A tenant's right to set-off

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In this article the author will discuss the attributes of set-off at common law and in equity. The decision of British Anzani (Felixstowe) Ltd ν International Marine Management (UK Ltd), has provided an impetus to the doctrine of equitable set-off in its application to leases. This case confirms a considerable latitude to a tenant to set off liquidated and unliquidated damages against rental. The author will then discuss the rules of set-off against a landlord constituted by a mortgagee in possession. This discussion will reveal that the application of set-off in that circumstance is dependent upon the local statutory provisions which affect the nature of the mortgagee’s interest and the ability of a mortgagee to recover rent. Finally the article will discuss the contractual provisions which can be applied between the parties so as to disrupt or enhance the tenant’s ability to seek set-off against rent against a mortgagee in possession.

Introduction

A tenant’s entitlement to seek equitable set-off against rental arrears is a remedy which can be vital to a tenant to prevent forfeiture at the hands of a landlord.

This article analyses the principles of the remedy of set-off and then deals with its application to leases. As part of this discussion the article focuses on the entitlement of a tenant to seek a set-off of rent against a mortgagee of the landlord who has entered possession of the subject property. In this respect it will become evident that quite apart from the implications of the stipulations of any contractual arrangements entered into between the mortgagee, mortgagor and tenant because of the terms of real property legislation in different states, the ability of a tenant to exercise this remedy varies considerably between jurisdictions.

What is Set-off?

Set-off is a defence that arises in equity and at law and may be pleaded by a defendant as a bar to a plaintiff’s action. A set-off exists when a countervailing claim absolves the defendant completely or partially from liability to the plaintiff. As a set-off is used defensively, if a plaintiff discontinues the action the set-off is thereby terminated. The defensive nature of a set-off also means no amount of excess of a set-off over a claim can be granted by a judgment in favour of a defendant. As a result where possible a defendant will plead the countervailing claim as set-off and counterclaim. By contrast, a counterclaim is not a defence but is a claim made by the defendant, employed offensively in the same proceedings brought by the plaintiff, as a separate action in its own right. A counterclaim survives no matter what is the fate of the plaintiff’s action. Current court rules usually require a defendant to raise both set-off and counterclaim concurrently to avoid circuity of action and to resolve

* I would like to thank my colleague Kay Lauchland for her helpful comments on an earlier draft of this article.

1 Meagher, Gummow and Lehanas, Equity: Doctrines and Remedies (The Law Book Co Ltd, 1975) p 768. If the defendant claims a set-off for less than the claim then the plaintiff can seek payment of the balance. An equitable set-off comprising of an unliquidated claim of more than the plaintiff’s claim, bona fide made, even if not precisely quantified can amount to a complete defence to the whole claim. Wood, English and International Set-Off (Sweet & Maxwell, 1989), p 113.

all matters between the parties, this being the purpose of the reforms introduced by the Judicature Act 1873 (UK).  

Although the judgment of Morris LJ in Hanak v Green has been the subject of criticism as well as praise Morris LJ provides a useful categorisation of set-off into three categories:

1. set-off under the Statutes of Set-off — (common law);
2. abatement at common law;
3. equitable set-off.

This article also uses this categorisation but focuses on the third category while the other two categories will be discussed to assist in differentiation from equitable set-off. This assists in analysis of subsequent cases where it appears some confusion between the categories has occurred. It seems this confusion has arisen by virtue of three factors:

1. The debt to ancient equity cases in the analysis of equitable set-off means those cases are often not readily reconcilable with modern authorities and one is left to ponder the proper basis for some decisions.
2. The indiscriminate use of terms such as “cross-demand”, “cross-claim”, “set-off”, and “deduction” has meant that it is often difficult to decipher the meaning which a judge intends to convey, especially in regard to the distinction between equitable and common law concepts.
3. The Judicature Act 1873 (UK) and local court rules create their own confusion as judges struggle to determine the impact of these provisions in equity and in law.

Category 1 — Set-off under the Statutes of Set-off

The first category encompasses actions at law, where, as a result of the passing of the Statutes of Set-off, mutual debts could be set off against each other. This type of set-off is a creature of statute as some rule of court or statute must provide the basis of this remedy which is unknown at common law. This was clearly demonstrated in the New South Wales decision in Southern Textiles Converters Pty Ltd v Stehar Knitting Mills Pty Ltd where the court held that as the Statutes of Set-off were repealed in New South Wales by the Debtors Relief Act, no common law right of set-off was at that time available in New South Wales.

An important requirement for this category of set-off was that the debts be liquidated or ascertainable with certainty at the time of pleading. Into this category can be placed the line of cases beginning with Dixon J’s judgment in McDonnell & East Ltd v McGregor (McDonnell & East case). Owing to what is apparently a misapprehension of the intent of Dixon J’s dictum this authority has been effective in Australia to restrict somewhat the application of doctrines of equitable set-off. The offending and often quoted statement by Dixon J (as he then was) was that “my opinion is that a liquidated cross demand cannot be pleaded as an answer in whole or in part to a cause of action sounding in damages or vice versa” [my emphasis]. Application of this statement, to equitable set-off, would stymie any attempt to seek unliquidated damages, for example, where an unliquidated cross demand was pleaded as an answer to a liquidated claim for rent.
Justice Dixon's Dictum — Of What Does it Speak?

A perusal of the McDonnell & East case reveals, however, that it is likely that the statement by Dixon J was made in relation to the first category of common law set-off. Justice Dixon in that authority was asked to decide a narrow point as to whether a Supreme Court judge had authority to enter judgment other than in accordance with the answers to specific questions given by a jury. Justice Dixon determined on separate grounds that the appeal should be dismissed but as argument was addressed to set-off he deemed it appropriate to make some comment. Accordingly even if related to equitable set-off the statements by Dixon J were obiter.

