Canterbury Precision Engineering Ltd*,[21] the following sequence of events occurred. The plaintiff company was indebted to the defendant company in the amount of £124. By contract, the plaintiff then agreed to supply goods for £159 to the defendant. Next, a floating charge, granted by the plaintiff to a third party debenture holder, crystallised. The goods were then supplied by the plaintiff and the defendant tendered a balance of £35 to the receiver sent in by the debenture holder to manage the plaintiff company, claiming a set-off for the £124 owed by the plaintiff. The receiver now sued for the £124 in the name of the plaintiff, and in substance contended that the £159 for goods supplied was owed, not to the plaintiff as such, but to the debenture holder, and that the £124 owed by the plaintiff was of no concern to the debenture holder. The court disagreed. It asserted that

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[20] *Supra* n 16.

[21] [1974] QB 1 (CA).

the crystallisation of the floating charge served to assign the plaintiff's assets, including its rights under the sale contract, to the debenture holder, and it concluded that the assignee debenture holder could be no better off than the assignor, namely the plaintiff. In other words, the rules relating to assignment were brought in to assimilate the position of the plaintiff and its debenture holder and to destroy the argument that mutuality was lacking between the defendant and the plaintiff's debenture holder. One might also add that, although the goods were actually supplied when the company was in receivership, it was the company that supplied them and not the debenture holder, since the receiver acts as the agent of the company and not the debenture holder.

Agency and Assignment Issues: Though aspects of the mutuality requirement, agency and assignment are extensive enough to merit a separate rubric. The relationship between principal and third party, and between account debtor and assignee, is one that has to be scrutinised in terms of mutuality. A third party dealing with an agent whom he knows to be an agent may not claim a set-off, in respect of the agent's personal indebtedness to him, in his dealings with the principal. This is illustrated by *Richardson* v *Stormont Todd & Co*[22] where the assets of a defaulting Stock Exchange member had, under the rules of the Exchange, passed to an official assignee empowered to settle the estate. The official assignee then employed the defaulting member, who was by now only the bare legal owner of certain shares that had beneficially vested in the assignee, to sell those same shares on his behalf to the defendants. When the official assignee sued for the price, the defendants tried to set off the agent's personal indebtedness to them. They were not permitted to do so. Though not members of the Stock Exchange themselves, they knew the agent was not acting in an unfettered way. They were well aware of his personal circumstances and of the involvement of the official assignee.

More difficult is the case of undisclosed principal and third party. In *Montagu* v *Forwood*,[23] the plaintiffs employed agents to collect

[22] [1900] 1 QB 701 (CA).

[23] [1893] 2 QB 350 (CA).

moneys due to them from certain underwriters. The agents, who were not members of Lloyd's, in turn employed as sub-agents the defendants, who were Lloyd's members. The defendants collected the moneys and claimed to set off against the plaintiff the agents' personal indebtedness to them. The Court, following *George* v *Clagett*,[24] where the purchasers of goods from a factor were permitted to set off against the undisclosed principal a cross-claim they had against the factor, held the defendants were entitled to their set-off. The defendants were entitled to stand in the same position as if the agents had been acting as principals in their own right. The defendants might well have dealt with the agents in the expectation of having a set-off. Moreover, the plaintiffs had allowed the agents to appear as principals and so must take the consequences. The agents were not brokers, and there was nothing in the circumstances of the case to alert the defendants to the fact that they were not dealing with a principal. As an earlier case observed, it was a matter of 'common honesty'[25] to allow set-off in a case such as this.

The vulnerability of undisclosed principals to set-off was diminished somewhat by the House of Lords in *Cooke & Sons* v *Eshelby*.[26] Undisclosed principals sued the buyer for the price of cotton sold through a cotton broker. The buyer claimed a set-off for moneys owed them by the broker, but this was refused. It was not enough for them to be unaware of the existence of the undisclosed principals, and so knowing that he might have been acting as an agent. They knew the broker bought and sold sometimes on his own account and sometimes for principals. To be entitled to set-off, they ought positively to have believed that, on the instant occasion, the broker was acting for himself. Moreover, this belief would have had to be induced by the principal's conduct in allowing the broker to sell the cotton as owner. The buyer should have made inquiries, in the event of which they could have refused to deal with the broker on finding out that he was an agent.

[24] (1797) 7 TR 539.

[25] *Turner* v *Thomas* (1871) LR 6 CP 610 (Willes J).

[26] (1887) 12 App Cas 271 (HL).

Further limits on the undisclosed principal's vulnerability to set-off appears in other cases. *Turner* v *Thomas*,[27] for example, limited the rule in *George* v *Clagett* to liquidated demands, thus excluding claims for unliquidated damages, like the undisclosed principal's action for damages for non-acceptance of the goods. In order, too, for the set-off to be permitted, it must concern a debt or other liability that has come into existence before the third party is faced with notice of the principal's involvement. This is illustrated by *Kaltenbach, Fischer & Co* v *Lewis & Peat*,[28] where Singapore merchants consigned goods to a London agent for the purpose of sale. The agent in turn employed as sub-agents certain brokers, to whom he was previously indebted, to sell those goods. The brokers (who for present purposes may be treated as the third party in their relations with the principal) sold the goods to a purchaser, who was allowed six months credit, and they then became aware of the agent's status prior to collecting the purchase price from the purchaser. When the money came in, the brokers had to account for it, undiminished by set-off, to the principal. There was no debt owed by the brokers, whether to the principal or the agent, until they received the money, by which time they had been informed there was a principal. The decision has been criticised, rightly it is submitted, on the ground that the brokers' position ought to have depended on whether they believed they had a set-off right at the time of their initial contractual commitment to the agent. Looking at a later event, the accrual of the debt, which happened when matters were beyond the control of the brokers, fails to meet the justice of the case when an individual is unwittingly dealing with an undisclosed principal.

Attempts have sometimes been made to argue that, even if the notice requirements of *Cooke & Sons* v *Eshelby*[29] have not been met, a third party should still be allowed a set-off by virtue of a special custom. They have generally failed. One case,[30] involving purchases from a hop broker, drew the conclusion that the custom was unproven

[27] *Supra* n 25.

[28] (1885) 10 App Cas. 617 (HL).

[29] *Supra* n 26.

[30] *Cooper* v *Strauss & Co* (1898) 14 TLR 233.

and probably too wide to be reasonable in any event. In another case,[31] involving a sale of shares off the Stock Exchange, it was held that a custom not known to both relevant parties was unreasonable.

How is the matter of mutuality of parties presented in the case of assignment? Most of the cases involve the preservation of set-off and similar rights that the account debtor has against the assignor. Unusually, *Bennett* v *White*[32] concerns an assignee, personally liable to the account debtor, seeking to set off an assigned debt. Applying the antecedent provision[33] to section 136 of the Law of Property Act 1925, the Court of Appeal held that, subject to the exception in the section, the assignee of a chose in action was in exactly the same position *qua* the account debtor as the assignor. It was as though the assignee had at all times been the creditor of the account debtor. Set-off was therefore allowed.

Where the action is brought by the assignee, and the account debtor wishes to set off the assignor's liability to him, the justice of allowing set-off has been put by the Privy Council in these terms:[34]

> It would be a lamentable thing if it was found to be the law that a party to a contract may assign a portion of it, perhaps a beneficial portion, so that the assignee should take the benefit, wholly discharged of any counter-claim by the other party in respect of the rest of the contract, which may be burdensome.

A simple illustration of the principle at work is *Young* v *Kitchin*[35] which dealt with the assignment of sums due under a building contract. The account debtor pleaded, by way of set-off and counterclaim, that he had the right to deduct from the sums owed a claim for damages for breach by the assignor of the building contract. He was held entitled

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[31] *Pearson* v *Scott* (1878) 9 ChD. 198.

[32] [1910] 2 KB 643.

[33] Judicature Act 1873, s25(6).

[34] *Government of Newfoundland* v *Newfoundland Railway Co* (1888) 13 App Cas 100.

[35] (1878) 3 Ex D 127.

to do so, though the court also added that there could be no question of asserting any counterclaim against the assignee in excess of the amount of the claim.

