Briefing

BURGES SALMON

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Debt factors and equitable set-off – rare application of little used and understood rights

The received wisdom is that if, as a debtor, you are considering equitable set-off arguments, you are clutching at straws. A recent case shows a rare example of when such rights can successfully be used however. This article explores the issues further.

The background

Set-off is a right under which one party, typically to a contract, (Party A) can reduce or eliminate the liabilities it owed to another party (Party B), by setting against those obligations liabilities which Party B in turn owes to Party A. Such rights may be express (written into a contract) or may be implied by statute (e.g. the mandatory set-off on liquidation under Insolvency Rule 4.90) or common law (such as a bankers right to combine current accounts). Where no express contractual rights of set-off are included within a standard commercial contract, it may still be possible to set off obligations owing under the principles of equity (known as "equitable set-off"). However, equitable set-off is more difficult to use, as not only do the obligations set off have to be of the same nature (e.g. contractual vs contractual), but the competing obligations must be so closely connected that it would be manifestly unjust to enforce one without taking the other into account (i.e. they arise from the same cause of action).

In *Bibby Factors Northwest Limited v ND Limited & Another [2015] EWCA Civ 1908*, the Court of Appeal had to consider equitable set-off issues in a unique set of circumstances. In this case Bibby has bought certain debts from a company which supplied goods (S). Under the factoring agreement, S had agreed to sell all of its debts to Bibby by way of legal assignment (under which Bibby became the legal owner of the debts and able to enforce them without involving S, pursuant to section 136 of the Law of Property Act 1925 ("LPA").

Bibby subsequently brough proceedings against certain customers of S, alleging they had failed to pay in excess of £180,000 in respect of supplies they had received from S. In their defence, the customers counterclaimed for a similar sum, stating that under the terms of their contracts with S they were entitled to a 10% rebate for every supply made in a calendar year, and a further 2.5% if payment was made in accordance with S's terms of business. They also raised the issue of debit notes issued for faulty goods supplied by S.

The issues

The Court had to decide whether the customers were allowed to exercise set-off against the factors. As part of the deliberations, Bibby pointed to a "take-on letter" issued to S's customers at the point the factoring agreement was set up, stating that any right of set-off by customers was excluded, and that customers were to notify Bibby of the existence of any disputes which would entitle them to defer payments. Bibby alleged that this letter estopped customers from relying on set-off rights.

What did the court decide?

The court decided that, an assignment of future debts being effective in equity, Bibby had no better rights to the debts than S, and took subject to any claims which S's customers might have against S. It ruled that equitable set-off was a single, composite test that a customer's cross-claim was so closely connected with Bibbys claim that it would be unjust to allow enforcement of the latter without taking account of the former. In this case, the claims were to be regarded as so closely connected, despite the fact that the customers had been in contact with Bibby for some 13 years about invoices and had never mentioned the rebate. The "justice" of this was not an issue - merely the close connection of the relevant claims. Bibby's take-on letter had no contractual effect (as Bibby was a stranger to the contracts between S and its customers), and gave rise to no obligation on the customers to inform Bibby or rights to rebate or cross-claims. The only obligation which Bibby could impose would be upon S itself to inform Bibby of such rights and claims. The customers had also produced the various debit notes for defective goods. Accordingly, Bibby's claims failed on all grounds save for the potential argument as to the additional 2.5% payment terms rebate.

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What does this mean for practitioners?

Equitable set-off is still a ticklish cause of action, despite the clarification of the tests to be applied relatively recently laid down in *Geldof Metaalconstructie NV v Simon Carves Ltd [2010] EWCA Civ 6*. Unlike the Rule 2.90 regime, under which all mutual dealings are automatically set off, equitable set-off requires a "close connection" between the competing claims. This may be clearly established in cases (for example) for payment for the supply of goods, where the buyer has a cross-claim for the goods being defective. In other cases, the picture may not be so clear, and will require careful analysis before the argument is raised. As ever, it is better to have set-off rights reduced to writing so that parties are not left to the vagaries of equitable principles!

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