As an intricate reading of the judgment is necessary to ascertain that the statement by Dixon J was dealing with common law set-off, this case has often been quoted as the basis for the rule that unliquidated damages cannot be pleaded in equitable set-off in Australia. As the Dixon judgment seemed at odds with English decisions to the contrary his judgment was discussed but was not followed in Edward Ward & Co v McDougall as it was seen as dicta and not binding. Justice Campbell was not prepared to follow Dixon J in Knockholt v Graff a case dealing with set-off relevant to leases.

However, the influence of Dixon J’s statement has been pervasive as it has support in other authorities such as in Fong v Cilli where a claim for set-off of liquidated and unliquidated damages against rent under a lease was refused. Fong v Cilli substantially relied upon the judgment in Bayview Quarries Pty Ltd v Castley Development Pty Ltd. In the Bayview Quarries case Dixon J’s judgment was relied upon to reject the claim for equitable set-off on the basis the claim was unliquidated damages as against a claim for a liquidated sum in relation to a contract for the sale of goods. However, for the purposes of analysis the court made an assumption that English cases, not limited by Dixon J’s dicta to the contrary, could be applied in Australia and concluded that equitable set-off still did not apply on the basis that there was insufficient connection between the contractual relationship and the counter-claim and thus there was no equitable ground for intervention. Thus stripped of the reliance upon the Dixon dicta the Bayview Quarries case does not deal with a matter relevant to a discussion of equitable set-off, and should not be relied on in relation to that topic. Similarly the authority of Fong v Cilli should be discounted as the claim for damages did not arise directly from the leasehold arrangement but from a separate contract of sale of land entered into by the landlord and tenant. As will be discussed below it is basic to an action for equitable set-off that the set-off claimed by a tenant must be so closely connected to the landlord’s primary claim for rental so as to impeach the landlord’s claim. It is doubtful if this connection existed in that case.

For these reasons it is suggested that the judgment of Dixon J should not be the basis of an unduly restrictive application of equitable set-off. Some recent authorities in Australia support the view that unliquidated demands can be set off against liquidated claims.

Category 2 — Abatement

This category relates to a common law doctrine (strictly not a right of set-off but a defence to action for the price) whereby in answer to an action for the price of goods sold and delivered a defendant could claim...
an abatement for breaches of warranty in relation to those goods if they were thereby reduced in value. Entitlement to claim such an abatement can be demonstrated by showing the diminution in the value of the subject matter caused by the breach. An Australian example of the application of this doctrine is provided in *Newman v Cook* where in answer to an action for non-payment of instalments due on the sale of a boat the defendant sought and obtained an abatement in regard to defects in the boat which demonstrated there was a breach of warranty by the vendor as to the condition of the boat.

**Category 3 — Equitable Set-off**

This category relied upon remedies available in a court of equity. Although the exact boundaries of this remedy are to some extent clouded, this remedy is characterised by circumstances where "the party seeking the benefit of it can show some equitable grounds for being protected against his adversary’s demand. The mere existence of cross demands is not sufficient". Spry expresses it somewhat differently as "what must be established was such a relationship between the claim of the plaintiff at law and the claim of the defendant that the right of the plaintiff should be regarded in equity as dependent on satisfaction of the claim of the defendant". An important requirement is that the equity must go to the root of the plaintiff’s claim. This aspect is traditionally demonstrated by the authority of *Piggott v Williams* where the principle was applied to allow an equitable set-off by a client sued for fees on a suit which was necessary because of the solicitor's own negligence. The equity can arise by fraud, whether equitable or legal, which causes the entering of the obligation by the defendant and can include situations where negligence creates the required equity as in *Piggott v Williams*.

Justice Forbes in the recent decision of *British Anzani (Felixstowe) Ltd v International Marine Management (UK) Ltd (Anzani case)* provided impetus to this doctrine in regard to leases. That decision dealt with an action by the plaintiff landlord (the landlord being the holder of a lease of 99 years) for possession of two warehouses and mesne profits based upon the default of the tenant in payment of rental. The quantum of the claim for rental in arrears was in excess of £570,000. This claim was met by a defence of set-off by the defendant tenant based on an alleged breach of express and implied obligations contained in two associated agreements and underleases. The breaches concerned defects in the floors of those warehouses, said to have been caused by the defective design work of the landlord. The tenant’s set-off included damages in relation to the loss of use of the premises, encompassing loss of profits, amounting to £315,000 in relation to warehouse one and £707,000 in relation to warehouse two.

Subsequent to the commencement of the action a receiver was appointed over the assets of the plaintiff landlord. As a result the receiver of the plaintiff continued the action. The question before the court was whether the defendant was entitled to set off against the admitted liability for rent, the claimed damages in relation to the agreements and underleases. The court concluded that a set-off was available and the reasons for the decision are a useful starting place for this discussion. It barely needs emphasis that the remedy of set-off was preferable to a separate cross-claim for damages by the tenant as any judgment obtained would have ranked as an unsecured debt in the liquidation or receivership of the landlord, thereby limiting recovery of damages.
An important requirement for equitable set-off is that there be a sufficient nexus between the claim and the set-off.\textsuperscript{32} The equity will only attach if the set-off impeaches the legal demand and must therefore go to the very heart of the claim, that is, in the context of a leasehold relationship it must arise from the landlord and tenant relationship and not some peripheral relationship. This requirement was important in the \textit{Anzani} case as the difficulty for the tenant was that the underlease contained no covenant for repair and the only covenant in that underlease that provided for works relevant to the flooring required an estimate of the costs of repair before liability accrued to the landlord. This estimate had not been obtained. As a result the judge had to consider whether equitable set-off was available as a result of a breach of an associated document between the parties that did contain a landlord’s repair covenant relevant to the flooring.\textsuperscript{33} It was significant that cl 11 of this agreement made provision for the agreement to apply notwithstanding the provisions of the under lease. This was the basis of an argument by counsel for the landlord that sufficient connection between the claim for rent and the set-off for damages was not shown as the set-off arose not from the lease but from the agreement.