If, nevertheless, 'wholly new obligations'[36] are assumed by the assignor to the account debtor, after the latter acquires notice of the assignment, the account debtor will be correspondingly denied a set-off against the assignee. An example of this is *NW Robbie & Co v Witney Warehouse Co.*[37] By means of a floating charge, a debenture secured all moneys due to a bank (the assignee) by an Irish company (the assignor). At a subsequent date, the floating charge crystallised with the appointment of a receiver and manager. The effect of this crystallisation was to assign to the bank certain liabilities owed by another company, the account debtor, to the Irish company. Later when the account debtor was plainly faced with notice of the receiver's appointment, and hence of the crystallisation of the floating charge, an associate company of the account debtor assigned to it certain debts owed to the associate company by the Irish company. Faced with a claim by the assignee bank, the account debtor now sought to set off the debts of the assignor that had just been assigned to it by the associate company. This was refused, on the ground that the new rights of the account debtor arose after the first assignment to the bank was completed on the crystallisation of the floating charge. There was thus no mutuality between the account debtor and the assignee in respect of these later debts.

It has been emphasised that the rule, allowing an account debtor to set off against the assignee defences that he has against the assignor, is distinct from the rule in section 136 of the Law of Property Act 1925 that the assignee takes 'subject to equities having priority over the right of the assignee'. They are distinct, though in most cases the generous spread of equitable set-off will make it virtually impossible to distinguish in practice these equities and the defence of equitable

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[36] *Government of Newfoundland, supra* n 34.

[37] [1963] 3 All ER 613 (CA).

set-off.[38] But there is a string of cases that show that set-off and the equities of section 136 are not completely coincidental. The key to it is to understand that common law set-off, when extending to unconnected but liquidated claims and cross-claims, exceeds the reach of equitable set-off. Nor does it fall within the equities of section 136.

These common law cases present a difficulty of their own. This difficulty lies in knowing which debts of the assignor are to be taken into account for the purpose of set-off between debtor and assignee. It all hinges upon on when the assignor's debt to the account debtor falls due. In *Watson Mid-Wales* v *Railway Co.*,[39] a Lloyd's bondholder (the assignor) owed certain rental payments to the maker of the bond (the account debtor) under a lease that was 'entirely collateral' to the bond. The bond was assigned and the assignee sought to recover on it from the account debtor. The latter than sought to set off the amounts owed under the lease by the assignor. But the debt due under the lease had accrued due after notice of the assignment had been given to the account debtor. No set-off was allowed. It made no difference that the debt had arisen under a lease that was concluded before the assignment of the bond.

Similarly, in *Re Pinto Leite and Nephews,*[40] a bank was indebted to the assignor for moneys held on deposit. This debt was then assigned. Meanwhile, under a separate transaction, the bank contractually agreed to take up certain accommodation bills drawn by the assignor. At the time of the assignment, while this contract already existed, the assignor had not yet become indebted to the bank for moneys expended by the bank in connection with the bills. The court held that, this debt to the bank not having accrued due at the date the bank received notice of the assignment, it was not a *debitum in praesenti* and it could not therefore be set off against the assigned debt owed by the bank.

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[38] See, *eg, Bank of Boston Connecticut* v *European Grain and Shipping* [1989] 2 WLR 440.

[39] (1867) LR 2 CP 593.

[40] [1929] 1 Ch 221.

The same result was reached in *Business Computers Ltd* v *Anglo-African Leasing Ltd*.[41] The defendant (the account debtor) owed the plaintiff (the assignor) a sum of money for computers acquired under a contract of sale from the plaintiff. Under a separate contract between the same parties, another computer was leased on hire purchase terms by the defendant to the plaintiff. A receiver was sent into the plaintiff company under the terms of a floating charge. This crystallised the charge in the normal way and effected an assignment to the debenture holder of the sums owed under the contract of sale by the defendant. By this time, the plaintiff had defaulted on its hire purchase agreement, but the defendant had not yet elected to terminate the contract. When, however, the receiver for the plaintiff company repudiated the hire purchase agreement, the defendant then terminated it. This triggered the defendant's right to recover certain liquidated amounts under an acceleration clause in the hire purchase agreement. The defendant now tried to set off these liquidated amounts against the debt that had been assigned to the debenture holder. Mr Justice Templeman refused the set-off, because the liquidated hire purchase cross-claim had not accrued due when the defendant obtained notice of the receiver's appointment. Nor could there be any equitable set-off with the protection afforded to the defendant by section 136 of the Law of Property Act 1925, given the lack of any connection between the sale and the hire purchase contracts. Had this been a liquidation instead of a receivership, the more generous insolvency set-off would have enured in favour of the defendant.

Suppose, however, that the cross-claim has accrued due before notice of the assignment is given but it has not yet become payable. This was the situation in *Christie* v *Taunton, Delmond, Lane & Co*,[42] where a share call became due on 3 November but was not payable under the company resolution making the call until 20 November. The shareholder was also a debenture holder of the company, and assigned

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[41] [1977] 2 All ER 241.

[42] [1893] 2 Ch 175.

his rights under the debenture to a bank, with notice of this assignment being given on 6 November. Could the company set off the above call against the claim of the assignee bank? The Court held that it could.

In sum, there is no set-off if the contract but not the debt comes into existence before notice of the assignment, but there is an available set-off if the debt has accrued due by that date, even if it is not yet payable. It should be repeated, however, that these last cases do not deal with equitable set-off, which in certain respects is more generous to the account debtor, always provided that the discretionary case for equitable intervention can be established.

(e) Special Cases

In certain cases, the entitlement to set-off is a controversial matter. For a while, it was thought there could be no set-off at all against a landlord's claim for rent, an attitude explained in one case as due to 'the insidious promptings of generations of common lawyers that there is something special about rent'.[43] In the same case, the judge firmly rejected the contention that 'the ancient common law remedies attaching to rent should govern in the fourth quarter of the twentieth century ... one's approach to a tenant's claim for equitable relief'. In *Lee-Parker* v *Izzet*,[44] the court held that tenants of certain properties were entitled to recoup out of future rent the cost of repairs they had made, the repairs falling within the landlord's express or implied covenants. Mr Justice Goff professed to see this as the exercise of 'an ancient common law right' rather than as something 'bound up with the technical rules of set off'. Equitable set-off, however, seems a more straightforward way to handle the matter, since the impeachment requirement appears to be easily enough satisfied in such a case.

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[43] *British Anzani (Felixstowe) Ltd* v *International Marine Management (U K) Ltd* [1908] 1 QB 137, 155.

[44] [1971] 3 All ER 1099.

The matter was put plainly in terms of equitable set-off, however, in *British Anzani (Felixstowe) Ltd* v *International Marine Management (UK) Ltd.*[45] The lessees of a plot of building land, the plaintiff builders, contracted with the defendant to build a warehouse for, and grant an underlease of the land to, the defendant. The plaintiff later bought an action for, *inter alia*, unpaid rent and possession of the warehouse. The defendant cross-claimed for breaches of obligations in the contract relating to the condition and repair of the warehouse floor. Although this cross-claim arose out of the contract, as opposed to the underlease, set-off was permitted because the contract and the underlease were so intimately connected that it was only fair and just to regard the defendant's equity as going to the very foundation of the plaintiff's claim for rent. The plaintiff's breach was, moreover, serious enough to make the warehouse quite unfit for the purpose for which it was let. In addition, the plaintiff was in receivership. If it had been in liquidation, the result in the case would never have been in doubt since (as we shall later) insolvency set-off is broader in application than equitable set-off. The result in *British Anzani* is that the defendant was not disadvantaged because it was a case of receivership rather than insolvent liquidation.

Regardless of whether there is a sufficient degree of proximity for a defendant's cross-claim to impeach the plaintiff's claim, the parties may by agreement exclude set-off.[46] Whether it be put in terms of such a contrary agreement, or of a long-standing commercial practice upon which the parties are presumed to have conducted their dealings, the position is that no set-off, equitable or otherwise, is allowed against a claim for freight under a voyage charterparty.[47] The matter received

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[45] *Supra* n 43.

