

## LEGAL AND EQUITABLE SET-OFF: AN OVERVIEW

---

*Although the law of set-off is potentially complex, an understanding of the basics can assist practitioners to avoid common mistakes which confuse set-off with procedural mechanisms such as cross claim or counter claim.*

*This paper provides a simple explanation of the function of set-off as it stands today<sup>1</sup>, the differences between legal and equitable set-off, when each species of set-off arises and what circumstances are required to plead a set-off in defence of a claim.*

### **What is set-off and how does it differ from a cross claim?**

At its most simple, set-off may arise in circumstances where there exist mutual debts between, for example, Party A and Party B. In the usual scenario, Party A claims payment of the debt owed by Party B, and Party B defends its debt by reference to the debt owed to it by Party A – thus the debt originally claimed is ‘cancelled out’ by the other existing debt. It is not necessary that the claim for the debt be brought in the context of litigation, however the important factor is that the mutual debts have become due and payable at the time the claim is made.

In contrast, a cross claim is a court proceeding brought by a defendant against the plaintiff (or a third party) for relief which relates to, or is connected with, the subject of the proceedings brought by the plaintiff.<sup>2</sup> A cross claim results in the delivery of separate judgments for the substantive proceeding and the cross claim, each in their own right.

Once these basic concepts are understood, the distinction between set-off and cross claim becomes clear. Whereas set-off is a legal principle that may be invoked if circumstances warrant it (whether in court or outside of court), a cross claim is a procedural mechanism used in litigation which does not require any ‘off-setting’ feature in respect of the specific claim being made.

There remains therefore a real distinction between these two concepts, even in cases where in practical terms, the result might be the same.

### **What is the difference between legal set-off and equitable set-off?**

There are in three distinct types of set-off which may be invoked, depending on the circumstances:

- Legal set-off
- Set-off under statute
- Contractual set off
- Equitable set off

---

<sup>1</sup> This paper does not discuss the history of the Statutes of Set-off and the law of set-off prior to the Civil Procedure Act in NSW

<sup>2</sup> Ibid s 22(1)-(2)

Set off under statute might be considered a sub-species of legal set off, but it is worth mentioning it here separately.

### **Legal set-off**

Legal set-off is a plea in bar in defence of a claim brought in the context of legal proceedings.

In New South Wales, the *Civil Procedure Act 2005* entitles a defendant to defend a claim against it by a plea of set-off in any proceedings where a mutual debt exists between the plaintiff and the defendant.

When pleading set-off as a defence, there exists the usual requirement of the existence of mutual debts, each being due and payable at the time the set off defence is filed. There is no requirement that each of the mutual debts in these circumstances be of the same or even of a similar nature or arising from the same transaction.<sup>3</sup> What is fundamental is that the mutual debts have become due and payable at the time of the court action. The existence of a liquidated sum is therefore a crucial factor. (Prior to the enactment of the *Civil Procedure Act* in New South Wales, procedural set-off required a liquidated sum, the authorities favouring the position that “money is only due and owing when, if not paid, the person to whom it should be paid may maintain an action for it at law or in equity.”<sup>4</sup>)

Since the entitlement to plead a set-off in NSW Courts does not impose any requirement to demonstrate a nexus between the mutual claims<sup>5</sup>, the steps required to meet the statutory requirements for pleading set-off are (usually) relatively straightforward.

(Note: Set-off of judgments provided in s 96 of the *Civil Procedure Act*, is discussed further in this paper).

### **Set-off under statute**

Quite apart from the general legal set-off available under the *Civil Procedure Act*, other statutory provisions have been enacted which provide specific entitlements for an applicant to claim a set off. Two such examples are:

#### *Bankruptcy Act 1966 (Cth)*

Section 86 allows an account to be taken (for the purpose of a set-off) in cases where there are mutual debts, mutual credits or other mutual dealings between a bankrupt and a person claiming to prove a debt.

#### *Sale of Goods Act 1923 (NSW)*

Section 54 entitles a buyer to a set off a breach of warranty claim against the price paid for the goods the subject of the warranty.

---

<sup>3</sup> *Civil Procedure Act 2005* (NSW) s 21(1)

<sup>4</sup> Young CJ in Eq in *National Australia Bank Ltd v Idoport Pty Ltd* [2007] NSWSC 1349

<sup>5</sup> Ibid: Under the statute, a set-off defence will be available “whether or not the mutual debts are different in nature.”