Although there are judgments that suggest it is necessary for the set-off to arise from the same contract,\textsuperscript{34} Forbes J in the \textit{Anzani} case was able to discern from a number of authorities including \textit{Hanak v Green}\textsuperscript{35} that it was sufficient that the two matters “are so closely connected that the principles affecting equitable set-off can be said to apply . . . in other words, in considering questions of this kind it is what is obviously fair or manifestly unjust that will determine the solution”.\textsuperscript{36} He then concluded

“applying these principles in the light of what is fair dealing between the parties, I have come to the conclusion that despite the insistence on preserving the agreement as an entity separate from the underlease, there is nevertheless here that close connection between claim and cross claim which equity requires. It would in my view be manifestly unjust to allow the landlords to recover the rent without taking into account the damages which it is alleged the tenants have suffered through failure by the landlords to perform their part of the agreement”\textsuperscript{37}

The test applied by Forbes J does not treat the close connection requirement as a singular element but incorporates that requirement with the general equitable tests of fairness and justice. This suggests a broader test whereby the ties of connection in the appropriate circumstance need not be as substantial. In such cases, where an unjust result could otherwise result, a court may allow a more gossamer like attachment. It should be noted this was a decision made in the face of a specific provision in the associated agreement that it was to remain a separate agreement and thereby provides some indorsement to the broader view of Denning MR in \textit{Federal Commerce & Navigation Co Ltd v Motena Alpha Inc} when he states in regard to the development of equitable doctrine:

“We have no longer to ask ourselves: what would the courts of common law or courts of equity have done before the \textit{Judicature Act}? We have to ask ourselves: what should we do now so as to ensure fair dealing between the parties?” \textsuperscript{38}
and accords with Spry’s statement that to rely on the requirement that the claims arise from the same contract would be to regard as a criterion what is only a matter relevant to the existence of an equity.  

The Anzani case represents a retreat to more traditional views of the doctrine and provides some answer to the concerns of Spry who views recent English decisions including Hanak ν Green and Morgan & Son Ltd v S Martin Johnson & Co Ltd as having a tendency to ‘ask simply whether the claims in question relate to the same subject matter, or to the same transaction, rather than to analyse more closely what is required for the establishment of a sufficient equity’. In particular, objection is made to the fact that in Hanak ν Green where an action was commenced against a builder for breach of contract in relation to certain building work the builder sought a set-off on the basis of a quantum meruit on work entirely separate to the building contract and in circumstances where it is arguable on more traditional arguments that no equity had arisen which impeached the plaintiff’s claim.

In the leasehold situation the authority of Beasley ν Darcy could safely be deemed in accord with traditional views of what impeaches a demand of a landlord entitling equitable set-off. There, a landlord’s action for possession based on non-payment of rent, was met with a successful application for equitable set-off in regard to damage caused to the demised premises by the landlord in clearance of trees from the demised premises. The answer to the question of whether the landlord’s claim in that case was impeached by his action was explained in O’Mahony ν Dickson on the basis it would be inequitable to allow ejection for non-payment of rent when the capability of a tenant to pay rent was affected by the actions of the landlord caused by the clearing of trees from the land by thereby affecting the income of the tenant derived from the property.

What Type of Damages can be Set-off?

Abatement Against Rental

At common law it is clear that a tenant is entitled to an abatement of rent where he or she expends money on repairs which are necessary as a result of the default of the landlord in satisfying the repair covenant or if money is expended on the premises by the tenant at the request of the landlord. These principles are subject to the requirement that the landlord must be notified of the want of repair and that the sum be a fixed and ascertained amount that has been acknowledged by the landlord or an amount which the landlord could not question. It should be made clear that a tenant cannot merely withhold rent in an effort to force a landlord to repair. This will result in the landlord being entitled to seek forfeiture for non-payment of rent, although a tenant may have thereby an action for damages or be able to seek specific performance of the repair covenant. In emergency situations where a landlord is bound to repair, so as to avoid further damage a tenant may be entitled to a right to abatement but without the need to give notice to the landlord.

These requirements relate to ancient common law doctrines and are not bound up with technical rules of set-off as if the tenant satisfies the above the quantum of the abatement is to that extent satisfaction of the rental payable such that no rent is then owing. By distinction a set-off is a defence to an action for rental.
Apart from the common law entitlement to seek abatement in the leasehold context what type of damages can be set off by a tenant against rental? Although it is clear that a tenant can claim an abatement for moneys expended on repairs the position in regard to unliquidated damages is not certain.

The Queensland decision of Knockholt v Graff is said to have confirmed the applicability of the doctrine of equitable set-off in Queensland. However, a perusal of the case would suggest the case is only dicta on this issue. The case involved an application for summary judgment for recovery of leased premises based on non-payment of rent. The tenant claimed a set-off in relation to the rent. The set-off sought comprised:

(a) damages for the breach of the covenant to repair, which, it can be surmised based on the figure used ($6,658.52), was the actual amount expended on the premises by the tenant;

(b) damages for the loss of profits from that breach totalling an amount of $11,178 with continuing losses at a rate of $103 per week from 10 July 1972 until judgment; and

(c) a sum of $835.66 in respect of moneys expended by the plaintiffs in repairs between July 1969 and July 1972.

Although the case has been seen as an example of the application of equitable set-off a close scrutiny may reveal that this view is incorrect. The defendants set-off claim appears to fall into two types:

1. Moneys actually expended by the tenant to the use of the landlord based upon the landlord’s obligation under the repair covenant after notice was given to the landlord requiring the landlord to comply with its obligations. It is suggested this encompasses the two quoted figures of $6,658.52 and $835.66 in (a) and (c) above being liquidated damages for amounts expended by the tenant. The recovery of these sums is not a matter which requires any resort to the rules of equity as these are liquidated sums recoverable at common law supported by authorities such as Taylor v Beal.

