BROAD'S CASE AND SET-OFFS

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Introduction

The law of set-off does not exist. The term "set-off" covers a number of disparate concepts which may or may not have elements of commonality. The concepts themselves derive from different historical and juristic sources and are applied in different situations.

To list but a few, there is the set-off derived from the law merchant, which is commonly but not exclusively applied to bankers. Mutton v. Peat [1900] 2 Ch. 79. Until 1972 that was always compendiously called the banker's lien, and we all knew what it was was. Then in Halesowen v. Westminster Bank [1972] AC 785 the House of Lords had an attack of semantic purity and renamed it the banker's right of set-off. One more different animal with the same name. There is set-off at common law before insolvency. There is set-off by statute upon insolvency. There is set-off by the Court in civil litigation. These are all different yet such is the poverty of the English language that we have only one name to describe them.

It is rather like cows. We call cows, sometimes brown or white cows. But a self respecting Zulu knows 800 words for cow, so that every cow in a herd can be described and a stranger would immediately recognise which cow was being talked about.

I speak with some feeling on this. In 1979 I was instructed, along with another Q.C. and two barristers, to write a definitive opinion on the law of set-off for use by one of the two firms of London solicitors who dominate the syndicated loan work. After about four years and 28 drafts we realised we could not do it. The subject grows like a triffid, or dry rot, creeping around and catching you in unexpected places, and doing serious damage to what you had thought was a soundly constructed intellectual edifice. It simply is not a coherent whole; no judicial attempt has been made to rationalise it, nor do we think such an attempt can be made because it is not one subject but several, and the parts do not sit readily together.

So now our draft sits in a word processor's memory. Every so often we take it out and amend it, up date it, or change it, and

re-write bits of it, of just dust it. I have brought a print out to show you how thick it is, and thereby to make you realise that I cannot do anything more than skate over bits and pieces. I am sorry that I cannot leave this draft with you, even if you wanted it, because our clients have the copyright. They were kind enough to say we could keep the paperback and TV rights, but they do not seem to be worth very much.

Banker's Right of Set-off

The banker's right of lien or set-off is a good place to begin, not merely because of this conference, but because of its own intrinsic interest. It derives from the law merchant. May I refresh your memories for a moment?

The law merchant once existed as a separate body of law administered in separate courts, the Courts of Staple. This, of course, is no longer so and it is often said that the law merchant is "part of" the common law. An important consequence is that "Courts of Justice are bound to know and recognise the law merchant" Brandao v. Barnett (1846) 2 CB 519 and 530. Thus a right which is part of the law merchant will be judicially noticed; it need not be pleaded unless a particular application might take the other party by surprise, and need not be proved; it will be applied without proof of intention that it should govern the transaction. These features distinguish a right arising under the law merchant from a contractual term, which must be pleaded and proved.

It must be remembered, however, that the law merchant still exists as a separate body of rules within the common law. Those rules are quite different in character from ordinary rules of common law:

> "Mr Benjamin's argument is founded on the view that the law merchant thus referred to is fixed and stereotyped and incapable of being expanded and enlarged so as to meet the wants and requirements of trade in the varying circumstances of commerce. It is true that the law merchant is sometimes spoken of as a fixed body of law forming part of the common law, and as it were coeval with it. But as a matter of legal history, this view is altogether incorrect."

Per Cockburn C.J. in Goodwin v. Robarts (1875) L.R. 10 Exch. at 346; affirmed (1876) 1 App.Cas. 476.

Sadly the Courts of Staple either did not keep very good records or else, more likely, they were lost, so we do not know a great deal directly of what their decisions were. We have to rely more often on their incorporation into the judgments of the common law courts, and especially those of Lord Mansfield. But this does not mean that the corpus of the law merchant became fixed 2 centuries or so ago. It is very much alive and kicking today for since the law merchant is made up of the customs of merchants and traders which have been ratified by decisions of courts of law,

it is capable of being expanded and enlarged as further customs are proved, or narrowed if it is proved that a particular custom no longer exists. Thus the entire C.D. (Certificate of Deposit) market in London revolves around new instruments deliberately made negotiable by the bankers of the City of London.