[46] *Hongkong and Shanghai Bank* v *Kloeckner* [1990] 3 WLR 634; *Coca Cola Financial Corp* v *Finsat International Ltd* [1996] 2 BCLC 626.

[47] Set-off is allowable against hire in time charters: *Federal Commerce and Navigation Ltd* v *Molena Alpha Inc* [1978] 3 All ER 1066 (HL); *The Chrysovolandou-Dyo* [1981] 1 ALL ER 340.

a thorough review in the House of Lords decision in *Bank of Boston Connecticut* v *European Grain and Shipping*,[48] a case dealing with a voyage charter from India to various European ports. The charterparty, as is the usual practice, required freight to be paid in advance. It provided:

> freight shall be prepaid within five days of signing and surrender of final bills of lading, full freight deemed to be earned on signing bills of lading, discountless and non-returnable, vessel and/or cargo lost or not lost...

On the face of it, this clause alone could well have justified refusing to allow an equitable set-off, but the House of Lords, in reaching the same conclusion, based its decision on a well settled practice of long standing.

The ship was arrested in Sri Lanka by creditors of the shipowner. The behaviour of the latter, unable to pay for bunkers previously supplied, was treated as a repudiation of the voyage charter. The charterer elected to terminate the charter, transhipped the goods and had them on-carried to European ports. In an action brought by the assignee of the ship's earnings, the charterer argued that equitable set-off should be allowed against a freight claim where the shipowner, over and above committing a breach of a warranty or other non-discharging breach, had repudiated the contract. But the House of Lords disagreed. First of all, their Lordships were not prepared to give a literal interpretation to R.S.C. Order 15 Rule 2(4), which allows judgment to be entered for the balance where a claim and 'counterclaim' are successful. Otherwise, the substance of equitable set-off would be altered and the result would be tantamount to allowing the Judicature Acts to overstep the boundaries of procedural law. One might add that the scope of equitable set-off, a matter of substantive law, is not to be altered by pleading practice.

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[48] *Supra* n 38.

Secondly, the House of Lords was not prepared to distinguish repudiatory and non-discharging breaches, given the modern orthodoxy that contracts are discharged prospectively on breach and not rescinded *ab initio*. Repudiatory breaches, furthermore, did not necessarily cause more harm than non-discharging breaches, and the risk of the shipowner's insolvency, which eventuated in the present case, existed in equal measure for both classes of breach. Earlier cases,[49] dealing with short delivery, had stressed the importance of maintaining a rule that had supported 'countless transactions', that encouraged charterers to settle their claims with their cargo insurers and that clarified the risk to be divided between a shipowner's freight underwriters and its P and I Club.[50] There was also no record of Equity intervening in shipping cases prior to fusion, nor had anything happened in the hundred years following the first of the Judicature Acts:[51]

> [T]here is no record of the alleged equitable defence having been essayed at any time since the Judicature Act 1873. Equity did not bark at all at a claim for freight during this century-long night; to adapt Holmes this would be a curious incident ...

Against these forceful arguments, little impact was made by the contention that modern shipping and commercial conditions were quite unlike those prevailing when 'freight was the mother of wages', seamen and repairers had to be paid out of freight earned and there was no such thing as the instantaneous transfer of money.[52]

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[49] *Henriksens Rederei A/S* v *PHZ. Rolimpex* [1974] 1 QB 233 (CA); *Aries Tanker Corp* v *Total Transport Ltd* [1977] 1 WLR 185 (HL).

[50] *Henriksens Rederei A/S, supra* n 49 (Roskill LJ).

[51] *Aries Tanker Corp, supra* n 49 (Lord Simon).

[52] *Henriksens Rederei A/S, supra* n 49 (Roskill LJ).

II. IS SET-OFF A TRUE DEFENCE OR A PROCEDURAL MATTER?

Professor Goode answers this question[53] by firmly asserting that set-off is a procedural rather than a true defence. He does, however, have to contend with a number of decisions, in which Lord Denning has played a leading role, which state quite clearly that set-off is a true defence. In *Henriksens Rederei A/S*,[54] for example, Lord Denning asserts that equitable set-off is an 'equitable defence' which is 'on a par with the case of a defendant who says that the plaintiff has repudiated the contract by an anticipatory breach, or that the plaintiff has been guilty of a breach going to the root of the contract'. Yet it is hard to see how such an assertion can be made about a contract that is distinct from, even though closely connected to, another contract. Moreover, even if only one contract is involved, it is a fair criticism that equitable set-off, if given the role of a true defence, rewrites the contract by creating contractual conditions and discharging breaches that the parties never intended and that are not countenanced by the rules relating to discharge for breach. A cross-claim by the defendant for breach of warranty, exceeding in amount the money claim of a plaintiff who might lawfully have terminated for the defendant's discharging breach, becomes then elevated to the status of a breach of contractual condition.

Despite all of this, it does seem that the question posed at the outset of this section is too ambitious. A better approach is to identify a series of practical questions and determine the answer provided by set-off, whether common law or equitable. Does set-off, for example, stop a lessor from re-entering premises and forfeiting the defendant's lease when the defendant falls behind with the rent? Or a shipowner from withdrawing the ship from hire when a time charterer defaults on the payment of hire? What is the effect of limitation periods on a set-off? How should costs be awarded if there is a set-off? Does set-

[53] *Legal Problems of Credit and Security* (Sweet & Maxwell, 2nd ed 1988).

[54] *Supra* n 49.

off prevent a plaintiff creditor from invoking an acceleration clause rendering all future instalments presently payable in the event of the defendant's failure to pay one instalment? Obviously, a construction of the contract may yield answers to these, by no means exhaustive, questions. But does set-off itself provide the answers if no help is forthcoming from contractual construction?

The limitation question seems reasonably clear. Whether we are dealing with a set-off or a counter claim, the limitation period runs from the same date as the claim.[55] This certainly suggests that set-off is procedural in scope, for a true defence is not as such time-barred. The rules as to costs seems reasonably well settled, though perhaps difficult to justify at times. Unlike counterclaim, where costs are awarded separately in respect of claim and counterclaim, with separate judgments for both,[56] only one judgment is entered where there is just a set-off against the claim - for the plaintiff if the set-off is partial, and for the defendant where the set-off altogether extinguishes the plaintiff's claim. Costs will then usually go with the cause. A set-off extinguishing the claim should therefore, from the costs angle, be better for the defendant than a counterclaim for the same amount. The justification usually given for a plaintiff suffering in costs in the face of such a set-off is that he should have known of the existence and the extent of the cross-claim.[57] As true as this may be of common law set-off, where the cross-claim has to be for a liquidated amount, it hardly applies to equitable set-off so far as it extends to unliquidated, and therefore quantitatively uncertain, cross-claims. To the extent that the award of costs is so generous to the defendant, equitable set-off at this point approximates to a true defence.

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[55] *Henriksens Rederei A/S, supra* n 49. See Limitation Act 1980, s35.

[56] *Medway Oil and Storage Co* v *Continental Contractors Ltd* [1929] AC 88 (HL).

[57] *Stooke* v *Taylor* (1880) 5 QBD 569.

The idea of a true defence seems also to be present in cases where a shipowner is prevented from withdrawing a ship from hire after the time charterer is given an equitable set-off; likewise, where the lessor is prevented from forfeiting the lease of a tenant who invokes set-off rights. In the latter case, it could be argued that set-off rights ought not, as such, to debar forfeiture, but should instead play a leading part in the exercise by a court of its discretion to grant equitable relief against forfeiture.[58] In the case of time charterers, it might equally be said that the substance of the matter could be determined by forfeiture principles. Against that, however, is the point that a time charterer does not take possession of the ship. Furthermore, the vulnerability of certain tenants to landlords is not repeated in the more equal bargaining climate of the time charter market.

This leaves outstanding the problem of acceleration clauses. For good or ill, the law has consistently maintained that a clause merely accelerating future instalments does not amount to a penalty clause or a forfeiture.[59] If equitable set-off is merely a procedural defence to a claim, it ought not to stop the acceleration clause from swelling the claim. If the issue were to arise, a court failing to find a satisfactory answer in set-off, might be tempted to appraise anew the traditional approach based on penalties and forfeitures. This might be the best solution to the problem.