If this was the only head of recovery no resort to equity would be needed.

2. The second type of damage sought to be set off related to damages by way of loss of profits being an amount of $11,178 plus $103 per week. This is not a sum expended on the premises entitling a common law remedy and does not easily fit within the first category set out in Hanak v Green as the unliquidated damages sought could not be set off against the liquidated demand for rental. These unliquidated damages could only be set off based upon the principles of equitable set-off. This appears to be a clear case where if the tenant's version of the facts is accepted, the claim for rent under the lease is impeached by the claim in that, as a result of the failure to observe the repairing covenant, the tenant’s business was adversely affected and it was inequitable to allow the action for possession by the landlord to succeed, based upon non-payment of rent. However, a perusal of the decision reveals the court makes no decision in relation to this aspect of the damages sought.

In Knockholt v Graff while discussing the principles in Hanak v Green Campbell J noted the apparent inconsistency with the judgment of...
Dixon J in *McDonnell & East* but sought to sidestep its implications. In regard to the first type of claim for recovery of expenditure the damages are liquidated and therefore satisfy the vice versa of Dixon J’s statement, that is, the claim to that extent is liquidated as against a liquidated demand for outstanding rental. Justice Campbell then states after reviewing the Dixon dicta that “despite the decision in *McDonnell & East v McGregor* the lessees may set-off the monies which they were obliged to expend upon repairs against the claim for rent”. Here the judge speaks of the monies spent on repairs under the first type discussed above not on the claim for profits lost. Justice Campbell then relies upon *Waters v Weigall* to find that set-off is available in the circumstances of that case. *Waters v Weigall* is a case supporting the common law remedy of abatement.

Justice Campbell then states:

“it appears from the defence in action no 995 of 1972 that the landlord failed to carry out necessary repairs after due notice given to that effect. It is also implicit in the pleading that the lessees were obliged to carry out the necessary repairs in order to carry on their business.”

As a result it is clear this is a reference to the requirements of common law abatement not requiring resort to equitable set-off. Justice Campbell then concludes:

“on the authority of *Waters v Weigall* I am of the view, on this application, I should answer that the lessees may validly claim to have expended money to the use of the applicants and to set-off such money against the rent.”

It appears that at no stage in the judgment that any clear reference to the claim for loss of profits is discussed indicating that the set-off would be allowed in regard to that item of damage, rather specific reference is only made to sums actually expended as a result of the breach of covenant to repair. This is curious as the judge had earlier stated:

“it seems to me that, should I consider that the lessees are entitled to set-off damages suffered by them by reason of the landlord’s breach of covenant, I could not hold that they have breached their obligation under the lease to pay the rental. If they are justified in pleading a set-off, they would be entitled to retain the rental until, at least, the set-off monies equal the rental payments due. Here, as I have said, the damages claimed exceed the rent due at the date of the issue of the writ.”

The total rental sought to be recovered based upon an approximation from figures supplied in the facts is, including interest, and other charges in the vicinity of $17,000 while all heads of damage sought to be set off were in excess of $30,000. However, if the first type of damage was recoverable only, without reference to lost profits, then the sum available to be set off would be reduced to approximately $8,000 which is less than the rental sought by the landlord. If the judge was referring in his judgment only to the monies expended by the tenant then it would appear that the landlord would be entitled to recover at least part of the rental due and the action for possession would be sustainable. This may suggest that the judgment does refer to the lost profits aspect of the damages but is for some reason not obvious from the judgment.

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56 (1795) 2 Anst 575; 145 ER 971.
58 Ibid at 90.
59 Ibid.
Knockholt v Graff has been held to be an example of the application of equitable set-off in Queensland but the above discussion does suggest this is not the real ratio of the case despite the apparent acceptance of the doctrine. Despite this apparent acceptance it is suggested that reference to that case as the basis of the doctrine in Queensland needs to be bolstered by reference to other authorities. The Anzani case does provide an adequate basis to conclude that if an equity can be shown to have arisen, which equity impeaches the claim of the landlord, then the remedy of equitable set-off is available to a tenant. The set-off encompasses loss of profits or other damages.

The conclusions reached in regard to this authority must be somewhat affected by the fact that the judge is hearing a summary judgment application and on finding grounds to decline judgment in favour of the plaintiff the judge notes the matter has been put down for speedy trial. Despite this apparent acceptance it is suggested that reference to that case as the basis of the doctrine in Queensland needs to be bolstered by reference to other authorities. The Anzani case does provide an adequate basis to conclude that if an equity can be shown to have arisen, which equity impeaches the claim of the landlord, then the remedy of equitable set-off is available to a tenant. The set-off encompasses loss of profits or other damages.

Examples of Application of Equitable Set-off in Leasehold Relationship

The following are examples of the type of damages that have been successfully claimed by a tenant as an equitable set-off against rental:

Beasley v Darcy — damage to value of land caused by landlord in clearing.
Anzani case — damages for loss of use of premises caused by the defect in flooring caused by landlord’s default.
Re Partnership Pacific Securities Ltd — damages constituted by loss of profits resulting from disruptions in access to property caused by the negligence of landlord during renovation.

Set-off Against Assignee of Landlord

If a set-off is available against a creditor it will also be available as against an assignee of that creditor. This will most usually apply in relation to the set-off as between a tenant and a landlord’s assignee on the basis that the assignee takes the interest of the assignor subject to the equities enforceable against the assignor. As the equity impeaches the landlord’s entitlement to rent this reflects on an assignee’s entitlement. A tenant can set off against rent due in respect of a period other than that in which the breach by the landlord occurred.

