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Abstract
This paper examines the tests used to determine whether a classical equitable set-off arises between two claims. A classical equitable set-off subtracts one claim from another where there is a particular nexus between them. This author argues that the orthodox approach, to inquire whether the counter-claim ‘impeaches’ the claim, appropriately identifies the nexus. The alternative approach, to set off claims that are inseparably connected is flawed. It proceeds upon a misunderstanding of the Judicature Act and certain decisions. The final alternative, the manifest injustice test, should not be endorsed because it assumes the fusion of law and equity and a superseded approach to consideration.

Keywords
debt, Judicature Act, claims, impeachment, defence
CLASSICAL EQUITABLE SET-OFF

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ABSTRACT

This paper examines the tests used to determine whether a classical equitable set-off arises between two claims. A classical equitable set-off subtracts one claim from another where there is a particular nexus between them. This author argues that the orthodox approach, to inquire whether the counter-claim ‘impeaches’ the claim, appropriately identifies the nexus. The alternative approach, to set off claims that are inseparably connected is flawed. It proceeds upon a misunderstanding of the Judicature Act and certain decisions. The final alternative, the manifest injustice test, should not be endorsed because it assumes the fusion of law and equity and a superseded approach to consideration.

1 INTRODUCTION

Classical equitable set-off utilises the facts of a cross-demand to extinguish or diminish the initial claim.1 Although it is a simple concept, the criterion upon which it operates is esoteric.2 The doctrine is said to have no practical utility since counter-claims diminish the amount payable on a claim.3 However, a set-off diminishes or extinguishes the initial claim in law.4 Once the set-off is established, the claim does not exist to the extent of the sum of the counter-claim. The significance of this is that a counter-claim that is set off against a debt will defeat a petition for winding up, since the debt will be effectively disproved.5 Equally, an unsecured creditor might satisfy their claim by using a set-off to diminish a countervailing claim.6 Similarly, if the claim that is set off is greater in value than the initial claim, costs will go in favour of the defendant.7 Initially, Lord Cottenham LC in Rawson v Samuel required that the cross-demand ‘impeach’ the claim8 and the High Court of Australia has endorsed this

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* LLB (Hons I) (UTS), tipstaff to a judge of the Supreme Court of New South Wales.
3 Hanak v Green [1958] 2 QB 9, 16.
5 Re Concord Pty Ltd [1976] VR 345.
6 Roadshow Entertainment Pty Ltd v ACN 053 006 269 Pty Ltd (Receiver & Manager Appointed) (1997) 42 NSWLR 462, 489.
7 Hanak v Green [1958] 2 QB 9, 16.
8 Rawson v Samuel (1841) Cr & Ph 161.
approach. 9 It has been applied many times. 10 However, there are two other competing criteria. First, it is said that the countervailing claims must be ‘inseparably connected’. 11 The genesis of that criterion lies in a misinterpretation of the Judicature Act. It was first applied in this country by the Victorian Court of Appeal in 1963. 12 Second, Lord Denning held that a set-off is established whenever it is necessary to prevent manifest injustice. 13 The New South Wales Supreme Court explicitly adopted this criterion in AWA Ltd v Exicom. 14 The test has been applied on a number of subsequent occasions. 15 The purpose of this paper is to critically analyse the doctrinal coherence of each of the tests. This author argues that impeachment is the most doctrinally coherent approach. It is a strict test requiring that the cross-demand contradict an assumption within a claim that is necessary for its establishment or prove that actionable conduct of the plaintiff contributed or somehow facilitated the conduct of which the plaintiff now complains. Prosecuting the demand of the plaintiff is unconscionable in these circumstances because that party is insisting that the defendant make amends when the plaintiff itself had a hand in committing the wrong. In requiring the plaintiff to account for its own participation in the act, through the diminution of damages for its own wrongful act, the doctrine should be seen as a manifestation of the maxim that he who comes to equity must do so with clean hands. 16 The virtue of the impeachment criterion is that, unlike the others, it does find an ‘immediate and necessary’ 17 relationship between the wrong that the plaintiff pleads and the cross-claim of the defendant. It should be noted that there is nothing preventing the parties from applying a broader test by consent and this has occurred before. 18 Section 1 by historical analysis distinguishes equitable set-off from its statutory counterpart and related procedures. Section 2 analyses the impeachment criterion. Section 3 analyses the inseparable connection test. Section 4 examines the

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9 Hill v Zytnack (1908) 7 CLR 352, 361–2.
11 Hanak v Green [1958] 2 QB 9, 16.
14 AWA Ltd v Exicom Australia Pty Ltd (1990) 19 NSWLR 705.
17 Ibid.
18 Gilsan v Optus (No 3) [2005] NSWSC 518.
manifest injustice test. Section 5 aims to identify the elements of classical equitable set-off.

