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Set-off as a security device

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SET-OFF AS A SECURITY DEVICE:

accuracy of perceptions and implications for third parties

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1. Introduction.

While discussion at this Conference will no doubt reveal many lessons to be learnt from the 'credit crunch', this paper contends that one critical lesson is the need for financial institutions to ensure not only that they have the power to exercise a set-off but that they understand the level of protection which it offers. Those who claim, for example, to be secured in a particular transaction by way of set-off may find themselves disappointed when they seek to exercise the set-off and discover that it does not operate as they anticipated. A description of set-off as a security might have led them to expect to obtain a proprietary interest in the debt sought to be set-off; such expectation will not, however, necessarily be fulfilled.

There is no doubt that the financial crisis has highlighted the importance of set-off. In normal trading conditions in Australia where two persons have mutual dealings, each may be reluctant for whatever reason to pay their debt in full when they are each owed money by the other. They may find it much more convenient to set-off their claims and have only the net balance payable. A set-off is usually preferable to incurring costs and expending time and effort in bringing proceedings against each other if the relationship deteriorates. A set-off can be especially valuable for an Australian resident if the other party operates in a foreign jurisdiction, where the ability to bring proceedings against that party may be uncertain as well as expensive.[1] It is, however, in circumstances where credit is 'tight', that the availability of such a remedy of set-off becomes critical. A reluctance to make full payment experienced in normal times becomes significantly heightened through the increased risk of insolvency. No person - individual, corporation or financial institution - wishes to pay out when the likelihood of recovering the debt owed to it in insolvency proceedings is minimal.

While set-off has long been relied upon in the general commercial world,[2] it clearly has particular significance in the finance sector where debts are constantly created and traded or otherwise dealt with. Viewed from the perspective of a financial institution, set-off has the potential to offer an effective remedy which is equivalent in an important sense to recovery of the debt owed to it. As Lord Hoffmann explained in 1995 in *Stein v Blake* [1995] 2 All ER 961 at 964:

> Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can *set off pound for pound* what he owes the bankrupt and prove for or pay only the balance. (emphasis added)

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[1] See Australian Law Reform Commission Report No 80 *Legal Risk in International Transactions,* AGPS, Canberra (1996) pp 126-128.

[2] See eg Braudel, *The Wheels of Commerce*, Fontana Press London 1985 at pp 90-91 where he examines the activities of the medieval European fairs and likens the process of settling accounts 'in which debts met and cancelled each other out' to snow melting in the sun.

The process is not, however, equivalent for all purposes. If the creditor in fact recovered the debt, it would receive the full amount owing and could use that amount as it wished. In a set-off, the creditor's action is restricted to the set-off of the debts.[3]

In offering a remedy, set-off certainly provides a level of comfort to the financial institution. Yet the precise nature and scope of that comfort is surprisingly unclear. The purpose of this working paper[4] is to explore one argument which has been increasingly discussed in commercial practice and which has accordingly given rise to this Conference Session, namely, the argument that set-off is to be regarded as a security. Unfortunately this is not a straightforward argument. Indeed the very title of the Session 'Set-off as a Security Device' reflects a measure of ambiguity inherent in the argument – the meaning of the term 'security'. Is set-off itself a security interest, in the technical legal sense of conferring rights over property? Alternatively, does set-off rather provide security in a looser, more commercial, sense insofar as its exercise is recognised in insolvency proceedings and results in a creditor not having to stand in line with other unsecured creditors?

Furthermore – and irrespective of which interpretation is given to the title - the title clearly assumes that set-off is, in some form or other, appropriately characterised as a security. That is, however, an assumption that requires examination. Certainly, there are some judicial statements, at appellate level as well as first instance, which –taken initially at face value- appear to suggest that set-off is indeed a security. Moreover and very importantly from the perspective of this Conference's audience of experienced practitioners, commercial documents typically used in the Australian financial markets appear not infrequently to be drafted on the basis that set-off is, or has the effect of, a security. Yet leading textbook writers are generally quick to dismiss the notion that it is a security.[5]

It is a central theme of this paper that differing views of set-off's role as a security can be attributed, at least in part, to a lack of consensus over how set-off actually operates; and in particular, to a difference in opinion as to whether it operates as a discharge of a personal obligation to make payment or as an appropriation of property for the purposes of making payment. It becomes therefore of fundamental importance to understand the possible bases on which these views have been formed, particularly since they appear rarely to be expressly articulated. Accordingly, the first section of this paper outlines the various ways in which the process or 'mechanism' of set-off may be interpreted as operating.

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[3] It does not purport to give any rights over any other property. See, for example, *Smith v Bridgend County Borough Council* [2001] UKHL 58 at [36] where Lord Hoffmann, rejecting on the facts the existence of an equitable set-off, said: "In my opinion a defendant could not, in the absence of a lien or other security, claim to retain an asset belonging to a plaintiff by way of set-off against a monetary cross-claim. If this were not the case, everyone would in effect have a lien over any property of his debtor which happened to be in his possession."

[4] This working paper has been prepared as part of more extensive research for the forthcoming third edition of McCracken, 'The Banker's Remedy of Set-Off', to be published by Bloomsbury Professional, London in 2010. The second edition was published by Butterworths, London in 1998.

[5] See eg Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (Thomson, Sweet & Maxwell London (2nd ed 2007) p 5; Goode, *Legal Problems of Credit and Security* (Thomson, Sweet & Maxwell London (3rd ed 2003) pp 13-14; Derham, *The Law of Set-Off*, Oxford University Press (3rd ed 2003) pp 762-774.

Having illustrated the issue by reference to a typical scenario, the paper then reviews the extent of current perceptions of set-off as security and examines the consequences of the differing interpretations for any technical classification of it as a security. It contends that such classification only becomes relevant if one particular interpretation prevails.

It is, however, not only set-off's role as a security that is impacted by the existence of different interpretations. Also potentially affected are third parties claiming rights over the debt forming the object of the set-off, who are commonly described as 'interveners'. The final section of the paper therefore explores by way of example one category of potential interveners; namely, secured creditors.