III. RULES AKIN TO SET-OFF

There are numerous rules and defences which, superficially at least, resemble set-off. Taking a brief selection, suppose first that A and B have a trading agreement under which each supplies goods to the other, and from time to time an account is struck with the net debtor paying the balance to the net creditor. There can be no question of A

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[58] *Cf. BICC Plc* v *Burndy Corp* [1985] Ch 232 (CA).

[59] *Protector Loan Co* v *Grice* (1880) 5 QBD 529 (CA); *Wallingford* v *Mutual Society* (1880) 5 App Cas 685(HL).

being successful in a claim for the price of all goods supplied when B has also supplied goods to A. Whether the goods supplied by B exceed or are less than the value of A's goods, B has a corresponding true defence against A. It is not a matter of set-off at all because the amount claimed by A as the consolidated price of all goods supplied by him was never at any time owed by B.[60]

The banker's right to combine accounts[61] is another case that is distinct from set-off. It has long been established that the banker-client relationship is normally, while the account is in surplus, one of debtor (the bank) and creditor (the account holder),[62] these titles being reversed when the account is in deficit. From this it follows that, unless the contract otherwise provides, accounts that are maintained separately amount in substance to one account. The banker may therefore, at his option, combine accounts in credit with accounts in deficit. Again, this is a true defence in that the banker, from the moment he makes his election, is not considered as being in debt at all to the extent that he has wiped out a pre-existing credit.

Perhaps the most prominent example under this heading is what has come to be called abatement and is clearly identified with the Exchequer case of *Mondel* v *Steel*.[63] As the rule is restated in section 53(1)(a) of the Sale of Goods Act 1979, a buyer sued for the price of goods supplied may 'set up' a breach of a seller's warranty obligation 'in diminution or extinction of the price'. This looks, superficially at least, like equitable set-off, though it is the creation of a pre-fusion common law court and not of a court of Equity. It is available as of right, as is the banker's right to combine accounts. The same rule has also been applied to labour and material contracts but has stopped short of voyage charterparties. It has been said by high authority that this abatement rule is a 'substantive defence' and 'no mere procedural

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[60] See *Re Charge Card Services Ltd* [1987] Ch 150 (factoring of accounts receivable).

[61] *Garnett* v *M'Kewan* (1872) LR 8 Ex 10.

[62] *Foley* v *Hill* (1848) 2 HLC 28.

[63] (1841) 8 M & W 858.

rule designed to avoid circuity of actions'.[64] Yet this hardly seems to fit the evolution of abatement and the reasons of the common law courts in the nineteenth century for expanding it. Though analytically distinct,[65] abatement seems virtually indistinguishable (apart from the discretion factor) in its effect from equitable set-off. The two rules are commonly harnessed together in the same case with no discernible difference in the way that they are treated. It may indeed be asked how useful it is to retain separate rules. Once again, it is submitted, rather than seeking answers to theoretical questions by asking whether abatement is procedural or substantive, it would be better to tackle the practical questions and then see what light is then thrown on the question whether abatement is procedural or substantive.

IV. INSOLVENCY SET-OFF

With insolvency set-off, we come to a rule that is quite distinguishable in scope and character from the various rules that have been previously examined, though it builds upon a number of the same features as those possessed by the rules treated earlier.

Legislative intervention in the area of insolvency set-off can be traced back to a temporary statute passed in the reign of Queen Anne. Until recent times, the relevant provision was section 31 of the Bankruptcy Act 1914,[66] since superseded and replaced by section 323 of the Insolvency Act 1986. The wording has changed at various points in the history of the bankruptcy set-off provision, so earlier authorities should be approached cautiously with that observation in mind. While set-off was to be found only in bankruptcy legislation, it had no evident role to play in the case of companies, at least before the Judicature Act 1873,[67] which extended the bankruptcy set-off section to company

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[64] *Gilbert-Ash (Northern) Ltd* v *Modern Engineering (Bristol) Ltd* [1974] AC 689 (Lord Diplock).

[65] *Hanak* v *Green* [1958] 2 QB 9 (CA).

[66] For the pre-1914 history, see *Re DH Curtis (Builders) Ltd* [1978] Ch 162.

[67] Section 10.

liquidations. The old bankruptcy section, with its references to receiving orders and acts of bankruptcy, could not apply literally to corporate liquidations, so analogies were found in the life, or more accurately the death, of a company. That is no longer necessary since Rule 4.90 of the Insolvency Rules now speaks directly to company liquidations.

According to section 323 of the Insolvency Act 1986:

(1) This section applies where before the commencement of the bankruptcy there have been mutual credits, mutual debts or other mutual dealings between the bankrupt and any creditor of the bankrupt proving or claiming to prove for a bankruptcy debt.

(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 bankrupt to another party shall not be included in the account taken under subsection (2) if that other party had notice at the time they became due that a bankruptcy petition relating to the bankrupt was pending.

(4) Only the balance (if any) of the account taken under subsection (2) is provable as a bankruptcy debt or, as the case may be, to be paid to the trustee as part of the bankrupt's estate.

Rule 4.90 of the Insolvency Rules is laid out in the same way with the following exceptions: liquidation is substituted for bankruptcy and company for individual; and the reference to bankruptcy petition in the notice provision (subsection (3)) is replaced by references to a meeting of creditors or a winding-up petition, as the case may be. Furthermore, while the former provision confined the application of set-off to cases where the company's assets were insufficient to satisfy all of its debts and liabilities, Rule 4.90 clearly extends to all company liquidations, voluntary and compulsory alike and irrespective of whether the company is solvent or insolvent.[68]

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[68] R Derham, *Set-Off* (Oxford, 2nd ed 1996), p. 152.

Mutual Credits, Mutual Debts or Other Mutual Dealings: This phrase, a very broad one, defines the scope of all claims and cross-claims that may be set off against each other. It is well established that the claim and cross-claim may be completely collateral to each other.[69] As regards the legal nature of the claims in question, whether they be in contract or tort or arise out of a breach of trust, for example, the scope for a set-off is ultimately to be found in the meaning of the expression 'mutual dealings'. The guide to understanding the meaning of this phrase lies in the notion of a provable insolvency claim.

To take a very obvious case, debts arising out of the same contract may be the subject of a set-off under section 323. Furthermore, it has long been settled that a debt claim and one for unliquidated damages for breach of contract may be applied against each other. Thus, in *Mersey Steel and Iron Co* v *Naylor Benzon & Co*,[70] the buyer of goods, obliged to pay for deliveries previously made, was allowed to set off damages for non-delivery in the winding-up of the seller company.

Over the years, some difficulty has been caused by tort claims in determining whether claim and cross-claim pass the test of mutuality. The source of this difficulty is the provision relating to provable claims in bankruptcy proceedings, which will be discussed shortly. Where a claim for damages sounding in tort resembled a contract claim, set-off was however allowed. In *Tilley* v *Bowman*,[71] for example, a contract for the sale of jewellery was rescinded because of the buyer's fraud but not before the buyer had pawned the jewellery. Upon rescission, the buyer had a claim in debt, for the recovery of a pre-paid portion of the price, as money had and received. Against this claim, brought by the buyer's trustee in bankruptcy, the seller sought to set off a claim for damages caused by the buyer's fraudulent misrepresentation, namely, the cost of redeeming the pawn and recovering the jewellery. Though this was a claim in the tort of deceit, set-off was allowed because 'the

[69] See, *eg*, *Re Daintrey* [1900] 1 QB 546 (CA).

[70] (1884) 9 App Cas 434 (HL).

[71] [1910] 1 KB 745.

claim of the trustee being in the nature of a claim under the contract, the misrepresentation which led to the contract was a mutual dealing.'[72] Any other result would have been most unpalatable.