One of the sensible things the law merchant did was to say that a banker looked at his customer as a whole man. He might lend him money for this on one occasion and for that on another, and some things might prosper and some might not, but the banker looked at his total exposure to his customer. This was recognised by the Courts and was the source of the banker's lien. See how it was put in the judgments in Garnett v. McKewan (1872) LR 8 Ex. 10:

> "Kelly C.B.:
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> The original basis of the rule was twofold. First, it used to be the practice of English bankers to take their customers 'as a whole'. Second, 'the managers of each branch are in the habit of communicating with each other, and honouring cheques of the customer according to the state of his general account'.
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> Bramwell B.:
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> 'in practice, bankers do constantly allow overdrawing at a particular branch, because they know they may debit the customer with his balance at some other branch'."

This lien under the law merchant had certain characteristics which were, and still are, different from those under a common law or equitable lien. The lien carried with it a right of sale, not merely a right to hang on to the property until paid. It also applied to any securities or other property deposited with the banker as banker (e.g. not including those deposited for safe keeping) even though they were not those of his customer, provided the banker acted in good faith: which in this context usually means he had no reason to doubt his customer's title to the securities.

Now the law merchant, as I have just said, is very much alive and kicking. So this lien applies to modern documents of title Lord Mansfield never heard of, as well as those he did. Bills of lading received under a letter of credit, warehouse warrants, certificates of deposit, letters of allotment, bearer shares, trust receipts and so on.

Looked at in this light you will see that the banker's right of set-off is merely the limiting case of the banker's lien, where what the banker holds as security is the customer's money and not a document that can be turned into money. That is why I suggested that the House of Lords semantic purity did practising lawyers no great service by insisting that henceforth we only apply the name lien to the right over documentary securities and

call the limiting case by another name already used for common law and equitable rights which are significantly different.

Before leaving the right of lien or set-off under the law merchant I must mention two other special characteristics. The first is that where a banker has several accounts, some in credit, some overdrawn, and some securities, he must set-off the balances in the accounts first and apply the securities to the customer's net indebtedness. Brandao v. Barnett (1846) 2 CB 519 "a lien for his general balance on securities deposited with him". And see also Mutton v. Peat [1900] 2 Ch. 79, in which Mr Peat was one of the founders of the great accountancy form Peat, Marwick, Mitchell.

The second, which I find fascinating to contemplate, is this. The law merchant was never nationalistic. Merchants traded across national boundaries long before bankers did so. They did not necessarily follow different practices in Hamburg or Paris. So it is not easy to circumscribe the right to the confines of one court's jurisdiction. To take the simplest example, why should a balance in Manchester be set off against a debit in London, but not a balance in Edinburgh? And if Edinburgh, why not New York?

If this is correct then it could mean that a multinational bank, with many customers having accounts in more than one country, would have to apply its rights of lien and set-off to the totality of the customer's obligation world-wide! I will not explore this potential lawyers' bonanza today, but it is inevitable that the Courts are going to have to decide it sometime.

Perhaps I should conclude this section by observing that, although I have been talking about banker's lien and set-off, I did say at the outset that this was only the commonest form of the right under the law merchant. The same rights undoubtedly apply to stockbrokers (Jones v. Peppercorne (1858) John 430), to solicitors, and I can see no reason why they should not apply to commodity brokers. In practice, though, the rights of those persons are often replaced by express contractual conditions of trading; it is just a peculiar characteristic of English bankers that they do not usually have Standard Conditions of Contract and so still resort to the general law. Contracted terms covering similar ground will generally have the effect of impliedly excluding the law merchant.

Equitable Set-off

May I turn now to the position which will nowadays govern most situations where the law merchant does not apply and where contractual provisions are silent: the set-off in equity. In England this right seemed to have fallen into desuetude until 1958, despite an extraordinarily far sighted decision of the Privy Council in 1888. In 1958 the Court of Appeal gave the kiss of life to the sleeping remedy in Hanak v. Green [1958] 2 QB 1, a

case of otherwise stupefying dullness. Fortunately, twenty years later Lord Denning re-stated and rationalised the law in his pellucid style in Federal Commerce Ltd. v. Molena Alpha Inc. [1978] 1 QB 927:

> "But the courts of equity, as was their wont, came in to mitigate the technicalities of the common law. They allowed deductions - by way of equitable set-off - whenever there were good equitable grounds for directly impeaching the demand which the credit was seeking to enforce. These grounds were never precisely formulated before the Judicature Act 1873. It is now far too late to search through the old books and dig them out. Over 100 years have passed since the Judicature Act 1873. During that time the streams of common law and equity have flown together and combined so as to be indistinguishable the one from the other. We have no longer to ask ourselves: what would the courts of common law or the courts of equity have done before the Judicature Act? We have to ask ourselves: what should we do now so as to ensure fair dealing between the parties? See United Scientific Holdings Ltd. v. Burnley Borough Council [1978] AC 904 per Lord Diplock ... But one thing is clear: it is not every cross-claim which can be deducted. It is only cross-claims that arise out of the same transaction or are closely connected with it."

This happily relieves me from having to try to keep you awake whilst examining the old common law rules of set-off.

Would you notice the last 6 words "or are closely connected with it". That was the wicked Lord Denning at his best: apparently cutting down a remedy, in fact subtly extending it. Only two years later Brightman J. (now Lord Brightman) in Bartlett v. Barclays Trust Co. (No.1) [1980] Ch. 515, had to consider the established rule that where a trustee is liable in respect of distinct breaches of trust, one of which has resulted in a loss and the other in a gain, the gain may not be set off against the loss unless they arise in the same transaction. In that case the gain and the loss both stemmed from exactly the same policy of the trustees, but not from the same transaction. Following the Molena Alpha Brightman J. held that justice required him to vary the rule so as to permit set-off: an interesting example of the court's modern disfavour of any attempt by a party to blow hot and cold.

An extreme example of this modern approach may be found in Canada Enterprises Corporation v. Macnab Distilleries (unreported) C.A. 21 January 1975 where the Court of Appeal stayed execution of a judgment against the defendant company, pending the trial of an action which the defendant's parent was going to bring against the 3 shareholders who owned the plaintiff company, but which had not yet been brought because the cause of action had not accrued! That was strictly a decision under the Supreme Court procedural rules O.47, R.1, but the principle was quite clear: equity

required the piercing of the corporate veil on both sides with a view to an ultimate set-off.

The Newfoundland Case

A moment ago I described as far sighted an 1888 decision of the Privy Council. That was Government of Newfoundland v. Newfoundland Railway Company (1888) 13 App.Cas. 199, whose significance has been largely overlooked, yet in many ways it could be said to have foreshadowed the reasoning of such diverse recent cases as Canada Enterprises, Bartlett v. Barclays Trust and the Court of Appeal decision in Federal Commerce v. Molena Alpha.

In that case the railway company contracted to build a railway for the Government in return for a 35 year subsidy, payable semi-annually in cash, and a grant of 5000 acres of land per mile in respect of each five-mile section completed. The cash subsidy was "to form part of the assets of the company as and when each five-mile section was completed" and the land was to be granted in fee simple on completion of each section of five miles. The company raised money for its operations by means of bonds, to the trustees for which they assigned the company's assets. The company got into difficulties when it had completed 85 of the 100 miles due, and stopped work. The trustees claimed that they were entitled to keep the land which had already been conveyed, which the Government did not dispute, and were entitled to land due for completed sections but not yet conveyed, to which the Government objected. On that the Government lost; but it was the money payments that were the real dispute. Could the trustees, as assignees of the assets, maintain their right to receive the subsidy for the completed sections, or was that right subject to the Government's counterclaim for unliquidated damages, even though that counterclaim had arisen after the assignment. The trustees argument was:

> "The assignees were not affected by any counterclaims by the appellants. Set-off is a question of procedure. You may set off in an action inter partes, not in an action by third parties who are entitled to sever the claim from the rest of the contract, when the claim is a completed one, notice of the severance and assignment having been given to the debtor."

In the 19th Century such an argument might well have succeeded. It did not. The Privy Council, whose judgment was delivered by Lord Hobhouse, argued boldly from a negative to a positive. In Watson v. Mid Wales Railway Company (1867) L.R. 2 C.P. 593 Bovill C.J. had said:

> "No case has been cited to us where equity has allowed against the equitable chose in action a set-off of a debt arising between the original parties subsequently to the notice of assignment, out of matters not connected with the debt claimed, nor in any way referring to it."