II THE CONCOMITANT BUT SEPARATE DEVELOPMENT OF EQUITABLE SET-OFF

As Derham has done, it is important to distinguish equitable set-off from the statutes of set-off, abatement and counter-claim. 19

A The Statutes of Set-Off

The Statutes of Set-Off20 provided for the deduction of debts owing between the same persons to produce a balance that the net debtor would pay.21 The purpose of the Statutes was to expedite the discharge of bankruptcies.22 As it is a procedure, it cannot alter substantive rights. It arises where the debts are owed between the same two parties23 and the amounts are liquidated24 or can be ascertained with certainty.25 It is only in equity that successors in title have the benefit of a set-off. An assignee cannot take the benefit of statutory, or legal, set-off. The Statutes operated in New South Wales until 1969 when the Imperial Acts Application Act26 inadvertently repealed them.27 Between 1980 and 2004 provisions of the Supreme Court Rules were held to succeed the Statutes.28 Section 21 Civil Procedure Act 2005 (NSW) now provides an explicit right of statutory set-off.29

B Abatement

At common law a defendant may, on an action for the price of goods, set up a breach of warranty in diminution of the price claimed.30 The Sale of Goods Act 192331 extends

19 Derham, above n 1, 74–76.
20 2 Geo II c 22, s 13 (1729); 8 Geo II c 24, s 4, 5 (1735).
22 2 Geo II c 22, s 13 (1729).
24 2 Geo II c 22, s 13 (1729); 8 Geo II c 24, s 4, 5 (1735).
27 Stehar Knitting Mills Pty Ltd v Southern Textile Converters Pty Ltd [1979] 1 NSWLR 692, 697.
Ibid at 521.
29 Civil Procedure Act 2005 (NSW) s 21.
30 Mondel v Steel (1841) 8 M & W 858; Sale of Goods Act 1923 (NSW) s 54.
31 Sale of Goods Act 1923 (NSW) s 54.
the defence to the use of any warranty.\textsuperscript{32} It is traditionally expressed as being confined to actions for work and labour done.\textsuperscript{33} Whereas the policy underlying abatement is to avoid circuity of action,\textsuperscript{34} equitable set-off operates on the relief of conscience.\textsuperscript{35}

\textbf{C Counter-claim}

The \textit{Judicature Act} instituted the concept of counter-claim whereby two claims between the parties could be litigated in the one proceeding.\textsuperscript{36} Like set-off, the ultimate result of a counter-claim is to reduce or extinguish the quantum of debt or damages owing. In the case of counter-claim, the deduction only occurs at execution to produce a balance payable by one party.\textsuperscript{37} Judgment is given in each claim and the claims still exist in law.\textsuperscript{38} By contrast, a set-off either diminishes or extinguishes the initial claim in law. Therefore, a set-off is a defence and so it is not subject to the Statute of Limitations, unlike counter-claims.\textsuperscript{39}

\textbf{D Set-Off in Equity}

There are four forms of set-off recognised by courts of equity. First, there is set-off by agreement, where the set-off arises by contract.\textsuperscript{40} Second, equity recognises rights to a legal set-off.\textsuperscript{41} Third, equity will apply the Statutes of Set-Off by analogy.\textsuperscript{42} Fourth, there is classical equitable set-off with which this paper is concerned. It is the subject of the next section.

\textbf{E Conclusion}

Classical equitable set-off differs from the forgoing defences and procedures because it arises where the liability under one claim is attributable to wrongful conduct of the claimant or that party prevented the satisfaction of the original claim or reduced a

\textsuperscript{32} Healing (Sales) Pty Ltd \textit{v} Inglis Electrix Pty Ltd (1968) 121 CLR 584, 595.
\textsuperscript{33} Gilbert-Ash (Northern) Ltd \textit{v} Modern Engineering (Bristol) Ltd [1974] AC 689, 717.
\textsuperscript{34} \textit{Street v Blay} (1831) 2 B & Adol 456, 462; \textit{Ex parte Stephens} (1805) 11 Ves Jun 24, 28.
\textsuperscript{35} \textit{Supreme Court of Judicature Act 1873} (UK) s 24(3).
\textsuperscript{36} \textit{Stumore v Campbell & Co} [1892] 1 QB 314, 317.
\textsuperscript{37} Brian Cairns, \textit{Australian Civil Procedure} (Thomson Reuters, 9th ed, 2011) 262.
\textsuperscript{38} \textit{Aries Tanker Corporation v Total Transport Ltd} [1977] 1 WLR 185, 192.
\textsuperscript{39} \textit{Jeffs v Wood} [1723] Eq Ca Ab 668.
\textsuperscript{40} See Meagher, Gummow and Lehane, \textit{Equity: Doctrines and Remedies} (LexisNexis Butterworths, 4th ed, 2002), [37-035].
\textsuperscript{41} \textit{Clark v Cort} (1840) Cr & Ph 154.
benefit to be received. This author suggests that those two categories of case are equivalents and that a set-off will also be granted where the claim of the defendant contradicts an assumption inherent in the claim of the plaintiff. The following explains its operation and the reasons for it.