Despite decisions like *Tilley* v *Bowman*, other authorities, notably *Re Mid-Kent Fruit Factory*[73] a decision of Mr Justice Vaughan Williams, the leading insolvency lawyer of his day, took the view that the claims must arise in contract. This view was also propounded in the 1908 edition of *Halsbury's Laws of England.* The clear implication was that the bankruptcy set-off section was confined in its operation to claims between traders. This approach was firmly rejected by Mr Justice Brightman in *Re DH Curtis (Builders) Ltd,*[74] who pointed to the juxtaposition of sections 30 (provable claims) and 31 (set-off) under the old Bankruptcy Act 1914. The former section excluded claims for unliquidated damages except those arising 'by reason of a contract, promise or breach of trust'. This exception covered a lot of ground, however, and went beyond the scope accorded to set-off in *Re Mid-Kent Fruit Factory*. Brightman J went on to say that a tort claim for unliquidated damages, not a provable claim under section 30, had to be kept out of a section 31 set-off, though he seems not to have had any intention to undermine decisions like *Tilley* v *Bowman*. He clearly formed a broad view of the type of 'dealings' giving rise to a set-off, on the ground that the real issue was whether the claims or dealings were 'mutual', that is to say 'commensurable'. Thus, in *Re DH Curtis (Builders) Ltd* itself, he saw the purpose of section 31 as the doing of 'substantial justice' between the parties. Furthermore, he allowed a set-off where the Commissioners of Customs and Excise, faced with a claim for the repayment of input tax, sought to deduct for moneys owed by the claimant to the Inland Revenue Commissioners and to the Department of Health and Social Security.

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[72] See also *Jack* v *Kipping* (1882) 9 QBD 113.

[73] [1896] 1 Ch 567.

[74] *Supra* n 66.

The main feature, however, of *Re DH Curtis (Builders) Ltd* is the bond it establishes between set-off and the proving of bankruptcy claims. This must now be considered in the light of section 322 of the Insolvency Act, which deals with the proof of debts, and of section 382, which defines a bankruptcy debt.[75] Section 382(2) makes it clear that a claim in tort can be a bankruptcy debt. This is fortified by subsection (4), which also throws in for good measure bailment and restitutionary claims. There seems therefore no reason artificially to delimit the meaning of 'dealings' in section 323, which means that the focus should be concentrated even more in future on the mutuality or commensurability of the two claims.

For claim and cross-claim to be mutual, they must also be commensurable, which has been discussed in a number of cases. A good example of the pitfalls that may present themselves is to be found in *Re.Pollitt*.[76] A solicitor, to whom a client already owed money, required to be put in funds in the amount of £15 to meet future costs before doing any further work for the client. Having received the advance the solicitor then called a meeting of the client's creditors and prepared a deed of assignment in bankruptcy. This act of bankruptcy took away the solicitor's authority to do further work for the client as against the money he had in hand. In addition, since the purpose for which the money had been advanced was no longer capable of being effectuated, it had to be paid back. It could neither be retained for services performed after the act of bankruptcy nor deducted by way of set-off from the amount owed by the bankrupt before he paid the £15 to the solicitor. The money was paid over for a particular purpose, so that the obligation to repay it, and the client's obligation to pay the solicitor for his services, were not commensurable.

Another example is *Re City Equitable Fire Insurance Co Ltd (No 2)*[77] where, under a treaty of reinsurance, a portion of the share of the premiums to be paid by the insurer to the reinsurer was under the

[75] For companies, see Rule 13.12 of the Insolvency Rules.

[76] [1893] 1 QB 455 (CA).

[77] [1926] 2 Ch 293 (CA).

treaty to be retained by the insurer to ensure due performance of the reinsurer's obligations. The reinsurer presented a winding-up petition and the treaty of reinsurance was determined, leaving a balance in favour of the reinsurer after all the rights and liabilities of the parties under that treaty had been settled. The insurer then sought to set off this balance against moneys owed it by the reinsurer under other treaties and policies of insurance and reinsurance. Set-off was refused because of the absence of commensurability:

> [T]he effect of handing over money for a specific purpose appears ... to be that it is taken out of the course of accounts between the parties to be held, so to speak, in suspense between them.

Such a state of suspense will last until a contrary, subsequent agreement is arrived at between the parties. Earlier authority[78] had already determined that the position was the same even if the purpose for which the money had been paid over was wholly fulfilled leaving a balance in the payee's hands.

Finally, the problem of commensurability has also presented itself where goods are handed over for a particular purpose, so that the trustee is seeking their return while the party in possession claims a set-off. This was disallowed in one case where cigars had been deposited as security for a specific debt.[79] The issue emerged in a contentious form in *Rolls Razor Ltd* v *Cox*,[80] a case arising out of the collapse of the John Bloom Empire. A salesman's contract was determined by his employer company some time before it passed a resolution for a voluntary winding-up. At the relevant time, the company owed him a sum of money representing commission already earned and the contents of a retention fund, held by the company as security against the salesman's defaults. For his part, the salesman had in his possession, *inter alia*, goods for sale purposes and goods for demonstration purposes. The Court of Appeal held that the goods held

[78] *Re Mid-Kent Fruit Factory*, *supra* n 73.

[79] *Eberle's Hotels and Restaurant Co* v *E Jones and Brothers* (1887) 18 QBD 459.

[80] [1967] 1 QB 552 (CA).

for demonstration purposes could not be the subject of a set-off. Lord Denning, following earlier authority,[81] failed to see that there were mutual credits, for these must in their nature terminate in debts, a requirement not met in the present case where the demonstration goods were not subject to a direction to sell so as to give rise to cash proceeds. Lord Justice Winn referred to the absence 'in our law of a concept of credit, properly so called, in respect of delivery of goods'. In consequence of this view, he would not even have been prepared to allow a set-off in respect of goods held by the salesman for sales purposes. The majority of the court, however, disagreed with him and permitted a set-off in respect of the sale goods. Lord Denning was of the view that there had been 'a giving of credit for the expected proceeds of sale'. So *Rolls Razor Ltd* v *Cox* puts some limits on the restriction of set-off in those cases where goods or money are held for a specific purpose. One should also add that the rise of the *Quistclose*[82] trust might lead to the mutual credits argument being presented now in a different but similarly effective way, so as to deny set-off where money or property is received on trust for a particular purpose, instead of where it is merely paid or delivered for a particular purpose.[83] On the whole, nevertheless, the substantial justice purpose of insolvency set-off should mean that insolvency set-off will only infrequently be refused because of an absence of mutuality.

Contingent Claims: An area that has proved persistently troublesome is that of contingent claims. A creditor may have a contingent claim that is greater or less than the insolvent's cross-claim. Alternatively, it may be the insolvent who has the contingent claim, which again may be greater or less than the creditor's claim. Section 323 is phrased in terms of the creditor proving or claiming to prove in the settling of the

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[81] *Rose* v *Hart* (1818) 8 Taunt 499.

[82] *Barclays Bank Ltd* v *Quistclose Investments Ltd* [1970] AC 597 (HL).

[83] The *Quistclose* argument failed in *Re Bank of Credit and Commerce International SA* (No 8) [1996] 2 BCLC 254.

bankrupt's estate. Where the larger claim is pressed by the bankrupt, so that the creditor raises set-off rights in a defensive way, the matter does not seem to fall within section 323(1). However, section 323(4) contemplates cases where the balance of the account is for or against the bankrupt, so it should not matter which of the parties is making the claim and which is seeking to exercise a right of set-off.[84] The matter would have been put beyond doubt if clause 193 of the Companies Bill 1989 had been enacted so as to modify section 323 in this respect. In one respect, the precise identity of claimant and cross-claimant will, as seen below, affect the set-off where one of the claims is contingent. The trustee-in-bankruptcy is empowered to value a contingent claim proven in bankruptcy by a creditor,[85] but there is no equivalent machinery for evaluating the contingent claim of the bankrupt against the creditor having to prove for an established claim.[86]

Turning to the case law on contingent claims, in *Re Asphaltic Wood Pavement Co*[87] a company in liquidation was contractually entitled to recover from the Commissioners of Sewers the agreed price for laying certain streets. The contract also laid on the company the obligation to keep the streets in repair, an obligation which had not yet been breached when the company went into liquidation. While no breach of contract had yet occurred on the company's part, it had by going into liquidation put it beyond its power to perform its contractual repair obligations in the future. In consequence, the Commissioner was entitled to lodge a proof in the company's liquidation and so could claim a set-off.

