KEY POINTS

- The *Hamersley* decision is all about set-off.
- Legal set-off and equitable set-off are not easily displaced.
- If insolvency set-off was an exclusive code it would have unintended consequences where debts are assigned.

Feature

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Is insolvency set-off an exclusive code?

What is the relationship between different types of set-off? If insolvency set-off applies can any other set-off apply at the same time? Is insolvency set-off an exclusive code? These questions are discussed following the Australian Court of Appeal's decision in *Hamersley v Forge* [2018] WASCA 163.

INTRODUCTION

Hamersley Iron Pty Ltd (Hamersley) and Forge Group Power Pty Ltd (Forge) entered into a contract to build a power station. Hamersley was the principal, Forge was the contractor. Forge entered into a facility agreement with Australia and New Zealand Banking Group Limited (ANZ) giving ANZ security over its property. When Forge entered insolvency, Hamersley's claim against Forge exceeded Forge's claim against Hamersley. Hamersley claimed that it was entitled to set-off the debt due to it against the debt due to Forge and prove for the balance. At first instance the set-off claim failed. The court held that insolvency set-off was an exclusive code regulating set-off in insolvency such that even when the statutory requirements were not met the provision nevertheless ousted any other form of set-off. As ANZ's security interest operated to negate the mutuality of interest between the cross-claims, no set-offs were therefore available. However, The Court of Appeal (Western Australia) reversed that decision and allowed Hamersley's insolvency set-off claim.

This article considers whether insolvency set-off should have a limiting effect on other set-offs.

HAMERSLEY'S SET-OFF CLAIMS

Hamersley claimed a contractual set-off, an equitable set-off, and an insolvency set-off pursuant to s 553C of the Corporations Act 2001.

Section 553C is closely analogous to Insolvency Rule 14.25, the English law provision that applies in company liquidations. The relevant words are the same. Insolvency set-off applies where there have been mutual credits, mutual debts or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted by the company (s 553C (1)).

Insolvency set-off is both "automatic" and "self-executing" rather than procedural in nature (*Stein v Blake* [1996] AC 243 (HL)). The set-off account is taken when the company "goes into liquidation". That date is the relevant date. It is not possible to contract out of, or waive, the operation of insolvency set-off (*National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785 (HL)).

COMPETING SET-OFF CLAIMS

Contractual set-off

Hamersley sought to rely upon a contractual provision that allowed it to set-off amounts due to it against payments due to Forge. This claim failed because the provision was not self-executing and had not been invoked by Hamersley before Forge entered insolvency. In any event, where insolvency set-off applies, contractual rights purporting to exclude it or give a more extensive or less extensive operation of it, would be unenforceable.

Legal set-off

The term "legal set-off" is used here to refer to independent or statutory set-off. This is a right of set-off, originating from the Statutes of Set-off enacted in 1729 and 1735 but now enshrined in the rules of court. Legal set-off does not require that there be any connection between the claim and the cross-claim. However, those claims must be liquidated and due. The claim and the cross-claim must also be mutual claims.

Legal set-off can sometimes be available in insolvency, but outside of the insolvency set-off section. *Davies v Gertig* ((No 2) [2002] SASC 257) is a case in point. G had a claim for costs provable in the bankruptcy of D. D had a damages claim against G for personal injury. This claim did not vest in the Trustee in Bankruptcy (being excluded by statute, s 116(2)(g) of the Bankruptcy Act 1966.) As a result, G could not rely upon the insolvency set-off provision because the claim and the cross-claim were not mutual claims. G sought to set-off his claim by way of a legal set-off in accordance with the rules of court. If he could not set-off his claim, he would have been obliged to prove for a dividend in D's bankruptcy whilst being obliged to pay the damages claim to D.

The set-off was allowed. The court recognised that this result would give G a better outcome than the other creditors. However, that outcome was not at the expense of those other creditors because the claim for damages did not vest in the Trustee in Bankruptcy. On the contrary, the other creditors would benefit because G was no longer proving for a dividend in the bankruptcy.

If the insolvency set-off provision was an exclusive code as contended in *Hamersley*, then G would have been denied a set-off.

Equitable set-off

The term "equitable set-off" or "transaction set-off" refers to a species of set-off developed independently by the court of equity.

Originally equitable set-off arose where the defendant could show that the demand of the claimant was "impeached". This would typically occur when there were cross-claims arising from a contract and it was inequitable for the claimant to insist on his terms without giving credit for any balance due to the defendant (*Rawson v Samuel* (1841) Cr & Ph 161; 41 ER 451.) However, more recently, it has been suggested that equitable set-off is available whenever the cross-claim arises out of the same contract or is closely related to the claim (*Geldof Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667; [2010] 4 All ER 847). The prevailing

view is that equitable set-off operates as a substantive defence, but it does not extinguish either claim until judgment on the claims (*Fearns (t/a Autopaint International) v Anglo Dutch Paint & Chemical Company Ltd and Others* [2010] EWHC 2366 (Ch)). Though the cross-claims do not need to be liquidated and of known amount, the cross-claims must be mutual.