III THE IMPEACHMENT TEST

The New South Wales Court of Appeal, on at least two occasions, and the Federal Court have affirmed the impeachment inquiry as the criterion of equitable set-off. There are two important points. First, it is necessary to survey Rawson v Samuel itself. Second, consideration should be given to the decisions to which Lord Cottenham LC adverted. Third, it is necessary to analyse those decisions decided after Rawson v Samuel. Fourth, it is necessary to dispose of the argument that Rawson permits the use of a number of different tests, of which impeachment is only one.

A Rawson v Samuel

In January 1835, the parties agreed that the defendant would consign goods to stores associated with the plaintiff. In exchange the defendant could draw bills of exchange upon the plaintiff for its costs and a commission. Some bills were dishonoured and the defendant sued for breach of contract, for which it obtained damages. The plaintiff sought an account of their dealings to reveal a significant debt owing from the defendant to the plaintiff which would be set off against the defendant’s claim against the plaintiff at common law. The plaintiff obtained a common injunction and the defendant appealed. The Lord Chancellor dissolved the injunction since the claims were of distinct object and subject matters; it was insufficient that they arose from the same contract. The Lord Chancellor held that:

“We speak familiarly of equitable set-off, as distinguished from 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 protected against his adversary’s demand. The mere existence of cross-demands is insufficient… In the present case, there are not even cross-demands, as it cannot be assumed that the balance of the account will be found to be in

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44 Miou Pty Ltd v Siantian Pty Ltd [2011] NSWCA 297, [59]; Product Development Solutions of Australia Pty Ltd v Parametric [2012] NSWCA 211, [5], [12].
46 Rawson v Samuel (1841) Cr & Ph 161, 178.
favour of the [d]efendants at law...Several cases were cited in support of the injunction; but in every one of them...it will be found that the equity of the bill impeached the title to the legal demand."

B Decisions prior to Rawson illustrating impeachment

Lord Cottenham LC considered a number of decisions pertaining to equitable set-off, the most prominent of these being: Preston v Strutton,48 ex parte Stephens,49 Piggott v Williams,50 and Beasley v Darcy.51 In Preston v Strutton an injunction was granted to prevent payment of a note that was issued to settle an account on the basis that the drawer of the note was indebted to its recipient. Since the basis for the debt was fraud, it could be set-off against the debt itself. A similar result obtained on analogous facts in ex parte Stephens. There, bankers sought to enforce a debt they obtained. They fraudulently represented to a client, Stephens, that they had invested her money when in fact they had kept it and became her debtor. When Stephens acted as surety on a debt for her brother on the strength of her belief that shares stood to her credit, it was held that she could set-off the sum which stood to her credit on account of the fraud against the debt. Beasley v Darcy is similarly illustrative. In this case, a lessor pursuant to the lease permitted a third party to enter the premises and de-forest the whole of the land. Later, the lessor sued for rent that was in arrears. The lessee counter-claimed for the damage caused by the felling of the trees. The report elliptically records that Lord Clare issued a prohibitive injunction to bar execution until the hearing of the damages claim. The appeal to the House of Lords was dismissed on other grounds. It appears that the felling of the total product of the land prohibited the lessee from using the property and thereby paying rent. Piggott v Williams is analogous. There a solicitor sued for the enforcement of a mortgage granted to secure his costs. However, it was held that since the costs would not have arisen without the negligence of the solicitor, the damages from that negligence could be set-off against the mortgage. The essence of Preston and ex parte Stephens is the contradiction or qualification of a condition necessary to the establishment of the claim of the plaintiff. On the other hand, Beasley and Piggott represent situations in which actionable conduct of the plaintiff has fostered or facilitated the conduct on which that party sues.