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[84] *Mersey Steel and Iron Co* v *Naylor Benzon & Co, supra* n 70; *Re Daintrey, supra* n 69, p. 549 (Wright J). The point is explicitly made by Lord Hoffmann in *Stein* v *Blake* [1995] 2 All ER 961, 966, that a set-off can be taken even if the creditor with the smaller claim does not prove in the bankruptcy.

[85] Section 322(3); Rule 4.86(1) of the Insolvency Rules (liquidations).

[86] Explained by Lord Hoffmann in *Stein* v *Blake, supra* n 84, p 965, on the ground that it would be unfair to advance the creditor's contingent liability to the bankrupt just because the trustee wants to wind up the bankrupt's estate.

[87] (1885) 30 Ch D 216 (CA).

A contingent claim against an insolvent company was also permitted in *Baker* v *Lloyds Bank Ltd*,[88] where the insolvent company discounted certain bills of exchange that it had drawn, accepted or indorsed with the claimant bank. At the relevant date, when the company's property was assigned to the plaintiff as trustee for its creditors, the bills had not yet fallen due and the company had thus not yet incurred liability under the bills. Mr Justice Roche permitted set-off because, although the amount that would have to be set off against moneys owed by the bank to the company was unknown at the date of the assignment in bankruptcy, it was 'certain' that there would be a deficiency as regards the accepted bills. Furthermore, the company was in breach of its obligations in respect of the indorsed bills as and when it made an assignment.

The untroubled appearance presented by these two authorities was, however, considerably disturbed by two subsequent decisions. The first of these was *Re Fenton*,[89] a particularly troublesome decision in view of the occurrence of a double insolvency. Fenton guaranteed advances made by a bank to a textile company in which he had an interest and later executed deeds of arrangement in favour of his creditors. The textile company also went into liquidation, leaving the bank with a debt claim against an insolvent company and a claim over against a bankrupt guarantor. The liquidator of the textile company lodged a proof against Fenton's estate in respect of various sums due from Fenton to the company. This proof was rejected by Fenton's trustee, who claimed an entitlement to set off the advances made by the bank to the textile company and guaranteed by Fenton. The bank had proved against Fenton's estate but nothing had been paid to it. Refusing a set-off, the Court of Appeal pointed out that none of the sums in question had been repaid by Fenton or his trustee to the bank.

The liquidator of the company had argued the case on two grounds. One was that Fenton's claim against the textile company was contingent, dependent upon the company's failure to repay the bank. This ground

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88. [1920] 2 KB 322.

89. [1931] 1 Ch 85 (CA).

does seem to have featured in Lord Hanworth's judgment, in that he saw section 31 of the Bankruptcy Act 1914 as

> connot[ing] an account capable of ascertainment on either side if not immediately, yet based upon authority or liability definitely undertaken ... [As regards Fenton] there was not a debt or certain liability, but one in respect of which there was a right of protection and no more ....

Lord Justice Romer, however, asserted that contingent liabilities are in general provable debts,[90] and the decision does appear to rest principally upon the second ground put forward by the company liquidator. This ground was the prohibition against the lodging of a double proof in bankruptcy. According to this well-established rule, the company in liquidation could not be subject to a claim by both the bank and by the guarantor Fenton in respect of the same debt. The decision in *Re Fenton* certainly supports the view that the rule against double proof could have been avoided if Fenton had been able to pay off the bank on his guarantee. But of course he was insolvent and so unable to do this. Later litigation in the same case[91] established that the rule against double proof was not avoided merely by Fenton's trustee paying the bank a dividend. Finally, it was no answer to the problem for Fenton's trustee, if allowed a set-off, to undertake to pay off the bank. The reason for this was that a surety who had not yet paid the principal creditor could not give a valid discharge binding the principal creditor. The surety might use the money for his own purposes and not for paying the principal creditor.

The contingent claim aspect of *Re Fenton* came to the fore in *Re a Debtor (No 66 of 1955)*.[92] Waite owed Clark a sum of money for goods sold to him by Clark. In order to supply the goods on credit terms to Waite, Clark had to borrow money from his bank. To enable Clark to do so, Waite guaranteed Clark's bank overdraft and deposited

[90] *Supra* n 89, p. 117.

[91] *Re Fenton (No2)* [1932] 1 Ch 178.

[92] [1956] 1 WLR 1226 (CA).

with the bank certain title deeds as security. A receiving order was later made against Waite, and later still Waite's trustee had to pay off the bank to secure the release of the title deeds. The question was whether Waite's trustee could set off, against Clark's claim for the price of goods previously supplied to Waite, the sum paid to the bank to secure the release of the deeds. The Court of Appeal said no, because at the relevant date (the date of the receiving order) no payment had been made to the bank by Waite or on Waite's behalf. Consequently, Waite's rights against Clark were only the

> special but contingent rights of a surety who had not been called on to make any payment by the principal creditor and had not exercised what has been called the protective right of the surety to require the principal debtor to relieve him of his liability by paying the debt owed to the principal creditor'.

Re Fenton was explained as turning principally on the double proof difficulty, but the centre piece of the decision in *Re a Debtor* was that, at the date when Waite's set-off right had to be in existence, no debt owed by Clark to Waite had yet fallen due. Clark's later indebtedness to Waite, arising out of the payment made to Clark's bank, could not be seen as the mere quantification of an obligation predating the receiving order. So the contingent aspect of Waite's claim at the relevant date was fatal to his set-off aspiration, and *Re a Debtor* goes beyond *Re Fenton* in making it plain that a surety who pays off completely the principal debtor does not improve his set-off position. It is not at all easy to see why this should have been the case.

The position taken by the Court of Appeal in *Re a Debtor* was trimmed a little by Peter Gibson J in *Carreras Rothman Ltd* v *Freeman Mathews Treasure Ltd*,[93] when he said that a sum could be due at the relevant date for the purpose of the set-off section, even if the precise amount of the sum could not be calculated until a later date. But the obligation had to exist at that date and could not itself be a contingent one. A more radical assault was made on *Re a Debtor*, however, by

[93] [1985] 1 All ER 155.

Mr Justice Millett in *Re Charge Card Services Ltd*.[94] Under a factoring agreement, the factor had a discretionary entitlement to retain moneys owed to the assignor company to avert the risk, *inter alia*, of default on the part of account debtors. The agreement also provided that, if the assignor were to go into liquidation, it could be called upon by the factor to repurchase any outstanding accounts receivable at face value. When the assignor later went into voluntary liquidation, various sums were owed by the factor to the assignor and, of course, the factor had not yet served notice on the assignor to repurchase outstanding accounts. The question, put by the assignor's liquidator, was whether the factor could set off any repurchase price owed by the assignor, if the factor were to exercise its right, against the retained sums owed to the assignor by the factor. It was the liquidator's contention that this could not be done since the assignor's repurchase obligation was contingent at the time of the liquidation. Since no surety was involved, there was no double proof issue in the case.

Mr Justice Millett held that the factor was entitled to set off the repurchase price of receivables against sums due from it, despite the contingent character of its repurchase entitlement at the date of the winding-up. Set-off was not confined, as *Carreras Rothman* had proposed, to existing claims whose quantum was unknown at the date of winding-up. It also applied where the claim itself was still contingent at that time, provided that the claim later did mature into a pecuniary demand capable of being set off. This would obviously be easier where the contingent claim was against the insolvent company, as in the instant case, for the liquidator had the power to value a contingent claim in the last resort. (No such expedient would exist, however, if the contingent claim was that of the company being wound up.)[95] In reaching the above result, Millett J examined the relevant authorities at great length and explained *Re Fenton* as turning upon the double proof rule. *Re a Debtor* was more difficult to dispatch and was dismissed as an obscure decision before the learned judge distinguished it in these terms:

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[94] [1987] Ch 150.

[95] *Re Daintrey* [1900] 1 QB 546, 557 (Wright J).