Since the negative was not so, the positive must be. Therefore Lord Hobhouse said:

> "The present case is entirely different from any of those cited by the plaintiffs' counsel. The two claims under consideration have their origin in the same portion of the same contract, where the obligations which gave rise to them are intertwined in the closest manner. The claim of the Government does not arise from any fresh transaction freely entered into by it after notice of assignment by the company. It was utterly powerless to prevent the company from inflicting injury on it by breaking the contract. It would be a lamentable thing if it were 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 shall 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. There is no universal rule that claims arising out of the same contract may be set against one another in all circumstances. But their Lordships have no hesitation in saying that in this contract the claims for subsidy and for non-construction ought to be set against one another.
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> ...
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> Unliquidated damages may now be set off as between the original parties, and also against an assignee if flowing out of and inseparably connected with the dealings and transactions which also give rise to the subject of the assignment." [Emphasis added.]

Such a robust and sensible conclusion may seem unremarkable today. It was not in 1888, especially when you remember that the assignments had been completed before the counterclaim arose. Perhaps it was then unpalatable, and of course the constitutional doctrine that the Privy Council was free to change its mind was put into practice more often than now, but for some reason this case dropped out of sight for almost a hundred years. You will not, for example, find it referred to in Paget's Law of Banking (though I am assured by Mr Mark Hapgood, the new editor, that it will be in the 10th Edition next year). Nor was it cited in the arguments of judgments in the Molena Alpha.

Following Lord Denning in the Molena Alpha I do not much care how the doctrine in the Newfoundland case should have been classified then or now. But I do say that if the words I have underlined had been in the text books many many disputes over the last few decades, especially in the field of syndicated loans, would never have arisen or, at least, would have been settled as soon as they had. Notice please, especially, the words in the second part of the citation. No doubt they are obiter, for the case was only concerned with matters arising out of a single contract, but their Lordships went out of their way to express a wider principle "... inseparably connected with the dealings and transactions which also gave rise to the subject of the assignment".

Prohibition of Assignment

Of course, if you want to protect your client or yourself you might prefer to prevent the assignment ever happening in the first place. Then you only have to consider the rights of set-off as between the original parties to whatever contract it was. The question is, can you do that?

This is an area in which the law in England, at any rate, was very confused. Until recently, the preponderance of authority favoured the effectiveness of an assignment in breach of a prohibition against doing so. The cases did not really deal with a provision that declared a debt not to be capable of assignment. They were all very unsatisfactory. Some of these were: Belsize Motor Supply Co. v. Cox [1914] 2 K.B. 244, Spellman v. Spellman [1961] 1 WLR 921 and Wickham Holdings Ltd. v. Brooke House Motors Ltd. [1967] 1 WLR 295.

Then in Helstan Securities Ltd. v. Hertfordshire County Council [1978] 3 All E.R. 262, Croom-Johnson J. having reviewed the authorities, held that a purported assignment in breach of a provision prohibiting assignment was invalid. His reasoning was as follows:

> "There are certain kinds of choses in action which, for one reason or another, are not assignable and there is no reason why the parties to an agreement may not contract to give its subject-matter the quality of unassignability."

Whether that statement of principle was correctly applied in the Helstan case itself or not it certainly makes sense.

It follows that a basic prohibition on assignment as distinct from a provision declaring a debt to be incapable of assignment will, as a matter of construction, be insufficient to invalidate an assignment.

Thus the difficult case of Siebe Gorman v. Barclays Bank (1979) 2 Ll.R. 142 might, on this ground, have been differently decided because there the relevant clause was a prohibition on charging an assignment without the prior consent of the Bank. Slade J. at p. 160, said:

> "I see no reason why, as between mortgagor and mortgagee, they should not have been valid contractual provisions. They were nonetheless in my judgment special provisions which a third party, such as Siebe Gorman, would not necessarily have expected to find in a mortgage creating a specific charge on future book debts.
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> ...
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> In these circumstances I do not think that Siebe Gorman can be treated as having had constructive notice of the cl.5(c) provisions at the date when it took its assignment."

When drafting, just in case I am wrong in thinking Lord Justice Croom-Johnson is right it may be wise to combine provisions, as for example:

> "The parties hereby agree that the choses in action created by Clause hereof shall be incapable of assignment. The lender further agrees not to attempt to assign the same."