Analysis in this paper is focused primarily at a conceptual level. It is assumed for the purposes of the analysis that the relevant claims sought to be set-off fall within the recognised legal criteria and hence are capable of forming the object of a set-off. Further, discussion of the case law is confined to several key authorities. As is so often the position in any discussion of set-off, it is critical to focus initially on 'the fundamentals'[6] before delving into the extensive, and at times regrettably complex, case law.

2. Differing interpretations of the 'mechanism' of set-off

It seems quite extraordinary that the concept of set-off has no universally agreed meaning under Anglo-Australian law, given that the concept in one form or another has been recognised since at least the 17th century.[7] It is true that the actual result of a set-off is clear; namely, that only the net balance of two pecuniary claims is payable. In the recent decision of *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ACSR 88 at 91 the Federal Court of Australia succinctly described an exercise of set-off in insolvency in just such terms. It said, quite simply:

> The amount due by one to the other is set-off against the debt due by that other and only the difference can be claimed.

It is, however, the means or 'mechanism' by which that outcome is produced which is far less clear. The range of explanations can be illustrated by considering the common situation where a customer has a deposit with a bank. Suppose, for the purposes of the example, that the customer has deposited $500 with the bank in one account, but is overdrawn by $300 on another account. On the exercise of a set-off, the bank owes the customer only $200. It is not difficult to identify the net amount. The problem lies in the fact that there are at least three ways in which, at a conceptual level, that exercise of the set-off by the bank may be explained:

- as a mechanical calculation;
- as an appropriation of property; or
- as a discharge of an obligation to make payment.

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[6] Posing the question whether set-off could be a security in law, Goode comments: 'We can answer this question only by going back to fundamentals': Goode, *Legal Problems of Credit and Security,* op cit p 13.

[7] See McCracken, *The Banker's Remedy of Set-Off,* op cit Ch 2 ,'An historical viewpoint'.

If the set-off operates by way of a mechanical calculation, the set-off is achieved simply by deducting the lesser sum (300) from the greater sum (500). If, however, set-off operates by way of an appropriation, part of the 500 (namely, 300) is applied to pay the outstanding 300 (or, more questionably, the 300 is used to pay part of the 500). In contrast to both these explanations, if set-off operates by way of a discharge, the original obligation on the part of the bank to pay 500 is discharged to the extent of the 300. These are clearly three very different processes for arriving at the same conclusion that 200 is owed by the bank; yet examples of all three can be found discussed under the heading of a 'set-off' in the cases and in the textbooks as well as being represented in a variety of clauses in commercial contracts.

In considering these processes, there is one further complicating fact that has to be taken into account; the fact that set-off can arise from a number of different sources. At a conceptual level, it might not unreasonably be expected that set-off should have the same meaning and should operate in the same manner irrespective of its source. In practice, however, this has not necessarily proved to be the case.

- Firstly, it has been traditional to distinguish between the different sources of set-off and to draw the conclusion that different rationales form the basis for each type of set-off, resulting in set-off potentially operating differently according to its type. [8] This make the matter complex as there are a variety of sources. Where parties are solvent, there are three sources. These are statute, equity and contract. Where one or both parties are insolvent, the primary - and in fact in most instances exclusive[9] - source is statute. Confusingly, statutory set-off in insolvency arises under different legislation[10] to statutory set-off pre-insolvency. [11]
- Secondly, the fact that set-off can be created by contract has meant that the boundaries of the concept have sometimes been 'pushed' by the particular interpretation of those drafting the contract. The operation of contractual set-off has arguably been a significant cause of some of the confusion over the actual concept.

While acknowledging both these factors, this paper focuses on simply one issue: the potential consequences of the differing interpretations of set-off for *its treatment as a security.*[12] While the writer's current research explores in depth the argument that set-off should operate simply as a discharge of a personal obligation irrespective of its

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[8] It can be argued that these different types of set-off have more in common than is often appreciated and may indeed share some common basis: see McCracken, *The Banker's Remedy of Set-Off* op cit p 61.

[9] While it is generally considered to be the exclusive form of set-off as between the original mutual debtors and creditors, the position may be different once a third party is involved: see discussion in section 4.

[10] *Corporations Act* 2001 (Cth) s 553C; *Bankruptcy Act* 1966 s 86.

[11] State legislation which currently exists in all States other than Queensland, is derived from the old English *Statutes of Set-Off* 1729 and 1735. See generally Derham, *The Law of Set-Off*, op cit Ch 2 at pp 36-43. In New South Wales, the previous statutory right pre-insolvency which was seemingly inadvertently abolished in 1969 was reintroduced under the *Civil Procedure Act* 2005 (NSW) s 21. For the background, see Law Reform Commission (NSW), *Set-Off*, Report No 94 (2000).

[12] The different interpretations have repercussions for the analysis of other issues. They may, for example, open for debate the conclusion by the House of Lords in *Stein v Blake* [1995] 2 All ER 961 that on insolvency both claims are extinguished and replaced by a new claim for the net balance.

specific source, the purpose of this paper is restricted to examining the *consequences* of the differing views.

3. Set-off as a 'security'

Historically, a very clear line divided the concept of set-off and that of security. In, for example, the 19th century case of *ex parte Caldicott* (1884) 25 Ch D 716 the Lord Chancellor, the Earl of Selborne, drew a firm distinction between principles applying to securities and those applying to 'mutual credits'. The notion of set-off as a security thus seems to be a modern phenomenon.

The interesting question is, however, the extent to which current perceptions of set-off as a security do in fact support a general view that set-off confers a security in the strict sense of conferring a proprietary or possessory interest. An examination of case law suggests that the term 'security' is often used rather loosely by the courts. Furthermore, at least one interpretation given to the mechanism by which set-off operates would indicate that set-off is simply *incapable* of functioning as a security in that strict sense.