48 Preston v Strutton (1792) 1 Anst 50.
49 Ex parte Stephens (1805) 11 Ves Jun 24, 28.
50 Piggott v Williams (1861) 6 Madd 95.
51 Beasley v Darcy (1805) 1 Sh & Lef 403.
C Decisions subsequent to Rawson applying impeachment

The requisite relationship between the claims is demonstrated in British Anzani v International Marine Management. The plaintiff sub-let warehouses to the defendant whom the plaintiff sued for unpaid rent and mesne profits. The defendants counter-claimed for breach of an implied obligation to provide a usable building, the floors being so cracked and deflected as to prevent the use of the buildings. Forbes J held that the counter-claim could be set off. The counter-claim contradicted the underlying condition of the demand: that the warehouses had been provided in useable condition. Contemporary cases also reflect the other manifestation of impeachment outlined above, namely where the plaintiff has contributed or facilitated to the problem of which it complains. One such case is Commonwealth Bank of Australia v GS Developments. Where, the wrongful failure of the mortgagor bank to provide the contracted finance so that the mortgagor developer could finish the development and repay the mortgage could be set-off against a claim for repayment of the loan. Likewise in Re Just Juice Gummow J, sitting in the Federal Court, held in obiter that where a receiver claimed on an indemnity, the creditors who appointed that receiver could use a claim for negligence against the receiver as a defence on the basis that the indemnity would be unnecessary but for the negligence. However, the remarks are obiter. Similarly, a set-off was permitted in Forest Enterprises Australia where the plaintiff had refused to release funds to the defendant, contrary to a binding obligation in a letter of commitment, which in the mind of the trial judge the defendant intended to use to pay rent to the plaintiff. These cases demonstrate that it is against conscience for a plaintiff to prosecute a demand where the facts of the counter-claim reveal that the plaintiff has facilitated the initial claim. In those circumstances, the conscience of the plaintiff is bound in equity since the wider facts reveal his participation in the matter of which he complains.

52 British Anzani (Felixstowe) Ltd v International Marine Management [1980] 1 QB 137.
55 Norman, in the matter of Forest Enterprises Australia Limited (Administrators Appointed) (Receivers & Managers Appointed) v FEA Plantations Ltd (Administrators Appointed) (Receivers Appointed) [2010] FCA 1444. It was the lack of evidence for this finding that resulted in the Full Court overturning the judgment: Norman; in the matter of Forest Enterprises Ltd v FEA Plantation Ltd [2011] FCAFC 99, [169]. However, it also held that the conclusion would have been correct, had the evidence supported it: [166]-[167].
D Rawson v Samuel does not provide criteria additional to impeachment

Sheelagh McCracken, who advocates the injustice approach, argues that Lord Cottenham LC contemplated the use of alternative criteria. McCracken argues that the judgment alludes to ‘notions of justice and fairness’ as being the cardinal principles and impeachment is but one instance of their satisfaction. The use of the phrases ‘any equity’, ‘what compensation can be made’ and ‘what equity have the plaintiffs’ support her point. Respectfully, the reader should not perceive the expressions ‘what equity’ and ‘any equity’ as allusions to other principles. They appear to be rhetorical devices that indicate the absence of any principle supporting the application. The reading attributes inordinate significance to the use of the words ‘what’ and ‘any’, as if they implied the existence of a plurality of tests. McCracken argues in addition that the purpose of these questions is to determine the justice and fairness of the case. McCracken assumes that general notions of good conscience determine whether a set-off arises, absent any doctrinal foundation. This is evident in her analysis of ex parte Stephens: a set-off arose as the prosecution of one demand without regard to the other was simply ‘against conscience’. However, Drummond J has held that set-off locates the relevant conscience in the mind of the party against whom the defence is alleged. It is submitted, with respect, that on a proper exegesis of the case, the expressions upon which McCracken relies are simply rhetorical. The concept of impeachment is sufficiently flexible to encompass a number of permutations of the concept. However, including additional tests dilutes the concept: on the one hand the inseparable connection requirement requires too little of the counter-claim, on the other hand the manifest injustice approach is uncertain.

E Conclusion

Impeachment is a manifestation of the unconscionability principle. The facts of the counter-claim must either contradict an assumption underlying the claim of the plaintiff or demonstrate that the plaintiff has wrongfully facilitated the conduct of which that party complains. The result is that even if the claim is entirely made out, the conscience of the plaintiff is bound in equity since the wider facts reveal his participation in his own action. In this way it is a true defence.