> [T]he true ratio of *re a Debtor* is that to come within [the set-off section] the liability must be exclusively referable not merely to an agreement already existing at the date of the receiving order, but to an agreement between the same parties as the parties to the set-off, and that the liability of the principal debtor to indemnify a surety who has paid the principal debtor does not pass this test.

This would be because the surety's right of indemnification arose by virtue of its agreement with the creditor and not by virtue of any agreement with the debtor, to whom it owed money. In other words, it was the absence of mutuality of parties rather than the issue of contingency that was fatal to the set-off claim in *Re a Debtor.* Perhaps the most important characteristic of *Re Charge Card Services Ltd*, however, is the way that the court saw the purpose of the set-off section as being to implement substantial justice between debtor and creditor, the attainment of which would be jeopardised by an unnecessary preoccupation with the contingent character of one of the parties' claims. This decision, likely to be the determining word on the subject,[96] would have been confirmed by clause 193 of the Companies Bill 1989. This referred to 'debts and liabilities to which each party is or may become subject' in its proposed recasting of section 323.

Guarantees and Mutuality: The collapse of that criminal conspiracy known as the Bank of Credit and Commerce International has illuminated dark areas of the law of set-off that might otherwise never have attracted attention. Suppose that a bank makes advances to a company and, by way of security for the company repaying the advance,

[96] See Lord Hoffmann in *Stein* v *Blake*, *supra* n 84, pp 961, 964-65, noting also at pp 965-66 that insolvency set-off operates regardless of whether a proof has been lodged by a claimant in the insolvency, as well as Hoffmann LJ in *MS Fashions Ltd* v *Bank of Credit and Commerce International SA* [1993] 3 WLR 220, 230.

requires from a director of that company the maintenance of a deposit account with the bank containing a minimum sum. The bank goes into liquidation having a right to recover the advance from the company but a liability to the director in the amount of the deposit. May the liquidator of the bank recover the advance in full from the company and leave the director to prove for the deposit, in which event the director will receive the traditionally modest insolvency dividend? Or may the director claim that he is a guarantor of the company's indebtedness and that his liability as such ought to be set off against the bank's liability to repay him? The consequence of this would be that the bank's claim against the company debtor would be abated to the extent of the set-off, to the benefit of the director in his capacity as shareholder of that company.

A fair starting point in this inquiry is that, the director and the company being separate persons in law, there appears to be a lack of mutuality of parties necessary for set-off to be permitted. The bank, A, is owed money by the company, B, but in turn owes money to the director, C. In *Re Bank of Credit and Commerce International SA (No 8)*, Rose LJ observed:

> It is not the function of insolvency set-off to confer a benefit on a debtor of the insolvent who has not been a party to the mutual dealing, nor to afford a preference to a creditor who has no liability to the insolvent or whose liability is only secondary and is capable of being satisfied by the party primarily liable.[97]

[97] [1996] 2 BCLC 254, 263. Another example of mutuality of parties is *Bank of Credit and Commerce International SA* v *Prince Fahd Bin Salman Abdul Aziz al-Saud* [1997] BCC 63, where the Prince's liability to the bank on a guarantee could not be offset against balances in certain accounts in the name of Ghazzawi, who handled the Prince's personal affairs. Under Islamic custom, the business relationship between the Prince and Ghazzawi was one of absolute trust. Ghazzawi had mingled the Prince's money with his own in those accounts. Since it could not be known how much of the Prince's money had gone into those accounts, there could be no set-off between the bank's liability to the Prince under those accounts and the Prince's liability to the bank as guarantor.

The answer to the questions posed in the previous paragraph seems therefore to depend upon whether the director incurs a personal obligation to the bank in respect of the repayment of that advance.

In *MS Fashions Ltd* v *Bank of Credit and Commerce International SA*,[98] three directors individually signed agreements with the bank by which they undertook a liability as 'principal debtor' to repay a sum advanced by the bank to their company. They thus incurred primary liability to the bank and, set-off being mandatory, the effect of this was that a set-off was struck as between the bank's duty to repay them the deposits they had been required to maintain with the bank and their liability on the loans advanced by the bank to their company. Furthermore, the outcome of the set-off, which took effect at the date of the winding-up, was that the company's indebtedness to the bank was abated to the extent of the set-off. The bank was not therefore in a position to disregard the directors and pursue a claim against the company for the full repayment of the advance.

In contrast, the beneficial owner of a company, in *Re Bank of Credit and Commerce International SA (No.8)*,[99] gave a charge over a deposit account to the bank that advanced money to his company. He did not expressly undertake that the loan would be repaid and the court declined to spell out of his agreement with the bank any implied undertaking to that effect. In particular, a personal undertaking could not be inferred from the failure of the arrangement to operate as a chargeback. The bank was liable to him to repay the deposit and free to pursue his company for the repayment of the loan. There was lacking the mutuality necessary to invoke Rule 4.90 of the Insolvency Rules. Consequently, any departure from the scheme of distribution laid down in the Insolvency Act, even if agreed by the bank, the director and the company debtor, would have offended the *pari passu* rule of distribution.

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[98] *Supra* n 96.

[99] *Supra* n 97. See also *Tam Wing Chuen* v *Bank of Credit and Commerce Hong Kong Ltd* [1996] 2 BCLC 69.

The intermediate case is that of the depositor who does not undertake primary liability but does undertake secondary liability as surety in the event of the primary debtor's default. This was discussed at some length by Hoffmann LJ at first instance in *MS Fashions Ltd* v *Bank of Credit and Commerce International SA*.[100] Where the surety becomes liable to pay only in the event of a demand being made by the creditor, no cause of action exists in the creditor unless and until a demand is made.[101] Meanwhile, the surety's liability is a contingent one. Hoffmann LJ appears to say, both, that the depositor's contingent liability cannot be the subject of a set-off against the bank's liability to repay the deposit, and that the contingent liability, appropriately discounted, can be the subject of a set-off.[102] The latter approach accords with principle but, in fact, there is not likely to be a significant practical difference between the two approaches. An insolvent creditor, properly advised, will not demand payment from the surety and will recover the principal sum from the debtor so as not to have to call on the surety. The contingent liability of the surety to the creditor will commonly be too precarious to effect a significant discount against the creditor's liability to the surety to repay the deposit. Although a set-off takes effect at the date of the winding-up order (the retroactivity principle),[103] the court will take account of developments since the winding-up order (the hindsight principle). By the time the account comes to be taken, the creditor may have recovered payment from the debtor so as to discount the surety's liability to nil.

Other Insolvency Issues – Notice of Insolvency: *Re Charge Card Services Ltd* contains cautionary words on the impermissibility of debtors, faced with the insolvency of their creditors, buying up debts owed by such creditors to third parties. Such debts would be provable

[100] *Supra* n 96.

[101] *Bradford Old Bank Ltd* v *Sutcliffe* [1918] 2 KB 833.

[102] *Supra* n 96, p 230.

[103] *Stein* v *Blake*, *supra* n 84.

in the creditors' insolvencies for the usual meagre dividend but, if capable of being the subject of a set-off in the debtor's hands, would obviously have a much greater purchasing power. The reason for disallowing set-off in such cases is that the debtors in question should not be able to improve their position when fixed with notice of their creditors' insolvencies. Nor should the third parties break ranks with other unsecured general creditors, for this would offend the principle of *pari passu* distribution. A free expansion of contingent claim set-off would clearly court the risk of offending these principles.

In *Re Eros Films Ltd*,[104] a debtor had notice of a winding-up meeting of the creditor company when it took an assignment from a third party (the parent company of the debtor) of a debt owed by the creditor company to that third party. The assigned debt had become due and payable when the creditor company was called upon to honour certain guarantees, which happened after notice of the winding-up meeting was received. The set-off was disallowed. There was notice of insolvency, for insolvency was the proper inference to draw from the meeting, which was to consider a creditors' voluntary winding-up. On similar grounds, a bank in *Re Gray's Inn Construction Co*[105] was not permitted, after receiving notice of a creditor's petition to wind up a debtor company, to credit certain sums of money to the debtor company's overdrawn account. To do so amounted to a preferential discharge of the debtor company's indebtedness to the bank. The court nevertheless exercised its discretion to allow certain payments into the overdrawn account, occurring after the commencement of the winding-up but before the bank had notice thereof, under what is now section 127 of the Insolvency Act 1986.