(a) Perceptions of set-off as a security

Modern perception of set-off as some form of security has been traced by one commentator to the 1960s and 1970s. In the introduction to a book entitled *Using Set-Off as Security,* Neate noted that legal problems relating to set-off emerged during that period in cross-border financing transactions where parallel loans were used and subsequently in currency swaps which replaced the use of parallel loans in the late 1970s.[13] He concluded[14] that:

> The phenomenal growth of the swap market is but one example of the increasing demand in the financial industry for legal mechanisms whereby one person's obligation to pay money can be 'secured' by being offset against the counterparty's obligation to pay an equivalent sum of money, in the same or another currency.

Current views of set-off as security seem to stem primarily from several leading English cases in the 1980s/1990s and from commercial documents now in use in financial markets.

(i) Judicial views

Some evidence of a judicial perception of set-off as security can be found, for example, in the judgment of Millett J (as he then was) in 1986 in *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309. After denying that a creditor could take a

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[13] Neate (ed), *Using Set-Off as Security*, Graham & Trotman and International Bar Association, London 1990 pp 1-3.
[14] Neate (ed), *Using Set-Off as Security*, op cit, pp 2-3.

charge over a debt which it itself owed,[15] Millett J commented that that it did not follow that an attempt to create a mortgage or a charge of such a debt would be 'ineffective to create a security' and proceeded to discuss set-off. However, the context makes clear that he was using the term 'security' in a very general sense to mean a right which was effective in a liquidation.

In 1995 in *Stein v Blake* [1995] 2 All ER 961 at 964 Lord Hoffmann, delivering the unanimous judgment of the House of Lords, described the use by a bankrupt of his 'indebtedness to the bankrupt' as a 'form of security'. Once again, however, it can be argued that the court had in mind a broader notion of the term security as the concept was explained by reference to the creditor exercising the set-off having only to pay the net balance rather than as an interest in property. Nonetheless, the notion of set-off as security was taken up in the subsequent House of Lords decision in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573. Noting, in accordance with *Stein v Blake*, that the impact of a set off is to render the net balance payable, Lord Hoffmann stated :

> The effect is to allow the debt which the insolvent company owes to the creditor to be *used as security for its debt* to him. The creditor is exposed to insolvency risk only for the net balance.

In this context, it is also noteworthy that Lord Hoffmann expressed himself (at 576, 577) to be in agreement with the view of the Court of Appeal that both contractual and insolvency set-off could be regarded as 'effective security', while disagreeing (at 577) with the latter's view on the different point that a charge back was conceptually impossible.[16]

While these dicta may well suggest that the description of set-off as security is to be understood in its more general sense of additional comfort rather than proprietary interest, there is a further interesting statement by Lord Hoffmann in *Stein v Blake* [1995] 2 All ER 961 at 964, which throws into question the extent to which set-off should be regarded even in loose terms as a security. In describing insolvency set-off as a 'form of security', he explicitly referred to the underlying purpose of insolvency set-off and to the oft cited dictum of Parke B in *Forster v Wilson* (1843) 12 M & W 191 at 204; 152 ER 1165 at 1171. He said the following:

> Bankruptcy set-off....affects the substantive right of the parties by enabling the bankrupt's creditor to use his indebtedness to the bankrupt as a form of security. Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can set off pound for pound what he owes the bankrupt and prove for or pay only the balance. So in *Forster v Wilson*....Parke B said that the *purpose of insolvency set-off was to do substantial justice between the parties*.... . (emphasis added)

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[15] In *Re Bank of Credit and Commerce International SA* (No 8) [1997] 4 All ER 568 at 575-578 the House of Lords disagreed with this view on the validity of the charge. It recognised that such a charge could be taken. The validity of such a charge remains a controversial issue in Australia, as noted below.

[16] 'The Court of Appeal said that the bank could obtain effective security in other ways [other than through a charge]. If the deposit was made by the principal debtor, it could rely upon contractual rights of set-off or combining accounts or rules of bankruptcy set-off under provisions such as r.4.90....All this is true. It may well be that the security provided in these ways will in most cases be just as good as that provided by a proprietary interest. But that seems to be no reason for preventing banks and their customers from creating charges over deposits if, for reasons of their own, they want to do so.' *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 577-578.

Care is required in considering this statement. This phrase attributed to Parke B is in fact in an abbreviated form. The full quotation makes clear that Parke B was not referring to some general notion of justice underlying the set-off, as the abbreviated phrase might infer, but rather to a much more limited notion. The full quotation is:

> ..to do substantial justice between the parties, *where a debt is really due from the bankrupt to the debtor to his estate*. (emphasis added)

This full quotation would, it is submitted, support an argument that insolvency set-off reflects not a notion of security but rather a different idea – a 'justice' that flows from a debtor not having to pay a debt to a creditor who in fact is indebted to that debtor through some mutual dealings. Such a 'justice' runs in fact through the history of set-off, particularly in insolvency, and explains for example the rationale for the criterion of mutual dealings in insolvency dealings as well as the consequential rule that claims of third parties are not available for the exercise of a set-off. As the Court of Appeal subsequently explained in *Re Bank of Credit and Commerce International SA (No 8)* [1996] 2 All ER 121 at 141:[17]

> There is no injustice in requiring a creditor against whom no claim is made to prove for the debt which is due to him.

Yet, the notion of set-off as security is arguably becoming entrenched. In 2008 in *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ASCR 88 at 91 the Federal Court of Australia explicitly used the description of set-off as security. Interestingly, it noted both its use in a general commercial sense as well seemingly[18] as in the more technical sense.

This brief overview of the cases does, however, raise for debate the extent to which the cases can be taken as authority for the proposition that set-off is a security interest. While the term 'security' is certainly used, it is submitted that an examination of the actual statements suggests that the term is used for the most part very loosely to refer to the availability of some form of protection. Hence it is necessary to look elsewhere for support for an argument that set-off involves the creation of a security interest.

(ii) Commercial documentation

Evidence of a more explicit link between set-off and a security interest can be found in commercial documents typically in use in Australian financial markets. Examples are provided by some forms of negative pledges which imply that set-off is to be treated as a security interest and in actual contractual set-off clauses in loan documentation which use the language of appropriation and thereby may be interpreted as charges.