Set-off Against Mortgagee in Possession — Relevance of Statutory Provisions to Mortgage Relationship

What is the tenant’s position in relation to equitable set-off where the landlord has secured the subject property by a mortgage and after default has occurred a mortgagee enters into possession of the property and then seeks to enforce payment of rent from the tenant? This issue requires consideration of two issues. First, is a mortgagee in possession entitled to recover rental from the tenant and if so does any accrued right of set-off

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60 In the Supreme Court decision in Re Partnership Pacific Securities Ltd [1994] 1 Qd R 410 this case was held to be the basis of applicability of equitable set-off in Queensland.
61 Rules of the Supreme Court Qld, O 6, r 7.
63 (1800) 2 Sch & Lef 305.
64 [1980] 1 QB 137.
67 Ibid at 386 and Barnhart v Greenshields (1853) 9 Moo PC 18; 14 ER 204.
68 Waite, op cit n 47, at 381. Under general law land leased by mortgagor after date of mortgage requires consent of mortgagee to be binding, Land Title Act 1994 (Qld), s 169 provides the interest of a registered proprietor is subject to short term leases (ie, leases for a term of three years or less). Section 66 provides that a lease of mortgaged land executed subsequently to the registration of a bill of mortgage shall be valid and binding against the mortgagee unless the mortgagor shall have consented. Any lease even if less than three years requires this consent. English, Scottish and Australian Bank Ltd v City National Bank Ltd [1933] St R Qd 81. Similar provisions in Transfer of Land Act 1958 (Vic), s 66(2); Real Property Act 1990 (NSW), s 53(4).
which may be available to a tenant against the landlord apply against the mortgagee and does this apply to arrears or current or future rental?

Re Partnership Pacific Securities Ltd

These issues were addressed in the recent Queensland Supreme Court decision in Re Partnership Pacific Securities Ltd.70

This case involved a tenant who had entered into an agreement to lease with the landlord for a pharmacy in a shopping centre. The agreement to lease provided for refurbishing of the shopping centre. As a result of delays and disruptions caused by these refurbishments the tenant alleged it had suffered substantial losses which it sought to set off against rental. The landlord subsequently defaulted in its mortgage and the mortgagee/applicant entered into possession and requested the court to determine whether the tenant was entitled to set off the alleged damages against the claim for rental arrears sought by the mortgagee in possession. The damages sought by the tenant were in excess of $760,000 with the rental arrears being $354,438.

In prior proceedings before de Jersey J,71 it was determined that s 117(2) of the Property Law Act 1974 (Qld), gave the mortgagee a separate entitlement to recover current and future rental from the tenant not dependent upon the interest of the landlord and that as a result the tenant was not entitled to a set-off that may have applied against the landlord before the date that the mortgagee went into possession. This is a decision that will be discussed further below, but in relation to the case at hand, meant that the application related only to rental arrears as at the date the mortgagee went into possession. However, the basis of the decision of de Jersey J that s 117(2) allowed the mortgagee to recover future rental dealt with matters relevant to the recovery of arrears and was necessarily a part of the judgment of Williams J.

The primary question that the court had to determine was whether a mortgagee in possession could recover rental from a tenant so that the question of set-off then becomes relevant.

Differing Statutory Provisions

In Queensland s 74 of the Land Title Act 1994 provides a registered mortgage: “operates only as a charge on the lot for the debt or liability secured by the mortgage” (the provision considered in the decision was the similar provision under s 60 of the Real Property Act 1861 now repealed).

This provision reflects the familiar statutory charge format of Torrens title mortgages. The significance of this feature in regard to a tenant is explained in the Partnership Pacific Securities judgment where the nature of a common law mortgage as against a Torrens title mortgage is described. Justice Williams states:

"the distinguishing feature of the common law mortgage is that there is a conveyance of proprietary rights: the fee simple is transferred from the mortgagor to the mortgagee to be held by the latter until his claims under the mortgage have been satisfied. It follows that at common law the mortgagee has all the rights of an owner at law and may exercise them unless equity for some good reason would restrain him from so doing. At common law where the mortgaged property was the subject..."
of a lease the mortgagee has the reversionary interest in the land and the primary right to receive the rent.”

The unique position of a common law mortgagee is the basis of the decision in *Reeves v Pope*.

This case involved an attempt by a tenant to set off a damages claim against the landlord under an agreement to lease. The agreement to lease required the landlord to build a hotel and then grant a lease of the hotel to the tenant from the date of completion. The hotel was completed subsequent to the agreed date but the tenant opted to enter into possession without prejudice to her rights in relation to the breach of agreement. Subsequently the landlord defaulted in its mortgage and the mortgagee entered possession. The mortgagee plaintiff then sought to recover arrears of rental due under the lease from the tenant who argued that the set-off available against the landlord applied also to the rent recoverable by the mortgagee.

It was argued that the position of the mortgagee was simply as an assignee of the landlord’s right to receive rent, and as a result was subject to the equities against that right. This argument was rejected based on the fundamental nature of the mortgagee’s interest as the judge considered:

“the mortgagees were entitled, as mortgagees, to the reversion expectant on the determination of the lease under which the defendant held, and as such the mortgagees they are entitled in their own right to enforce payment of the arrears of rent. They were not assignees of the rent: they were persons claiming to enforce payment of the rent as entitled thereto as mortgagees; they could have distrained for the rent. They were asserting the legal right to rent which was due to them as owners of the reversion expectant upon the term.”

As a result the mortgagee was not bound by the equities of the landlord as they were asserting a right to recover rental on the basis of their own interest not as assignee of the mortgagor. As this describes the circumstance of an old system mortgage which is now comparatively rare in Australia (virtually non-existent in Queensland) one might be forgiven in thinking this discussion was of limited value in Torrens title jurisdictions. However, the statutory provisions in some state jurisdictions do provide an opportunity to apply this reasoning.