If the first part of the clause is effective, the banker's position is unaffected, and there would be no point in pursuing a claim for damages. But if the first part is ineffective, there is no reason why a foreseeable loss directly and naturally following from the breach should not be compensated in damages in the ordinary way. If the assignment has impaired the banker's rights of set-off, the banker has an accrued right to damages as from the moment of assignment, and it is possible that this claim for damages could be set-off against the assignee under the Newfoundland principle. So no-one escapes in the end!

British Eagle v. Air France

This was a case in 1975 which made headlines when British Eagle went bust. As a matter of law it concerned multiple mutual set-offs. As a matter of fact it concerned a netting-off through the International Air Transport clearing house of airlines obligations on tickets issued which was not dissimilar from the procedure followed in major banking centres, certainly in London: all inter airlines obligations are pooled and the net result is paid or received by or through the clearing house. By a majority of 3-2 the House of Lords over-ruled a unanimous Court of Appeal, and held in favour of the liquidator that he was not bound by the IATA clearing house regulations.

It did not matter that the regulations were not intended to escape the statutory scheme which springs into operation on insolvency. If that had been the intention they would have been struck down by long established authority e.g. Ex parte MacKay (1873) 8 Ch.App. 643. IATA was far from that intention. Its system was the one which operated all the time between all members, and they said the calculations should be carried out in the same way after insolvency as before. But IATA's argument failed. Lord Cross, delivering the leading speech said:

> "The respondents argue ... that the power of the court to go behind agreements, the results of which are repugnant to our insolvency legislation, is confined to cases in which the parties' dominant purpose was to evade its operation. I cannot accept this argument."

Instead, he laid down a new test: a provision is invalid against a liquidator if its effect is to prefer one unsecured creditor or class of creditors to another, or (which is the same thing) if it achieves a distribution of assets other than that provided by [the Statute].

So Air France had to pay the Receiver in full for all the Air France tickets still in the clearing which had been honoured by British Eagle, but receive only a dividend in the winding-up for the equivalent British Eagle tickets honoured by themselves.

One spin-off which you may have noticed was that airlines immediately, and ever since, have been very leery about accepting flight coupons from airlines not of the highest credit-worthiness. That is why you sometimes have problems getting coupons endorsed across to another airline when you change your routing or flight plan: once other airlines could not look to IATA to pay the little pieces of paper ceased to be as convertible as dollar bills. Of course, you are all right with Qantas tickets, but a few years ago you had difficulty with, say, Braniff tickets. From the point of view of the banker to an airline in difficulty this makes things worse. The airline's cash flow gets a two month hiatus as it cannot sell its own tickets for anything but its own flights. It therefore loses all its direct interline sales, and has to depend for much of its income on receipts from IATA's clearing. So the British Eagle decision was no help to airlines or their bankers.

Mutuality and Maturity

Having looked at a number of general questions, it is important to look at these two requirements, which are not identical.

(1) Mutuality

It used to be said that there are two requirements: the debts must be mutual, and the debts must have matured. These requirements underlie the whole law of set-off; they are always sufficient, but they may not always be necessary. The requirement of mutuality is that the debts to be set-off have to be owed by both parties in an identical capacity. Thus a banker may not set-off against a debt owed by a customer, privately a debt owed to that customer in his capacity as trustee - re Gross, Ex parte Kingston (1871) 6 Ch.App. 632.

An obvious application of this requirement which is of particular importance to bankers is that a joint debt may not be set-off against a several debt. Thus a credit balance on a joint account may not be set-off against a debt owed by one of the account holders individually. This rule does not prohibit the setting off of either a joint debt or a several debt against a joint and several debt, and it can be a problem with syndicated loans in particular in deciding which or what.

(2) Maturity

The requirement of maturity of indebtedness is that the debts to be set-off must be presently due and payable. There can be no set-off as such of future debts or of contingent debts. This does not mean that before bankruptcy or liquidation the banker is always without a remedy.

A debt is presently due and payable if it is presently recoverable by action. Common examples of such debts in banking transactions are (a) the debt owed by a borrower after a loan is called in or, in the case of a term loan, after the contractual date for repayment has passed; (b) the debt owed to a customer after a demand for repayment of a credit balance on current account, and (c) the debt owed by a surety after demand made by the creditor.