Date of Ascertaining Existence of Set-off Right: In *Re Daintry*,[106] a bankruptcy decision, the relevant date for the existence of a set-off entitlement was said to be the date of the receiving order rather than the date of commencement of the bankruptcy, when the act of

[104] [1963] Ch 565.

[105] [1980] 1 WLR 711 (CA).

[106] *Supra* n 95. See also the discussion of contingent claims *supra*.

bankruptcy was committed. Confirmation of this was given in *Re Charge Card Services Ltd* where the point was also made that the relevant date in a corporate winding-up was the date of the winding-up order itself[107] rather than the date the winding-up commenced, as was suggested by some of the earlier authorities. The importance of this date is diminished, obviously, by the willingness to admit contingent claims, but a rather difficult issue emerges from the conjunction of the relevant date and the absence of notice.

The old set-off provision, section 31 of the Bankruptcy Act 1914, used to deny set-off where the applicant 'had, at the time of giving credit to the debtor, notice of an act of bankruptcy committed by the debtor'. Although the date of the receiving order was when the set-off right had to be ascertained, a claimant could already have lost the right by earlier notice of an act of bankruptcy. Now, a problem arises from the wording of section 323(3) of the Insolvency Act 1986 (as well as from the similar wording of Rule 4.90(3) of the Insolvency Rules). The concept of an act of bankruptcy no longer applies in insolvency legislation, so a reference to a bankruptcy petition being 'pending' is substituted for the commission of an act of bankruptcy. Although the meaning of this may become difficult to determine - what about the creditor who suspects that a bankruptcy is in the air? - the real trouble lies in the substitution of debts being 'due' on the date the creditor has notice for the old wording of 'giving credit to the debtor'. Does not this new wording rule out contingent claims that have not yet materialised when the creditor is fixed with notice? If one looks at the cases, dealt with earlier, on common law set-off and

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[107] [1987] Ch 150, 177, approving Nourse J in *Barclays Bank Ltd* v *TOSG Trust Fund Ltd* [1984] BCLC 1, 25 (by parity of reasoning, date of resolution for creditors' voluntary winding-up). An important illustration of this rule is *Stein* v *Blake* [1995] 2 All ER 961, where a bankrupt's trustee assigned back to him, in return for 49% of the net proceeds recovered, a breach of contract action against the defendant. The defendant had a cross-claim for damages for misrepresentation. The House of Lords held that the trustee had succeeded, not in assigning the breach of contract claim as such, but so much of a positive balance as existed in the trustee's favour after account had been taken of the cross-claim. The validity of the assignment did not therefore depend upon whether the account had actually been taken.

assignment, the response would appear to be that a debt could be due for the purpose of section 323(3) even if it is not yet payable - *debitum in praesenti sed solvendum in futuro*. Consistently with the admission of contingent claims, 'due' should therefore be interpreted as 'contingently due'.[108] Clause 193 of the Companies Bill 1989 would have amended section 323 of the Insolvency Act 1986 so as to exclude set-off where the relevant claim 'arises by reason of an obligation incurred at a time when the creditor had notice that a bankruptcy petition relating to the bankrupt was pending'. This formula would allow a broad range of contingent claims to be admitted to set-off. A clarificatory amendment of this sort to section 323 still represents the best solution to the problem.

Insolvency Set-off, Investment Exchanges and Clearing Houses: We start from the position that the insolvency set-off provision has been stated at a high judicial level to be compulsory in its application.[109] The relevant parties may not therefore in principle abridge or extend their set-off rights. The law's interest in ensuring an orderly and just distribution of the insolvent's estate is accordingly treated as of paramount importance. Yet this stance is a little surprising in that the justice of the matter has traditionally been looked at as between creditor and insolvent debtor, rather than as among the various creditors of the insolvent debtor. (Set-off, it should be emphasised, is even more effective than secured debt in protecting creditors for it affects the flow of assets going into the estate of the insolvent party for distribution.) Why, for example, should not a contractual agreement be allowed that enlarges a debtor's estate for distribution to other creditors? Why indeed is the law so generous to set-off creditors when the effect of this is to prefer them to other creditors in the debtor's insolvency? Not all set-off creditors will enter into an agreement with a debtor with the purpose of acquiring a set-off entitlement that can

[108] R Derham, *Set-Off* (Oxford, 2nd ed 1996), p 240. See also Lord Hoffmann in *Stein* v *Blake, supra* n 107, p 965.

[109] *Re Fenton, supra* n 89 (Lord Hanworth MR); *National Westminster Bank Ltd* v *Halesowen Presswork & Assemblies Ltd* [1972] AC 785 (HL).

be exercised against a later claim on them by the debtor's trustee or liquidator. For some creditors, a set-off right will be a pure windfall.

The need to consider carefully the role of insolvency set-off in the financial markets lay behind the substantial and daunting mass of provisions constituting Part VII of the Companies Act 1989. These provisions were designed to protect the integrity of the financial markets and to save them from a domino collapse of numerous institutions prompted by the insolvency of just one of them. They were, *inter alia*, a response to the fears triggered by the decision of the House of Lords in *British Eagle International Air Lines Ltd* v *Compagnie Nationale Air France*.[110] This case involved a clearing house, the International Air Transport Association (IATA), through which all the member airlines settled their debts to each other for services provided. Instead of a multiplicity of bilateral settlements, obviously wasteful and time-consuming and 'involving a vast number of cross remittances in a variety of currencies', airlines that were net debtors over the relevant period paid moneys owed other airlines to IATA, which disbursed moneys to net creditor airlines in the appropriate amounts. Over the period in question, British Eagle was a net debtor under the terms of the clearing house arrangement, though a number of airlines, for example Air France, were indebted to it. The liquidator contended that he was not bound by the clearing house arrangement and might recover a sum of money from Air France for services rendered. He claimed that the clearing house arrangement offended the principle of *pari passu* distribution to unsecured creditors under what is now section 107 of the Insolvency Act 1986;[111] it preferred creditors who were members of the clearing house to non-member creditors. By a bare majority, the House of Lords ruled in the liquidator's favour, thus insisting on the bilateral character of debt and refusing multipartite set-off. It did not matter that membership of the clearing house was stated in the contractual agreement to involve a contract between each and every member of the scheme and IATA itself. Preferring the clearing

[110] [1975] 2 All ER 390 (HL).

[111] See also Rule 4.181 of the Insolvency Rules.

house creditors in the way advocated by Air France would have been to make them in substance chargees over each other's book debts without the agreement ever explicitly creating such charges and without any such charges ever being registered. It would also have created a 'mini-liquidation' within a larger liquidation.

The effect of the House of Lords decision in the financial markets was overturned by the Companies Act 1989. In the case of recognised investment exchanges and clearing houses, section 154 states the broad aim of preserving the integrity of market settlement procedures and sections 158-59 make it very plain that the law of insolvency is subordinated to these procedures. In section 163, provision is made for the net sum owing after market settlement procedures have been worked through to be dealt with in insolvency proceedings in the usual way. Under sections 170-71, the Secretary of State has a very broad rule-making power to extend these provisions to other financial institutions. The Companies Act 1989 therefore permits the very thing denied by the House of Lords in the *British Eagle* case: it permits mini-liquidations prior to the operation of the normal insolvency process. The netting rules of the financial institutions, together with their set-off and similar arrangements, therefore enjoy an unimpeded operation. The Act also made special allowance for the case where one or more, but presumably not all, of the creditors of the insolvent have notice of an impending insolvency. As we saw above, under section 323 of the Insolvency Act there is no entitlement to set off where sums fall 'due' from the bankrupt after the creditor is fixed with notice that a bankruptcy petition is pending. Section 163(4) preserves the integrity of the new mini-liquidation while permitting the liquidator or trustee in bankruptcy to take proceedings against any creditor or creditors with notice to claw back benefits improperly obtained thereby.

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