Does insolvency set-off displace equitable set-off? Derham cites a number of cases as authority for this proposition, though it is not his own opinion. (Rory Derham, *The Law of Set-Off*, 4th edn London: OUP, 2010 para 6.25, 6.26.) It is submitted that on a very narrow view, if insolvency set-off applies then equitable set-off cannot apply at the same time. That narrow view accords with the judicial statements (*Re Daintrey* [1900] 1 QB 546, 567 (Bigham J); *Brown v Cork* [1985] BCLC 363, 376 citing *Re A Debtor (No. 66 of 1955)* [1956] 1 WLR 1226, 1236 (Lord Evershed MR)). The wider question is when an insolvency set-off claim fails can an equitable set-off arise in its place?

In *Hamersley*, the Court of Appeal noted the "potential vitality" of equitable set-off notwithstanding the insolvency of one of the parties. The starting point was *Ex parte Stephens* ((1805) 32 ER 996). S instructed her bankers to sell some annuities and invest the proceeds. They carried out the sale but kept the proceeds for themselves, without informing S. Later, S's brother, J, borrowed £1,000 from the bankers on the security of a joint and several promissory note given by S and J. When the bankers went into bankruptcy, the Trustees in Bankruptcy sued J on the note. J could not rely on an insolvency set-off because J did not have a claim against the bankers. S had a claim but was not being sued on the note. At that time insolvency set-off was not thought to be automatic and self-executing because otherwise S could have relied upon insolvency set-off without waiting to be sued by the Trustees.

S and J brought proceedings claiming *inter alia* that S be at liberty to set-off what was due to her against what was due on the note. Lord Eldon LC granted an order to this effect. He said (at 997):

> "… and it was competent to her … to have desired, that so much of the debt should be cancelled, and the difference paid; and to have said, she had a demand against her brother for the sum of £1,000, as paid to his use; also upon the statute of mutual debts and credits; and they shall not be permitted to say, she shall not, if she chooses, pay the debt; when the consequence is that she loses her money and they can call upon him. If she had this equity before the bankruptcy, so she has it afterwards; and therefore she has a clear right to say, they shall hold £1,000 of her money in discharge of the note; and shall deliver up the note."

There are a number of alternative explanations of Lord Eldon's decision. (See Derham, paras 12.37-12.38.)

In *Hamersley*, the Court of Appeal considered that the concealment of the fact that S was a creditor gave rise to an equity that prevented the bankers from suing S on the promissory note. S did not lose that equity when the bankers went into insolvency. It was not a question of set-off in the "strict and technical sense" in that the "question upon the whole" was whether equity could be interposed in the action at law brought by the bankers against James (*Hamersley*, para 167).

In practical terms, the Trustees were in the same position that they would have been in had J been entitled to rely upon insolvency set-off, or if they had sued S on the note. However, if the Court of Appeal's interpretation is correct then to what extent can it be argued that where insolvency set-off does not apply, equitable set-off can arise in its place? The decision in *Ex parte Stephens* does not answer this question because although S had a right of set-off, it had not operated to discharge S at the time the proceedings started, because in 1805 insolvency set-off was not considered to be automatic and self-executing. Had it been so regarded then S would have been entitled to rely upon insolvency set-off whether or not the Trustees had elected to issue proceedings against her. The fraud allowed equity to intervene to ensure that S got the benefit of the set-off.

HAMERSLEY: THE COURT OF APPEAL'S DECISION

Insolvency set-off was permitted by the Court of Appeal in *Hamersley* and the decision of Tottle J was reversed on this point. This was on the narrow ground that at the commencement of the winding up, ANZ's security interest did not affect the nature of the debt due to Forge which was at that time a circulating asset available to Forge. This was because an event of insolvency had yet to occur. (The appointment of the administrators, that would have effectively "crystallised" the bank's charge. Note that the Australian Personal Property Securities Act 2009 (PPSA) does not recognise floating charges as such. However, where there is a single security interest over circulating assets the same jurisprudence seems to have been applied; *Hamersley* at para 219.)