A future debt is an existing debt payable in the future - debitum in praesenti, solvendum in futuro. Common examples are (a) the debt owed by a banker in respect of a credit balance before demand for repayment - Joachimson v. Swiss Bank Corporation [1921] 3 K.B. 110; and (b) a time deposit or term loan before the date for repayment has arrived.

The term "contingent debt" is technically a misnomer in that until the contingency occurs, there is simply no debt in existence. Much better is the term "contingent liability", which was defined by Lord Reid in re Sutherland, decd. [1963] AC at p. 249:

> "... 'contingent liabilities' ... must mean sums, payment of which depends on a contingency, that is, sums which will only become payable if certain things happen, and which otherwise will never become payable."

These words were spoken in relation to the Finance Act 1940 section 50(1), but are of general application. Examples of contingent liabilities (a) are the liability of a confirming bank to a beneficiary under a letter of credit before presentation of documents; (b) the liability of a bank to a borrower before a facility for borrowing is drawn on; and (c) the liability of a surety to a creditor before demand is made under a guarantee.

Although the law of set-off cannot be defined without using these sort of terms, it should always be borne in mind that they are not terms of art, and that many obligations cannot be classified as easily as the simple examples given above. In particular the word "contingent" is used loosely in many of the authorities on section 31 of the Bankruptcy Act 1914.

All is not lost to a banker if some of the liabilities he would like to set-off are not yet mature, or even contingent. Canada Enterprises v. Macnab Distilleries which I mentioned earlier was a spectacular judicial innovation. It points the way.

Other possibilities exist, but they are mostly procedural and therefore dull. So I will not explain them today.

Third Party Set-off

I said that the requirement of mutuality was not always necessary. Equity will often permit set-off where set-off at common law or under the Statutes of Set-off would not have been

permitted. Most of the cases involve claims between three parties. Some examples of general interest to bankers are:

(1) A defendant may in certain cases set-off against an assignee a debt owed to him by the assignor. This is because the assignment takes place "subject to the equities". And in The Raven (1980) 2 Ll.R. 266, Parker J. robustly held that this principle is of general application and not confined to "such set-offs as are equitable set-offs".

(2) A surety may set off against the creditor a debt owed by the creditor to the principal debtor if such debt arises out of the same transaction as that giving rise to liability under the guarantee - Bechervaise v. Lewis (1872) LR 7 CP 372.

(3) A defendant may set off against an undisclosed principal a debt owed to him by the agent provided that he was induced by the principal to believe that the agent was selling on his own account - Cooke v. Eshelby (1887) 12 App.Cas. 271.

(4) A defendant may set off against a trustee suing as such a debt owed to him by the cestui que trust, the beneficiary, - Jones v. Mossop, 3 Hare 568; Banks v. Jarvis [1902] 1 KB 549; cf. Re Willis, Percival & Co., Ex parte Morier (1879) 12 Ch.D. 491.

Tactical Set-offs

There are two related types of set-off which can sometimes be useful but which are surprisingly often over-looked in litigation. The first is in relation to statute barred debts, depending on the effect of the statute. In some countries, Germany for example, the expiry of the limitation period destroys the right: the claim is dead and gone for all purposes. On the other hand in England it is only the remedy which is barred, not the right. What you cannot do is enforce the right by action (including counterclaim). But you are perfectly entitled to set-off a stale debt against a current claim in pro-tanto discharge, because doing that is not enforcing by action. So when Fred Smith returns from the Old Country, seven years after forgetting to pay you the $1,000 he owed you, ask him in the friendliest way to paint your house, or repair your car. Then, when you get his bill, remind him about that ancient debt, and knock it off. There is nothing he can do.

The other analogous right is that of appropriation. Suppose someone is your debtor on all sorts of different matters, as happens with bankers and others, and he makes a payment to keep you quiet or happy or whatever without identifying, expressly or by implication, which debt he wants reduced or discharged. No doubt he thinks it is generally "on account" and may even use those words. They mean nothing. You as the creditor may appropriate that payment to a statute barred debt if you have one. If not, then appropriate it to a debt in respect of which you have no security: every little will help if he goes bust.

But remember to do it unambiguously in your books, and tell him, because he has the right of appropriation too and it is simply a question of who did it first.