A negative pledge typically includes a prohibition on creating 'Security' and permitting 'Security' to exist, 'Security' usually being defined for these purposes as

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[17] A similar notion of justice can also be argued to underlie set-off in equity and indeed other forms of set-off, although such an argument is controversial. See McCracken, *The Banker's Remedy of Set-Off*, op cit, Ch 2.

[18] The court specifically stated that set-off had been called a security interest and cited Lord Hoffmann in *Stein v Blake* [1996] AC 243 at 251; 2 All ER 941 at 964. Neither report , however, appears (at least in the online version) to record this phrase. Lord Hoffmann is reported only as having described it as a 'form of security' (as to the meaning of which, see discussion in section 3).

including not simply the security interests of mortgages, charges and pledges but also arrangements having a similar effect. This general prohibition is often supplemented by a more specific prohibition under which persons are precluded from entering into arrangements under which money or the benefit of an account may be set off. That gives rise to an inference that a set-off falls within the scope of a Security and is on a par with a security interest. That inference is further strengthened by the fact that such a negative pledge would also typically contain a clause expressly excluding certain types of set-off arrangements such as those made in the ordinary course of banking arrangements for purposes of netting debit and credit balances. Such an exclusion implies that other forms of set-off arrangements are to be regarded as within the term, Security.

Sometimes less explicit but nonetheless always of considerable interest is the set-off clause itself. Its content obviously depends on individual drafting. Where the draftsperson uses the language of appropriation in stating, for example, that funds are to be applied by way of set-off, it is arguable that such language expressly creates a particular type of security interest, namely a charge.[19] Furthermore, where the draftsperson chooses not to explain how the set-off actually operates but simply states that the debts are to be set-off, there is a risk that it too could be a charge to the extent that that wording is interpreted as an act of appropriation (a risk which is discussed below).

There is unfortunately, but perhaps not surprisingly, no published history of the drafting of set-off clauses showing the language of the clause over the years. It may be speculated, however, that the modern draftsperson's selection of the words to describe the process of set-off may well have been influenced over the last ten years or so in the context of security by an *obiter dictum* of the English Court of Appeal in *Re Bank of Credit and Commerce International SA (No 8)* [1996] 2 All ER 121 at 132. Discussing the mechanism by which it was then contended that a charge could be taken over a debt owed by oneself, Rose LJ who delivered the unanimous judgment of the court commented:[20]

> It is said that some legal mechanism must be involved. That is true; the mechanism is that of set-off. This process can be variously described, but a debtor's *right to appropriate a debt which he owes to his creditor and apply it in reduction or discharge of a debt which is owed to himself* whether by the creditor or a third party is in our opinion accurately described as a right of set-off.

Such language is, however, akin to that of a charge.

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[19] See, for example, *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431 at 449-450; *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309; and, more recently, *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* [2008] FCA 594 at [38]: 'A charge differs from a mortgage because it does not depend upon a transfer of the ownership of the charged property. It is of the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor, or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability: *Re Cosslett* [1998] Ch D at 508.'

[20] While the House of Lords overruled the Court of Appeal on its stance that such a charge was conceptually impossible, it made no comment on this definition of set-off: *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568.

(b) ***Can set-off conceptually be a security?***

Whether a right has a security character is said to be a question of law and not the intention of the parties. [21]

The general schema of security interests is well established,[22] being constituted by those arrangements which offer some form of proprietary or possessory interest in another person's property (mortgage, charge, pledge and lien). In addition, it is not uncommon to include within a broader more commercial concept of security contractual arrangements which provide some additional level of comfort through the creation of an additional promise. Such a promise is generally taken from a third party (eg a guarantee or an indemnity) but may sometimes be taken from the debtor itself (eg a negative pledge).

Where in such a schema does set-off sit? The answer, it is submitted, depends quite simply on whether set-off is interpreted as a discharge of an obligation or as an appropriation of property.

Set-off, in so far as it operates as a discharge of a personal obligation to make payment, simply cannot be a security interest. In enabling a financial institution, for example, to claim that it no longer has to make payment by reason of the fact that its corporate counterparty owes it money, the set-off does not purport to create rights over that counterparty's property. Accordingly, it is submitted, it is only if set-off is viewed in terms of some form of appropriation of property, that the possibility of a true security interest becomes relevant.

Unfortunately, however, it is difficult to draw any firm conclusion from the case law as to how in the context of security the courts view the process of set-off operating.

Examples of both viewpoints – discharge and appropriation- can be found. On the one hand, as noted above, the Court of Appeal in *Re Bank of Credit and Commerce International SA (No 8)* was very clear in its description of a set-off as an appropriation. It was not the first time that such language was used. In 1993 in *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq) (No 2)* [1993] 3 All ER 769 at 785 Dillon LJ in the Court of Appeal, with whom Nolan and Steyn LL J agreed, appeared also to speak in terms of appropriation of the debt, concluding that the documentation at issue enabled the deposit of a third party who had accepted liability as a personal debtor to be 'appropriated without further notice'.

On the other hand, such statements can be contrasted with the description by Millett J in *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309:

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[21] See eg *Smith v Bridgend County Borough Council* [2001] UKHL 58 at [53], citing *Agnew v Commissioner of Inland Revenue* [2001] 3 WLR 454, 465-466 per Lord Millett.

[22] It will, however, change if the proposed Personal Property Securities Reform legislation is enacted. For the current state of reform proposals and the *Personal Property Securities Bill 2009*, see www.ag.gov.au under 'Consultations Reforms Reviews' and then 'Personal Property Securities Reform'.

> The debtor cannot, and does not need to, resort to the creditor's claim against him in order to obtain the benefit of the security; his own liability to the creditor is automatically discharged or reduced.

Sometimes, however, it is simply not clear how the set-off is understood to work. Lord Hoffmann's description in *Stein v Blake* [1995] 2 All ER 961 at 964, for example, is ambiguous.

> Bankruptcy set-off ...affects the substantive rights of the parties by enabling the bankrupt's creditor to *use his indebtedness to the bankrupt as a form of security*. Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can set off pound for pound what he owes the bankrupt and prove for or pay only the balance.