Therefore, in this brief interregnum, the dealings between Hamersley and Forge were said to be mutual dealings within the meaning of s 553C of the Corporations Act, notwithstanding ANZ's security interest. (*Hamersley*, para 132.) More particularly, the court determined that if it was wrong to conclude that insolvency set-off applied, there was nothing in s 553C or its purpose or policy which would relieve the chargee of any equities which would otherwise apply to the charged debt. In other words, other set-offs might be available. (Note that s 80(1) of the PPSA preserves rights of set-off against a transferee in an analogous way to the common law. This is considered further below.)

INSOLVENCY SET-OFF AND ASSIGNMENT

It is helpful to consider the position of an assignee of a debt. This is a typical occurrence in commercial life, in factoring arrangements for example. Suppose that C owes 150 to D and D owes 75 to C. A takes an assignment from C of C's claim. C then goes into insolvent liquidation. Insolvency set-off can only apply to mutual claims and cross-claims. Therefore, when C assigned its claim to A mutuality was destroyed between C and D. This is because D is left seeking to set-off a debt due to it from C against a debt now owed to A. This arrangement will not give rise to an

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insolvency set-off. A gets the full value of its claim (75), to D's detriment.

OTHER SET-OFF CLAIMS AND ASSIGNMENT

If insolvency set-off is an exclusive code that ousts any other set-off even when its terms are not met, A would always take free of D's rights. However, the rules governing D's defensive rights against A prevent this.

First, D may show that the amount claimed is not due either because of some substantial defence or right of abatement. Second, D may have a contractual right of set-off. Third, D may have a cross-claim giving rise to an equitable set-off. Fourth, D may have a cross-claim that is independent of the claim against him, giving rise to a legal set-off (*Bibby Factors Northwest Ltd v HFD Ltd and Another* [2015] EWCA Civ 1908.)

The principles underlying these rules have been neatly summarised (see *Goode and Gullifer on legal Problems of Credit and Security*, 6th Edn, 2017, Sweet & Maxwell, paras 7-70-7.75). Two of these principles deserve greater attention here.

A takes subject to any equitable set-off claim or right of abatement held by D, arising at any time, including after assignment. The assignee cannot stand in a better position than the assignor. Where C owes 150 to D and D owes 75 to C, if C can simply assign his claim to A to defeat D's claim this leads to a significant injustice to D. If C then goes into insolvency, D is restricted to proving for his claim in C's insolvency whilst A recovers in full from D. In truth, at the point that A takes the assignment, the claim against D is not worth 75. One might think of C's claim as a flawed asset, in that reduction or extinguishment are inherent in the claim at the point of assignment.

The second principle is that an assignee takes subject to equities (which include legal set-off) that the debtor has against the assignor before the debtor receives notice of the assignment. This principle protects the debtor from the injustice that might otherwise arise as a result of the assignment. In effect, C's claim against D is impressed with an equity on assignment to A and A cannot take free of it.

It is submitted that it is frequently the case that a third party has an interest in one of the claims comprising the set-off. This could be by way of assignment or it could be akin to an assignment by way of a fixed charge or a crystallised floating charge. Typically, the assignee sues the solvent debtor. The assignor is insolvent. In *Hamersley*, the Court of Appeal decided that ANZ took subject to any equities that existed before notice of the assignment, in reliance on s 80 of the PPSA (*Hamersley*, at para 218). The receivers of Forge had sought to argue in effect that had Hamersley's insolvency set-off failed, any other set-off would also be precluded with the result that the bank was entitled to a windfall. This would have been the result because Hamersley would have been obliged to pay ANZ in full whilst proving its claim in the insolvency of Forge.

In the *Bibby Factors* case, the debtor did not seek to rely upon insolvency set-off because although the assignor/creditor was insolvent the claim and the cross-claim were no longer mutual as explained above. Bibby was the assignee unsuccessfully opposing the debtor's equitable set-off claim.

CONCLUSION

The receivers' claim was ambitious. They sought to interpret the insolvency set-off provision as a code that was both exclusive where it applied and, where it failed, exclusive of any other set-off. Had this argument succeeded it would have had unintended consequences. It would have prejudiced the debtor and the unsecured creditors in cases like *Davies v Gertig* (above). It would mean that debtors' rights on assignment would be severely curtailed. It would lead to windfall payments to assignees in the position of ANZ or Bibby (above). The principles and rules developed by the court ensure that equity will protect debtors' rights and this is to be supported. Insolvency set-off can be limited in its effect. However, that limitation does not depend on insolvency set-off being an exclusive code. ■

Further Reading:

- Set-off and assignment in administration (2011) 2 JIBFL 92.
- Assignment of unsecured debts, security and insolvency (2014) 10 JIBFL 626.
- Legal Ease: Revisiting the effect of assignments on rights of set-off in the light of the application of the Business Contract Terms (Assignment of Receivables) Regulations 2018 (2019) 2 JIBFL 139.

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