## *Civil Procedure Act 2005 (NSW)*

Section 96 provides courts in New South Wales (apart from the Supreme Court) the power to order a set-off of judgments under certain conditions. For a discussion of this application of set-off, see “Set-off of Judgments” below.

### **Contractual set-off**

Also referred to as set-off by agreement, this species of set-off is as the name suggests – in other words, the availability of set-off arises directly from a term of the contractual relationship itself. In accordance with the law of contract formation, such terms will be construed either from the written contractual agreement, by oral agreement or by course of dealing or conduct.

In New South Wales, the common law recognizes this form of set-off as being “in law equivalent to actual payment on each side”<sup>6</sup> and not the kind of set-off that may be derived from statute. Put simply, it is the equivalent of a payment.

An example of simple contractual set-off is the inclusion of a contractual term in an agreement between two parties which authorizes Party A to apply any money it owes to Party B towards satisfaction of any sum due and payable by Party B to Party A (*National Australia Bank v Idoport Pty Ltd*<sup>7</sup>).

Another example is an insolvent company with its creditors to issue shares of an equivalent nominal value for the discharge of debts owed (*Pro-Image Studios Ltd v Commonwealth Bank of Australia*<sup>8</sup>).

There are other examples, some inherently complex, of contractual set-off in action, too numerous to cover in this paper. It is hoped the above two examples provide a simple demonstration of contractual set-off being equivalent to “actual payment on each side.”

### **Equitable set-off**

By contrast to all of the above forms of set-off, the requirements of equitable set-off differ substantially from those of legal set-off and require something more than the mere existence of a cross-claim, whether arising by means of mutual debts or statutory entitlement. In its application, equitable set-off is (arguably) the more interesting and varied species of set-off.<sup>9</sup>

The test by which true equitable set-off is established originates in Lord Cottenham’s judgment in *Rawson v Samuel* (1841) 41 ER 451 at 458. That test requires the defendant to show some *equitable* ground for being protected against the plaintiff’s claim, such that the plaintiff’s title to the claimed debt has been impeached:

We speak familiarly of equitable set-off, as distinguished from the set-off at law; but it will be found that this equitable set-off exists in cases where the party seeking the benefit of it can shew some equitable ground for being

---

<sup>6</sup> McLellan J in *Re Application of Keith Bray Pty Ltd* (1991) 23 NSWLR 430 at 431

<sup>7</sup> [2007] NSWSC 1349

<sup>8</sup> Supreme Court of Victoria, (1991) ASCR 586

<sup>9</sup> Equitable set-off by analogy with statutory set-off is not included for discussion in this paper

protected against his adversary's demand. The mere existence of cross-demands is not sufficient... Is there, then, any equity in preventing a party who has recovered damages at law from receiving them...? ... Several cases were cited in support of the injunction; but in every one of them, except *Williams v. Dairies*, it will be found that the equity of the bill impeached the title to the legal demand.

The "impeachment of title test" was explained by Sheller JA in *Lord v Direct Acceptance Corp Limited (in liq)*<sup>10</sup>:

In *Bank of Boston Connecticut v European Grain and Shipping Ltd* [1989] AC 1056 at 1102, Lord Brandon of Oakbrook said that the concept of impeaching the title to the legal demand was not one familiar today and referred to the expression used in *Government of Newfoundland v Newfoundland Railway Co* (1888) 13 App Cas 199 at 212-213 that a claim may be set-off if "flowing out of and inseparably connected with the dealings and transactions which also give rise to the claim". The concept is better stated in Meagher, Gummow and Lehane, *Equity, Doctrines and Remedies*, 3rd ed (1992), par 3709(h) at 818, where the learned authors say that it is an indispensable requirement of equitable set-off that the set-off actually go to the root of, be essentially bound up with, "impeach" the title of the plaintiff.

More recently, his Honour Justice Barrett, in *Hawes v Dean*<sup>11</sup>, commented on this fundamental test of equitable set-off as follows:

**[61]** The "impeachment of title" test remains applicable in Australia... The Full Federal Court noted that, in *Forsyth v Gibbs*, Keane JA (with whom McMurdo P and Fraser JA agreed) said at [10] that equitable set-off does not depend upon an unfettered discretionary assessment of what is fair. Rather, it is essential that there be such a connection between the claim and cross-claim that the cross-claim can be said to impeach the claim.

...