The indebtedness of the creditor to the bankrupt (the amount that the creditor owes) is obviously the asset of the bankrupt. It is not clear from this passage as to precisely how the creditor uses it – is the creditor, for example, appropriating that property?

This notion of this 'use of a claim' is found again in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573 where Lord Hoffmann, delivering the unanimous judgment of the House of Lords, said:

> The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its debt to him.

This is somewhat confusing as it appears, on one reading at least, to suggest that a different asset is being used as security – namely, the debt owed by the insolvent person rather than the debt owed to the insolvent person. The distinction is important. The debt owed by the insolvent person is the creditor's asset while the debt owed to the insolvent person is that insolvent person's asset. While both may be described as a use (or appropriation) of property, it is only appropriation of the property of *another* which gives rise to a charge.

Wood has certainly argued that a creditor uses the debt owed to it, which is its asset, to pay off the other claim,[23] thereby distinguishing it from a charge. This has been criticised by Derham,[24] partly on the basis that the existence of the different types of set-off make it difficult to draw any general conclusion as to how set-off operates.[25] In considering the position on insolvency and in particular the fact that set-off operates automatically, Derham concludes:[26]

> ..that it is not profitable to consider which of the demands is set-against the other. They are simply brought together, by force of statute, into an account.

This writer would, however, agree with Wood that the analysis of the process of setting off is critical, although would disagree with the description given by Wood. Although Wood defines set-off more generally as the discharge of reciprocal obligations to the extent of the smaller obligation, he regards it as a form of payment.[27] This writer views it rather as a discharge of an obligation to make the payment.

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[23] Wood, *Set-off and Netting, Derivatives, Clearing Systems*, op cit pp 4, 10-13.
[24] Derham, *Law of Set-Off*, op cit, pp 766- 768.
[25] Derham, op cit p 767.
[26] Derham, op cit, p 767.
[27] Wood, op cit, p 4.

As noted previously, the danger in 'sliding into' the language of appropriation of another person's asset is the risk that a charge is created. As a result, what is intended to be a 'set-off arrangement' becomes at law a charge. Yet ironically those who draft the set-off using the language of appropriation would seem to distinguish it from a charge. They commonly expressly describe the clause as a 'set-off'.

This crossing of the line between set-off and charge has been noted by Goode,[28] who concludes that the recognition of the validity of the charge back arrangement by the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 has caused the distinction between contractual set-off and security to become blurred as both are effected in the same way ie through book entry. He comments:[29]

> ..it seems the only way of distinguishing a charge over the debtor's obligation from a contractual set-off is by the label given to the agreement by the parties…

In England, the issue of whether set-off is a security appears to have become inextricably mixed up with the debate as to whether a charge can be taken over a debt owed by oneself. This has dogged the discussion for many years but it can be argued that it is a separate issue and that there is room in the debate for an intermediate position. Insofar as the contractual set-off is drafted explicitly as a charge, it is – and should be recognised as - a charge. However, the set-off can be drafted in different terms – namely, as a discharge from an obligation to make payment. In that case, contractual set-off has a distinct role to play.

The distinction between charge and contractual set-off, based on an interpretation of contractual set-off as a discharge from an obligation, is particularly important in Australia as a matter of practice, for two reasons:

- a charge over a deposit made with oneself has not been clearly recognised yet in Australia. The weight of authority is, however, still against recognition.[30]
- specific rules regulate the operation of a charge; for example,
    - a charge cannot generally be enforced in an administration without the written consent of the administrator or leave of the court;[31]
    - a charge may be registrable; [32]
    - priority rules apply either at common law or under the *Corporations Act* 2001 (Cth) to resolve the ranking of competing claims;
    - a charge may have remedies implied by statute (eg sale; receivership under State legislation such as the *Conveyancing Act* 1919 (NSW) s 109 and its State counterparts.[33]

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[28] Goode, *Legal Problems of Credit and Security,* op cit, p14.
[29] Goode, op cit, p 14.
[30] See *Broad v Commissioner of Stamp Duties* [1980] 2 NSWLR 40; *Estate Planning Associates (Australia) Pty Ltd v Commissioner of Stamp Duties* [1985] 2 NSWLR 495; *Esanda Finance Corporation v Jackson* (1993) 11 ACLC 138; *Wily v Rothschild Australia Ltd* (1999) 47 NSWLR 555. Cf *Cinema Plus Ltd v Australia and New Zealand Banking Group Ltd* (2000) 35 ACSR 1 at 6.
[31] *Corporations Act* 2001 (Cth) s 440B, subject to s 441A where the charge is over the 'whole, or substantially the whole, of the property'.
[32] *Corporations Act* 2001 (Cth) s 262.
[33] *Property Law Act* 1974 (Qld) s 83; *Law of Property Act* 1936 (SA) s 47; *Conveyancing and Law of Property Act* 1884 (Tas) s 21; *Property Law Act* 1958 (Vic) s 101; *Property Law Act* 1969 (WA) s 57.

Some discussion of the distinction between a contractual set-off and a charge arose in the decision in 2000 of the New South Wales Court of Appeal in *Cinema Plus Ltd v Australia and New Zealand Banking Group* Ltd (2000) 35 ACSR 1. However, the issue was not clear cut. While the court concluded that a particular contractual clause – referred to by the court as a set-off clause – did not amount to a charge, the court did not clearly distinguish between the right of combination and the right of set-off. This is a further 'grey area' as the right of combination is often regarded as a type of set-off, although this writer would disagree with that view.[34]

The relevant clause, under the heading of 'Consolidation of Accounts' stated:

> We may at any time combine, consolidate, merge or apply any credit balance in any of your accounts, or any amount available to us by way of set-of[sic], lien or counterclaim, towards payment of money which is then, or will become, due and payable by you to us under any transaction document.

Leaving aside the conceptual issue of whether a charge can be taken over the debt which the chargee owes, the New South Wales Court of Appeal found that this specific wording did not give rise to a charge but rather to a contractual right. Spigelman CJ said (at [46]):

> Clause 21 does not manifest an intention to make available the company's property in an account as security for the company's obligations. There was no deposit specifically made by the customer for purposes of security. There was no obligation to maintain any account. There were no restrictions on the conduct of any account. Nor was any account, or indeed the body of accounts as they may exist from time to time, appropriated in any way, either immediately or contingently, as security for any present or future debt.
>
> The cumulative effect of these aspects of cl 21 leads to the conclusion that cl 21 creates a contractual right. It does not, in my opinion, constitute a charge.