Section 60 of the *Real Property Act 1900* (NSW) confers power upon a mortgagee to enter “in the same manner in which he might have made entry . . . if the principal sum . . . were secured to him by a conveyance of the legal estate in the land” while s 63 provides that on entering into possession the power of a mortgagor to receive rent and profits is suspended and transferred to the mortgagee.

Section 81 of the *Transfer of Land Act 1958* (Vic) provides that “the mortgagee has the same rights and remedies at law and in equity . . . as he would have had if the legal estate in the mortgaged land had vested in him as mortgagee”. Thus a mortgagee in those jurisdictions is deemed to be in the same position as if it were the owner in fee simple, and, if the land mortgaged is subject to a lease it held the reversionary estate in the land. In those circumstances the mortgagee has a right to sue for rent.

Section 74 of the *Land Title Act 1994* (Qld) (this type of provision is common to South Australia and Tasmania) does not suggest the mortgagee is anything other than merely a chargee on the title to the land. Section 78(2)(b) and (c) of the *Land Title Act* provides that a mortgagee can “enter into possession of the mortgaged lot receiving rents and

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73 [1913] 1 KB 637 and [1914] KB 284.
74 [1914] KB 284 at 289-290.
profits”. This provision does not provide words sufficient to confer a right of action for rental against the tenant but is sufficient only to acknowledge a right of recovery against the mortgagor. As Francis acknowledges, to compel payment of rent a mortgagee could compel a mortgagor to account for rents received and he or she could sue the lessee for rent if he or she were to join the mortgagor either as plaintiff or as defendant. 75

As a result of the statutory framework in Queensland Williams J in Re Partnership Pacific Securities Ltd concluded that the mortgagee was not by any statutory provision entitled to recover rental from the tenant and the question of set-off was not by that provision relevant. 76 This was not a conclusion that accords with the view of de Jersey J as he considered s 117 allowed the recovery of current and future rental by the mortgagee in possession. Justice de Jersey excluded recovery of arrears on the basis of how the summons documentation was drafted but commented in passing, without making any decision:

“...I am not at all confident that there is a strong argument that the mortgagee can pick up the arrears, as it were, against the lessee and I say that because I regard the terms of section 60 of the Real Property Act. on my present understanding as prospective.” 77

Justice Williams then passed to a consideration of the impact of s 117(2) of the Property Law Act. 78

The Effect of Section 117 — Property Law Act?

This provision is in the following terms:

Section 117(1) Rent and Benefit

Rent reserved by a lease, and the benefit of every covenant, obligation, or provision therein contained, touching and concerning the land, and on the lessee’s part to be observed or performed, and every condition of re-entry and other condition therein contained, shall be annexed and incident to and shall go with the reversionary estate in the land, or in any part thereof immediately expectant on the term granted by the lease, notwithstanding severance of that reversionary estate, and without prejudice to any liability affecting a covenantor or her or his estate [my emphasis].

Section 117(2) [Recovery]

Any such rent, covenant, obligation, or provision shall be capable of being recovered, received, enforced, and taken advantage of, by the person from time to time entitled, subject to the term, to the income of the whole or any part, as the case may require, of the land leased.

Justice de Jersey was of the opinion that s 117(2) aligns the position of the mortgagee in Queensland into accord with New South Wales, Victoria and the United Kingdom and accordingly provided the means by which current and future rent could be recovered by the mortgagee importantly not subject to a set-off. 79 Justice de Jersey felt constrained to make the declaration that the mortgagee was able to recover rental limited only from the date of taking up possession and not including arrears of rental.

Whether s 117(2) was effective to provide a basis for an action for rental by the mortgagee was considered more fully by Williams J in the Partnership Pacific Securities Ltd case as this was potentially a means by which the arrears of rental may have been recoverable by the mortgagee.

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75 Francis, Mortgages and Securities (2nd ed. Butterworths), p 148. The earlier decision of Re Partnership Pacific Services Ltd v Terry White Group Pty Ltd, a decision of de Jersey J, confirms the above when he stated “there is no right to enforce payment of rent by suit given by section 60 of the Real Property Act. That section gives a right to ejectment, but that is a different matter”, transcript, p 2.
77 Transcript, pp 3-4.
78 Equivalents in other States, Conveyancing Act 1991 (NSW), s 117; Property Law Act 1958 (Vic), s 141; Property Law Act 1969 (WA), s 77; Conveyancing and Law of Property Act 1884 (Tas), s 10.
79 Transcript, p 3.
Justice Williams began by considering the provision in subs (1) which referred to the benefits of covenants, rent and so forth being vested in "the reversionary estate in the land". This provision was seen as significant as in the opinion of Williams J a mortgagee, even a mortgagee in possession, is not the owner of the reversionary estate in the land. The judge seems to read subs (2) with subs (1) so as to allow a party to sue for rent under subs (2) when it can be shown that the party entitled has the reversionary estate in the land. This view can be based upon the use of the term "any such" at the commencement of subs (2) and the obvious correlation between the subject matter dealt with by both provisions.

The view that a mortgagee in possession under Torrens title is not the holder of a reversionary interest in land is based upon the characteristics of a Torrens title mortgage as constituting merely a charge on the land. There are a number of authorities which suggest that a mortgagee is the holder of the reversionary estate in the land however these authorities do not deal with Torrens title land and can be distinguished on that basis.

Justice Williams’ view of s 117(2) and its relationship to s 117(1) does not accord with the English decision in Turner v Walsh, where the statutory provision dealt with was similar to s 117(1) and (2) though contained within one paragraph. This case required consideration of the ability of a landlord under old system title, who has taken an assignment of the reversionary estate subject to a lease and has then mortgaged that estate by an old system mortgage, to sue the tenant for arrears of rental.

The court there concluded that the section provided for two distinct matters quite independent of the other, that is, it annexes rent and the benefits of covenants to the reversion notwithstanding a severance of the reversion (this corresponds with s 117(1)), and separately makes the rent recoverable by the person from time to time entitled, subject to the term, to the income of the land (this corresponds to s 117(2)). The court was of the view that the provision dealt with distinct issues with the entitlement to the reversionary estate not necessarily being the person entitled to recover rental under the latter part of the provision.