**[63]** A more recent statement of the principle in this Court is found in the judgment of Emmett JA (Beazley P and Meagher JA concurring) in *HP Mercantile Pty Ltd v Dierickx* (above). His Honour said (at [136]), referring to the decision of Gummow J in *James v Commonwealth Bank of Australia* (1992) 37 FCR 445:

For there to be an equitable set-off, the set-off must essentially be bound up with and go to the root of, challenge, call in question, or impeach the title of the claimant. Equitable set-off is available where the party seeking it can show a recognised equitable ground for being, to the relevant extent, protected from its adversary's demand. The mere existence of a cross-claim is not sufficient. There must be some ground for equitable intervention beyond the mere existence of a cross-claim, such that it can be said that the equity of the defendant impeaches the claimant's title to the legal demand being enforced.

Barrett J referred to three examples of equitable set-off to cited by Emmett J in the *HP Mercantile* case that illustrate this concept of impeachment of title on equitable grounds:

---

<sup>10</sup> (1993) 32 NSWLR 362 at 367

<sup>11</sup> [2014] NSWCA 380

1. Where a mortgage is granted to a solicitor as security for costs and the mortgagor client has a cross-claim against the solicitor for faulty work;
2. Where a builder has a claim for money due under a building contract and there is an unliquidated claim against the builder for damages for breach of that contract;
3. Where a lender fails to provide promised further advances for a development project and the borrower is unable to complete the development project and repay the advances actually made.

The equitable claim arising in each of these examples can thus clearly be seen as going to the root of the title claimed and of which Barrett J observed<sup>12</sup>:

... two wrongs or defaults are so closely connected that a net position or result ought in equity to prevail between the parties because it would be unconscionable to allow one of them to insist on its legal right without first accommodating the other's countervailing legal right. It is the existence of that unconscionability that causes the first party's claim to be "impeached" (that is, undermined and defeated) by the second party's claim.

It is also clear that the mutual claims do not necessarily have to be liquidated sums in order to claim an equitable set-off.

### **Set-off of judgments**

And finally, a further example of set-off pertaining specifically to judgments in the NSW Supreme – and other – courts.

There exist two discrete sources of power that enable a litigant to set-off judgments.

The Supreme Court has inherent power to order that one judgment be set off against another judgment. This power arises from the "equitable jurisdiction" of the court and the subject of Justice Young's quotation of Montagu in *Wentworth v Wentworth*<sup>13</sup>:

Opposite demands arising upon judgments may upon motion be set-off against each other, whenever such set-off is equitable though the judgments are in different courts, and though the parties to the different records are not the same. Costs may be set-off against costs only, or against debt and costs.

More recently, Brereton J in *Aquatic Air Pty Ltd v Siewert (No 2)*<sup>14</sup> articulated the basis of the Supreme Court's jurisdiction to order a set off of judgments:

The set-off of judgments did not depend upon the Statutes of Set-Off; but on the general jurisdiction of the court over the suitors in it. The common law courts always had an equitable jurisdiction, for the purpose of preventing absurdity or injustice in cases where there had been judgments for damages between the same parties in distinct actions, to set-off one judgment against the other, and to allow execution to issue in respect of the balance only. Opposite demands arising upon judgments may upon motion be set-off against each other, whenever such set-off is equitable.

---

<sup>12</sup> Ibid, at [65]

<sup>13</sup> Unreported, NSWSC, 12 December 1994 per Young J (quoting Montagu on Set-Off, 1925 American ed, at 6-8) BC9403409 at 3-4

<sup>14</sup> [2016] NSWSC 10 at [36]

For courts other than the Supreme Court, section 96 entitles a judgment debtor to apply to the court for an order setting-off judgment debts in situations where there are two or more judgment debts in the same court and “*the judgment creditor and judgment debtor under one or more of the judgments are the judgment debtor and judgment creditor, respectively, under the other judgments.*”<sup>15</sup>

(An example of the application of s 96 and the framing of orders can be found in Brereton J’s judgment to which reference is made above).

### **Planning and preparation**

From this brief overview of legal and equitable set-off, it is hoped that the reader will now be aware that there are many ways in which the various species of set-off can be applied, limited only by the unique circumstances of each case. Choosing the correct form of defence when faced with factual circumstances involving mutual obligations is therefore a critical first step in planning and preparing a cogent and effective defence narrative.

\*\*\*\*\*

February 2017

---

<sup>15</sup> *Civil Procedure Act 2005 (NSW) s 96(1)*