Sheller JA and Giles JA agreed that it was not a charge.

Spigelman CJ explained the effect of the arrangement as follows:

> In my opinion, cl 21 is, in effect, a contractual right to 'seize' an account in the future. ..It does not manifest an intention on the part of the parties to create any form of present right over property of the company. It confers a *right to take steps in the future, which have the consequence that the company's chose in action will be extinguished in whole or in part.* (emphasis added)

Two further general observations may be made in relation to the debate over whether set-off may be a charge, stemming from the factual situations in which the discussion of security has taken place.

- it is not surprising to find the discussion of security and/or the language of appropriation in cases such as *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq) (No 2)* [1993] 3 All ER 769 and *Re Bank*

[34] See McCracken, *The Banker's Remedy of Set-Off*, op cit, Ch 1.

of Credit and Commerce International SA (No 8) [1997] 4 All ER 568. Both these cases involved a deposit. Claims to set-off against deposits are often expressly established by contract and it is not difficult to see how any rights in relation to that deposit could be characterised as some form of security. There is a natural, albeit mistaken, tendency to picture a deposit as a 'bag of money' rather than as the ledger entry required by *Foley v Hill* (1848) 2 HL Cas 28; 9 ER 1002.[35]

- For that reason, it is interesting to find the description 'security' appearing in *Stein v Blake* [1995] 2 All ER 961 where the claims at issue did not involve a deposit but were claims for breach of contract and for misrepresentation. *Stein v Blake* was not a situation where the parties had negotiated for security. Lord Hoffmann's remark in fact was part of a general description of the history and purpose of insolvency set-off, rather than specifically directed at these two claims. Neither party, it is submitted, would have seen their claim as a form of security.

Finally, in discussing the nature of set-off in *Broad v Commissioner of Stamp Duties* [1980] 2 NSWLR 40 at 44 Lee J described 'security' as having a wide meaning of 'something which makes the enjoyment or enforcement of a right more secure or certain'[36] and noted (at 48) that set-off might be able to be included within this wide description of the term. However, it is very doubtful, in this writer's view, whether it is useful to think of set-off in terms of a security. In the first place, it does not resemble those contractual promises which traditionally have been regarded as security in the broader sense, such as the guarantee. It is not a promise by a person (debtor or third party) to do or not do some action, in particular pay money or forebear from creating security. Rather, the set-off is directed at ensuring that a person does not have to pay out when in overall terms, through the mutuality of the dealings or the relationship of the claims, the person does not owe that full amount.

Perhaps this modern tendency to view set-off as security can be attributed to a perception that it changes the *pari passu* rule. In *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ACSR 88 at 91, for example, Finkelsein J described set-off as 'a significant encroachment upon the pari passu rule'. A similar view is evident from Lord Hoffmann's explanation as to why insolvency set-off is limited to mutual dealings in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573:

> There can be no set-off of claims by third parties, even with their consent. To do so would be to allow parties by agreement to subvert the fundamental principle of pari passu distribution of the insolvent company's assets... .[37]

It is however submitted that when set-off's purpose is viewed as ensuring that a person does not have to make payment when it itself is owed an amount and particularly where set-off's operation is interpreted as discharging a person from an obligation to make payment, little is added to the general understanding of the concept

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[35] This decision made clear that money deposited by a customer with the bank becomes the money of the bank. The customer's asset becomes the debt then owed by the bank to the customer, given that the bank '..has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands.': *Foley v Hill* (1848) 2 HL Cas 28 at 36; 9 ER 1002 at 1005.

[36] He cited Jowitt's *Dictionary of English Law*.

[37] He cited *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 2 All ER 390.

by describing it as a security device. Indeed that appellation rather risks adding confusion to the discussion of set-off. In this context, it is interesting to note that the *Personal Property Securities Bill 2009* expressly excludes 'any right of set-off or right of combination of accounts' from the operation of the Act.[38]

Rejecting the notion that set off is some form of security does not, however, mean that set-off is not relevant to a discussion on security. Quite the opposite is true. It is highly relevant, both pre-insolvency and on bankruptcy or liquidation itself, insofar as the set-off may impact on the rights of those who claim to be secured over the debt sought to be set-off.

4. Rights of interveners, such as secured creditors

What happens if a third party (often described by commentators as an 'intervener') makes a claim on the debt owned by the original creditor (C1) which would otherwise be the object of the set-off? There may be a number of reasons for that intervention. In the context of a discussion of security, the following two scenarios are not improbable:[39]

- the debt owing to C1 is *mortgaged* by C1 to another person (C2);
- the debt owing to C1 is *charged* by C1 to C2.

In such circumstances, should that intervening creditor, C2, be able to take the debt free of any claim of set-off by the debtor (D)? Or can D claim to exercise the set-off against C2? During the life of the debt, this is a major risk for D. The debt that was to form the object of the set-off may no longer be available for that purpose. Is that a risk that should be borne by D? (While this Conference Session focuses on the position on liquidation, that position depends to an important extent on the position pre-insolvency, for reasons explained below.)

At a conceptual level, it is submitted that the reaction of D to an intervention will be influenced by how the set-off is understood and debtors and creditors may well hold very different views depending on whether they see the set-off as a means of discharge of an obligation or as an appropriation of property.

Those who view the set-off as an appropriation could be expected to argue that D has rights over the debt and that D should have a stronger right to that debt than C2. By contrast, those who regard set-off as a discharge of an obligation might logically argue that the intervention of C2 means that D is no longer in a situation where there are mutual or related dealings between D and C1 which could give rise to a set-off. Such an interpretation does not of course mean that they are not concerned about the

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[38] *Personal Property Securities Bill 2009* s 8(1)(d). See also s 8(1)(e) for exclusions of rights and interests held under netting arrangements under the *Payment Systems and Netting Act* 1998 (Cth).