This view may assist an argument to suggest that s 117(2) could allow a mortgagee to recover rental from a tenant on the basis that it is only necessary to show an entitlement to income to allow recovery of rental under s 117(2). This could be shown by taking possession of the property and receipt of rents as a mortgagee.

Even if this authority may indicate that Williams J’s view of the relationship of s 117(1) and s 117(2) may not be consistent with this authority his conclusion may be correct as a result of the fact that it appears s 117(2) was not apparently drafted with a view to providing a mortgagee with the ability to recover rental but was a procedural provision.

The historical equivalents of s 117(2) were designed to assist tenants in recovery of rental as under old system land tenure the legal estate was vested in the mortgagee and where a lease by the mortgagor preceded a mortgage it was necessary to use the mortgagee’s name to sue under the lease covenants. Section 117(2) was designed to overcome this requirement by vesting in the person “entitled ... to the income of the whole or part, as the case may require, of the land leased” the ability to recover such rent or to enforce the covenant and so forth dealt with in the equivalents of s 117(1) “the question then becomes simply one of fact. Who is entitled to the income of the mortgaged property?”

86 Transcript, p 18.
87 Turner v Walsh [1909] 2 KB 484 and Municipal Permanent Investment Building Society v Smith (1888) 22 QBD 70.
88 Turner v Walsh ibid.
89 Ibid at 491 and 492.
90 Conveyancing Act 1881 (Imp), s 10.
91 Turner v Walsh [1909] 2 KB 484.
92 Ibid at 494.
context of old system land the issue revolved around whether the mortgagee had given notice to the mortgagor and tenant of its intention to now receive the rental. Under the old system title the mortgagor "receives rent by a tacit agreement with the mortgagee, but the mortgagee may put an end to this agreement when he pleases". 87

Subsection (2) or similar sections in the English jurisdiction have accordingly been seen as only procedural provisions and deemed not to have created new rights. 88 In the context of a Torrens title mortgage the provisions of s 117(2) would not it is submitted be sufficient to provide a basis for recovery of rental.

Justice Williams’ opinion that s 117 was not effective to allow the mortgagee to recover rental from the tenant differs from that reached by de Jersey J but one which by the perusal of the relevant authorities appears to be correct. One should bear in mind that de Jersey J’s decision did not appear to be a considered judgment and we have little evidence as to the actual argument given to the court nor is there any detailed argument considered in the judgment. Despite this consideration currently we have two contradictory decisions on this important provision in Queensland. In a practical sense this difference in viewpoint did not greatly impact on this case as subsequent comments by Williams J meant the result would have been similar owing to the contractual relationship that existed between the parties.

**Agreement Between Mortgagor, Mortgagee and Tenant**

If the matters discussed above were the only issues the set-off would not have been available, as there was no statutory basis to conclude the mortgagee had any right to recover rental from the tenant. However, the court in the *Partnership Pacific Services* case was required to consider the effect of a tripartite agreement between the tenant, landlord and mortgagee.

This agreement was in the form of a standard consent document signed by those parties containing the consent of the landlord to the granting of the lease. Of greatest importance were cl 4 and 5 of this document.

Clause 4 appointed the mortgagee as the party entitled to enforce all covenants and provisions of the lease and to exercise all rights, powers, privileges, remedies and so forth of the lessor under the lease.

Clause 5 required the lessee to pay to the mortgagee all future rents and profits after due notice to that effect until the mortgagee shall withdraw that notice.

This document was considered sufficient by the court to overcome the statutory barrier to the recovery by the mortgagee of the rental and to thereby constitute the basis of a valid assignment in equity of the right to receive rent once default had occurred and notice has been given to the lessee. However, such assignment was subject to the equities then existing in favour of the lessee. This conclusion was based upon a quote from James LJ in *Phipps v Lovegrove* where he stated "an assignee of a chose in action ... takes subject to all rights of set-off and other defences which were available against the assignor". This is also contemplated in s 199 of the *Property Law Act* (Qld) which deals with statutory assignment of choses in action which are deemed to be "subject to equities having priority over the right of the assignee". The judge summarises the position when he states:

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87 *Moss v Gallimore* (1779) 1 Doug 283; 99 ER 182.
88 *Re Ind, Cooper & Co Ltd* [1911] 2 Ch 223 and *Turner v Walsh* (1909) 2 KB 484 at 494.
89 (1873) LR 16 Eq 80 at 88.
90 (1881) Ch D 520 at 526.
‘here the applicant mortgagee seeks to exercise rights previously (that is prior to 27th February 1982), vested in the lessor (Roggette) and to enforce those rights against the respondent. What is important is the applicant acquired those rights not by statute, not by virtue of being a mortgagee, nor by virtue of being a mortgagee in possession, but by virtue of an assignment of the relevant choses in action. Such assignment occurred on the giving of the notices dated 27th February, 1982. It follows that such assignment was subject to equities existing in favour of the respondent as at that date.’

Thus the mortgagee was by the provisions of the agreement able to recover rental from the tenant but that right was burdened by the tenant’s right of set-off.

Justice Williams avoids the apparent inconsistency as to the meaning of s 117 by stating that cl 4 and 5 of the agreement would have clearly supported the decision of de Jersey J without reference to s 117.

As the mortgagee was granted a contractual right to sue the tenant for rental by the terms of the Deed of Consent (though subject to equities such as set-off) Williams J then discussed the particular issues relevant to set-off. He states:

‘once the applicant has to sue either as the assignee of the relevant right from the lessor, or in the name of the lessor, personal obligations of the mortgagor/lessor to the tenant may give rise to a set-off. In those situations decisions such as Government of Newfoundland v Newfoundland Railway Co (especially at 211-3) and British Anzani (Felixstowe) Ltd v International Marine Land Management (UK Ltd) [1980] 1 QB 137 become relevant.’

At this stage the court needed to be satisfied that the grounds for the application of equitable set-off existed. Justice Williams considered that there was such a close connection between the claim for damages for breach of covenants in the lease and the associated agreements for lease and the claim for rent that a set-off would be available. There appears to be a clear equity created by the landlord in so disturbing the enjoyment of the premises of the tenant such that the claim for rent was impeached by such action. In this an analogy with Beasley v Darcy could easily be drawn.

Justice Williams relied on Knockholt v Graff as an authority supporting the availability of the remedy of equitable set-off in relation to rental as between a landlord and tenant. Reference is made to my discussion above as to the validity of this position.

No Deduction Clauses

The rental clause (cl 2.03.2) in the lease contained the usual provision that rental was to be paid ‘without any deduction’. It was contended thereby that the tenant had no right to set off any amount against the rent. In a recent Victorian decision of Citibank Pty Ltd v Simon Fredericks Pty Ltd Beach J held (without citation of authority) that such a provision excluded a right in the lessee to set off against rent.

The two matters of greatest importance in this issue are firstly, the general principles of contract law which suggests that a court will read down a provision in a contract which appears to limit the parties in what would normally be their full contractual rights and secondly, the nature of

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the remedy of equitable set-off may assist us in deciding whether such a clause is effective.

The discussion of the first point was commenced by Williams J with reference to the judgment in *Gilbert Ash (Northern) Ltd v Modern Engineering (Bristol) Pty Ltd* which contains statements indicating that to construe a contract which suggests that one party has abandoned any remedy one must rebut the presumption that each party is to be entitled to all those remedies as would arise by operation of law and "to rebut that presumption one must be able to find in the contract clear unequivocal words in which the parties have expressed their agreement that this remedy shall not be available in respect of breaches of that particular contract". This is an expression of the general contractual rule sometimes called "contra proferentum" whereby a court will construe against a party relying upon a clause which will limit the rights of the other parties. Justice Williams was of the view that the provision "without deduction" is a term not sufficiently global to suggest it would exclude a remedy such as equitable set-off but rather does it suggest that the term "deduction" refers to items such as bank charges, stamp duty, exchange and the like. This conclusion drawn on these facts should not blind a drafts-person to the possibility of drafting a clause which can be sufficiently clear so as to exclude the right of set-off.

It is of the nature of equitable set-off that it impeaches the landlord’s entitlement to rent such that rent is no longer due. The common law concept of this remedy contemplates the court allowing a cross claim which will stand with the valid claim for rent and which in procedural terms will be adjusted with the quantum of the original claim. The inherent nature of equitable set-off by impeaching in equity the basis for the claim for rental would tend to support an argument that a limited "no deduction" clause will not oust equitable set-off.

Waite relates the fact that some ancient cases suggest that set-off cannot be excluded by agreement though he acknowledges in the modern situation the court might consider it inequitable to interfere with bad bargains. It would seem from the judgment that:

(a) Equitable set-off can be excluded by agreement either expressly; or

(b) impliedly as in *Mottram Consultants Ltd v Bernard Sunley & Sons Ltd* where the court determined that exclusion of a clause directed to set-off in a standard contract was sufficient to conclude the parties had directed their minds to the matter and determined to exclude a right of set-off.

**Drafting Implications**

This article should raise some important concerns for drafts-persons in considering drafting of leases and the mortgaging of properties subject to leases.

First, when considering the clauses to be contained in a lease, if acting for a landlord, an attempt should be made to exclude the right of set-off. If acting for a tenant the same clause should be excluded for obvious reasons.

Secondly, the above discussion should indicate that, especially in jurisdictions like Queensland and Tasmania, where the mortgagee is secured by Torrens title mortgages a Deed of Consent to Lease should be

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97 Ibid at 718.
98 Waite, op cit n 47 at 389.
99 Ibid at 388. *Taylor v Okey* (1806) 13 Ves 180; 33 ER 263 and *Lechmere v Hawkins* (1798) 2 Esp 625; 170 ER 477.
100 (1975) 2 Lloyds Rep 199.
executed by the tenant, mortgagor and mortgagee. This consent should contain covenants which provide the mortgagee can recover rent from the tenant either before or after default by the mortgagor. This will secure the ability of the mortgagee to sue for rental without the necessity to join the mortgagor as a party to the action. This could be in addition to the rights usually granted under mortgages whereby the mortgagor appoints the mortgagee its attorney to recover rent from any tenant of the mortgaged property.

Thirdly, although such a document may confirm the right to recover rental from a tenant the Partnership Pacific Securities Ltd case indicates this document can result in the mortgagee being subject to equities it would not have otherwise been subject to. For this reason, any such consent should clearly specify in unequivocal terms that the right of set-off which may have existed against the lessor are not exercisable against the mortgagee.

Fourthly, the implications of the law of set-off should also be taken into account when a mortgagee is considering its exposure when securing over properties where leases are already executed and Deeds of Consent which protect against set-off have not been signed.

**Conclusion**

The nature of equitable set-off grants a tenant a potentially important avenue to protect against forfeiture if it can be shown that an equity has arisen. It seems that the courts are moving towards an expansion of the grounds based upon which a set-off will be allowed limited only by equitable principles. If referring to authorities on this point cognisance must be had of the apparently narrower view taken by some Australian courts in the light of Dixon J’s dicta in the McDonnell & East case though as this judgment is seen in its true light this restriction may be less influential. For a tenant it seems the Anzani case now can be used to attempt to embolden courts in the direction of allowing equitable set-off when the acts of the landlord can be shown to affect the tenant’s ability to pay rental and thereby raise an actionable equity. For a landlord or mortgagee, attendance to properly drafted documentation can to a great extent overcome this concern.