[39] For other examples of interveners, see generally Wood, *Set-Off and Netting, Derivatives, Clearing Systems*, op cit Ch 5. In Australia, a further interesting question beyond the scope of this paper is raised *by Banking Act* 1959 (Cth) s 13(A)(3) which sets out priorities for the application of assets of ADIs in Australia where the ADI is unable to meet its obligations or suspends payment.

loss of a right of set-off. Rather, they acknowledge that a set-off logically might be lost and that therefore D must take other means to protect its position; for example, by attempting to preclude any dealings with the debt by C1 and C2.[40] Nonetheless, it is also conceivable that they could alternatively argue that D should remain able to be discharged from its obligation to make payment, given the particular nature and interrelationship of the competing claims. Both are plausible.

These conceptual arguments are not necessarily reflected in the way the law actually operates in practice. When dealing with mortgages of a debt, the law draws on principles of assignment. The law in this area is not clear. Indeed, one commentator has described the relevant legal rules as '..both astonishingly complex and at times scandalously uncertain'. [41] Further, although not often discussed, there is an important issue as to whether the relevant rules relating to assignment actually apply whenever the intervener is secured by a fixed charge rather than a mortgage. Both English and Australian courts and indeed commentators have tended for the most part to assume that the assignment rules apply. If they do not apply, the outcome could differ depending on whether C2 holds a mortgage or a charge.

The issues are briefly outlined in the following scenarios. It is assumed in each case that the intervener claims a fixed security, such as a legal or equitable mortgage or a fixed charge. If the intervener simply has a floating charge, an exercise of a set-off pre- liquidation is not affected as the intervener cannot claim an interest in the debt until crystallisation.[42]

(i) Set-off viewed as an appropriation of the other party's asset and thus as a fixed charge

This is probably the easiest scenario to deal with, arising through the drafting of an express set-off clause which is phrased in terms of an appropriation of the other person's asset. It depends however on the courts being willing to recognise that a charge can arise over a debt owed by oneself, an issue that remains unresolved in Australia.[43]

If D argues that it has a charge over the debt owed by it by reason of having a right to exercise a set-off, its claim will be treated as any other priority issue. Assuming the validity and enforceability of the charge, the issue is whether the competing charges are both registrable. If so, the priority rules under the *Corporations Act* 2001 (Cth) will apply. If not, common law rules will apply. A critical point in that discussion will be the registrability of the D's charge over the debt; in particular, whether it is a book debt for the purposes of the *Corporations Act.*[44]

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[40] The effectiveness of a prohibition on assignment is controversial: see generally Goode, *Legal Problems of Credit and Security,* op cit, pp 106-110.
[41] Tettenborn, ' Assignees, equities and cross-claims: principle and confusion' [2002] LMCLQ 485 at 485.
[42] *Biggerstaff v Rowatt's Wharf Ltd* [1896] 2 Ch 93.
[43] See discussion above.
[44] See McCracken, *The Banker's Remedy of Set-Off,* op cit, p 211.

(ii) Set-off viewed as a discharge of an obligation

As this discussion proceeds on the basis that set-off operates by way of discharge of an obligation to make payment, there is no longer a true priority issue as there are no competing claims over property.

It is necessary in the discussion to draw a distinction between the situation where the intervener has a mortgage and where it has a charge. It has been argued that there should be no distinction between these two positions,[45] but as a matter of law mortgages and charges give different rights and the position requires examination.

(a) Intervention through mortgage[46] of the debt by C1 to C2

Logically it may be argued that by C1 transferring to C2 the title of the debt owed by D, C1 has fundamentally altered the position by introducing a new person with a new claim over the debt.

C2 would certainly be keen to argue that it has obtained the title to that debt and as it does not owe any debt to D, it therefore has a right to payment in full. As noted above, D might conceptually at least accept the argument that there is no 'injustice' in the set-off sense as mutual debts are no longer owing between D and C1 and are not owing between D and C2. On this basis, D would not have a set-off against either C1 or C2.

Such an argument however ignores the rules that have developed relating to assignment of debts. There is a further principle that comes into play that impacts on the analysis – namely that the assignee should not be in a better position than the assignor (at least until notice of the assignment is received by the debtor).

The rule that originally developed in equity[47] and was subsequently adopted by statute is that the assignee takes subject to equities arising prior to the debtor receiving notice of the assignment. 'Equities' for these purposes includes a set-off (whether arising pre-insolvency under statute, by contract or in equity).[48] The classic description is that given by Templeman J in *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 2 All ER 741 at 748:

> The result of the relevant authorities is that a debt which accrues due before notice of an assignment is received, whether or not it is payable before that

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[45] See Derham, *The Law of Set-Off,* op cit, p 832, noted below.

[46] For these purposes, the legal mortgage and equitable mortgage are treated in the same way as they both involve an assignment and the relevant legal and equitable rules relating to the equities to which an assignment takes subject are the same on this point, as discussed below.

[47] See explanation given by the Court of Appeal in *Pellas v Neptune Marine Insurance Co* [1874-1880] All ER Rep Ext 1509: 'Without the aid of the statute the assignee might have sued at law in the name of the assured, and in a court of equity in his own name. The statute was passed because the Legislature wished to give the assignee a more convenient remedy, and intended that he should be in the same position as if he sued in a court of equity; no alteration in the rights of the parties was contemplated…'.

[48] See generally Derham, *The Law of Set-Off*, op cit, pp 457-458, 805-811.

> date, or a debt which arises out of the same contract as that which gives rise to the assigned debt, or is closely connected with that contract, may be set-off against the assignee. But a debt which is neither accrued nor connected may not be set-off even though it arises from a contract made before the assignment.

If pre-insolvency, C2 takes subject to D's set-off against C1, what happens on insolvency? There is clearly no mutuality between D and C2 for the purposes of insolvency set-off. Nonetheless, an argument can be made on the basis of general principle that although insolvency set-off is usually described as the only operative source of set-off once the debtor goes into liquidation, the assignee should nonetheless take subject to equities to the same extent that it would pre-insolvency.

(b) Intervention through charge of the debt by C1 to C2

Assume that C2 takes a charge over the debt owed by D to C1. The question now is whether the effect of this intervention is to destroy mutuality between D and C1? If it is a fixed charge creating an immediate equitable interest, at a conceptual level the initial answer would seem logically to be yes. If it is a floating charge, mutuality will be potentially destroyed when the charge crystallises and the equitable interest is created. If mutuality between D and C1 is destroyed and if there are no grounds for C2 taking subject to any equities held by D, an intervener as chargee will be in a stronger position than if it was a mortgagee. D will have no set-off.

The position has generally been considered by the courts in the context of an appointment of a receiver under a charge. Interestingly, the courts have for the most part addressed the issue by expressly applying the rules relating to assignment, even though technically it can be argued that the creation of a fixed charge does not involve a transfer of title, but rather the creation of new rights over the property charged. There appears to be a policy view that C2 as chargee should not be in a stronger position than C1: *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 2 All ER 741. [49]

This conclusion is open to debate. It can be argued, for example, that it is not actually justified by s 12 of the *Conveyancing Act* 1919 (NSW), and its equivalent State counterparts,[50] which deal with:

> ... any absolute assignment by writing under the hand of the assignor (not purporting to be *by way of charge only*) of any debt.... .

This terminology clearly covers a mortgage which operates as a transfer of title, but it does not appear to cover a charge. The distinction between mortgage and charge for these purposes was clearly made in the 19th century in *Burlinson v Hall* (1884) 12 QBD 347. [51]

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[49] See also *Rother Iron Works Ltd v Canterbury Precision Engineers Ltd* [1974] QB 1 at 6 per Russell LJ; *George Barker (Transport) Ltd v Eynon* [1974] 1 WLR 462.

[50] *Property Law Act* 1974 (Qld) s 199; *Law of Property Act* 1936 (SA) s 15; *Conveyancing and Law of Property Act* 1884 (Tas) s 86; *Property Law Act* 1958 (Vic) s 134; *Property Law Act* 1969 (WA) s 20.

[51] This case was followed in *Tancred v Dalagoa Bay and East Africa Railway Co* (1889) 23 QBD 239, where the security in question was a mortgage rather than a charge.

In *Roadshow Entertainment Pty Ltd v (ACN 053 006 269) Pty Ltd* [1997] 42 NSWLR 462 at 482 the NSW Court of Appeal accepted[52] that on the crystallisation of a floating charge the relevant debts owed to the companies were caught by a fixed charge and they too explicitly described that fixed charge as operating:

> ...as a completed equitable assignment to the secured creditors....

However, some contradictory dicta can be found. Authorities for and against the statement were considered more recently, for example, by the Queensland Supreme Court in the unreported decision of *Vangale Pty Ltd (in liq) v Kumagai Gumi Co Ltd* [2002] QSC 137. The court also noted criticism by academic commentators[53] describing the holding to that effect in *National Mutual Life Nominees Ltd v National Capital Development Commission* (1975) 37 FLR 404 as 'very debatable'.

As a result, the position on liquidation is unclear. There is no mutuality between D and C1, nor between D and C2. However, C2 may take subject to D's claim if the charge is treated as an assignment, but not otherwise.

Derham argues that the distinction between a mortgage and a charge should not be critical.[54] The point is important, particularly given the extent to which a debtor can protect itself. While admittedly the position on assignment is not free from doubt, the current view appears to be that a prohibition on assignment will prevent C1 from assigning the debt owed to it to C2. However, a prohibition on creating a charge, which is in substance a negative pledge, is likely on breach to result only in damages or, if equity will assist in the circumstances, receivership. It does not prevent the creation of the interest in favour of C2.

The complexity of the arguments highlights the benefits in these circumstances of the alternative view that set-off operates as an appropriation of the property. If, however, the view is taken that set-off can only operate as a discharge from an obligation, which is this writer's view, there is no alternative but to attempt to address that complexity.

5. Conclusion

Although commercially financial institutions and others may consider themselves protected by having the power to exercise a set-off in relation to mutual dealings, the only conclusion that can be drawn is that the extent of their protection is unfortunately far from clear. Any suggestion that a set-off confers some form of security must be carefully considered. On current authority, judicial characterisation of set-off as a security should not be understood as indicating the existence of some proprietary interest. It is only if set-off can legitimately be interpreted as operating as an appropriation of property, that it may amount to a security in the form of a charge. If, however, set-off is interpreted as functioning as a discharge from an obligation to make payment, it cannot amount to a charge. For as long as both these competing views of set-off's operation persist, differing opinions as to whether set-off should be regarded as a security will inevitably be held. This means uncertainty not simply as

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[52] *Re ELS Ltd* [1995] Ch 11 is cited as authority.
[53] Sykes & Walker, *The Law of Securities*, Law Book Co Sydney 5th ed 1993 at p 960.
[54] See, for example, Derham, *Set-Off*, op cit, p 832.

between the two immediate parties to the set-off but also potentially vis-à-vis interveners such as secured creditors. The position of those interveners is further complicated by the interplay of technical rules relating to assignment of debts and by the doubts over the application of these latter rules to charges.

One final observation. As a matter of practice, it is likely that it is only the person seeking to exercise the set-off that will tend to view the arrangement as a 'security'. Those against whom the set-off is sought may hold a very different view. This has been well illustrated recently in the retail banking sector in the UK where banks are reportedly using their powers of set-off as a means of recovering debts owed to them. The English newspaper, The Observer, ran the following headline on Sunday 28 June 2009 'Banks exploiting obscure law to raid accounts and recover debts', summarising the issue as 'Secretive practice of 'setting off' sees savings and even benefit payments being snatched from customers'. It noted that in extreme cases customers were left 'unable to pay basic bills or buy food'. Bank customers are reported to be outraged. According to The Observer, their claims have been referred to the Financial Ombudsman Service and the matter is now under investigation by the Banking Code Standards Board. It would indeed seem implausible that these customers would regard their banks as having a legitimate security device.