57 Ibid 64.
58 Ibid.
59 Ibid 108.
60 Walker v Secretary, Department of Social Security (1995) 129 ALR198, 208.
61 Ibid.
IV THE INSEPARABLE CONNECTION TEST

According to one group of cases, the seminal judgment of which is Hanak v Green, a set off will apply against one claim where the counter-claim flows out of and is inseparably connected to the dealings that give rise to the claim. According to Morris LJ, the high threshold that the term ‘inseparable’ would appear to import, Morris LJ considers that all that is necessary is for the claims to arise out of the same contract or transaction. The judgment of Morris LJ evolved from a consideration of distinct cases; they do not form an unbroken line. Morris LJ weaved those cases together to found a new test. It is important to dispose of this alternative to impeachment as Lord Brandon adjudged them to be equivalent in the House of Lords’ most recent treatment of the subject. This section examines the Hanak judgment itself and address the cases upon which it is based: Young v Kitchin, Morgan & Son Ltd v S Martin Johnson & Co Ltd, Smith v Parkes, Government of Newfoundland v Newfoundland Railway and Bankes v Jarvis. With great respect, it is submitted that the judgment of Morris LJ is faulted in two respects. First, it conflates the test for determining when an assignee takes subject to claims arising after the assignment and second it misapprehends the effect of the Judicature Act. The first error is evident in the citation of Newfoundland and Smith v Parkes. It is submitted that the reason for this conflation of set-off and the aforementioned test is that the analytical methods are similar: both examine the nexus between the demands and determine whether one should account for each in allowing for the other. Nonetheless they are different because one is a threshold and the other is a substantive, equitable, defence. The second error is evident in the citation of Young v Kitchin and Smith v Parkes. The third point is that Morgan & Son is a genuine set-off decision but it reflects impeachment and not the simple contractual nexus that Morris LJ requires. This section will cover the Hanak judgment and address the two arguments advanced above.

A Hanak v Green

The plaintiff purchased a house from the defendant. The plaintiff requested, and the defendant agreed, to do work on the property before completion of the sale for a sum additional to the purchase price. When the plaintiff entered the property she complained, ultimately, that sixteen items of work had been done badly. The defendant made three cross-claims. First, that there were additional works for which the plaintiff had not paid. Second, the defendant had wrongly been refused access to

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the site and third that the plaintiff had trespassed against the defendant’s tools in wrongly disposing of them. Those claims, and fifteen of the sixteen items that the plaintiff claimed, succeeded. There was no order as to costs. The value of the claims of the defendant exceeded the value of the claims of the plaintiff. The defendant argued that he ought to have his costs since he had successfully defended the suit by way of equitable set-off. In commencing his analysis, Morris LJ noted that the entry into force of the *Judicature Act* provided that a defendant could bring a claim in the same proceedings as the defendant.65 Morris LJ relied on s 41 of that Act, which is reproduced in full below:

No cause or proceeding at any time pending in the High Court or the Court of Appeal shall be restrained by prohibition or injunction but every matter of equity on which an injunction against the prosecution of any such cause or proceeding might formerly have been obtained, whether unconditionally or on any terms or conditions, may be relied on by way of defence thereto.

Morris LJ then addressed *Young v Kitchin* and *Morgan & Son*. As to *Young v Kitchin*, the “position” was that the plaintiff’s claim was met by a counterclaim “arising out of the same contract”.66 Morgan & Son is another example of the same principle. Morris LJ then addressed *Bankes v Jarvis*, where a claim of a purchaser was set-off against the claim of the trustee for the vendor. Morris LJ found that the justification for the set-off was that “there was a close relationship between the dealings and transactions which gave rise to the respective claims”.67 That case accorded with *Government of Newfoundland v Newfoundland Railway Co* for the reason that assignee in neither case was permitted to be in a better position than the assignor.68 Critically, Morris LJ summarised his understanding of these authorities as authorising equitable set-off where there is the classical basis or where it is necessary for “giving protection on equitable grounds to a defendant”.69 It is submitted that equitable set-off is not so broad that it is merged with the rule that assignees take subject to equities. In the result, Morris LJ held that the claims of both parties arose under contract and it ‘would not be equitable’ for one set to be allowed without the other. Furthermore, the ‘whole matter’ could be dealt with in equity. An assignee of the claim of the plaintiff would have to account for the claims of the defendant. Sellers LJ likewise held that

66 Ibid 20.
68 Ibid 25.
69 Ibid 25.
the claims of the defendant “arose directly under and affected the contract on which the plaintiff relies”. ⁷⁰

_B Whether an assignee is subject to a claim arising after notice of assignment requires analysis similar to that required by equitable set-off but one is a threshold and the other is a defence_

Contrary to the remarks of Sellers and Morris LJ, equitable set-off, with the greatest respect, is not a catch-all defence for giving general equitable protection whenever the source of the counter-claim coincides with the claim of the plaintiff. This section argues that the invocation of _Newfoundland_ reveals that Morris LJ, and to a lesser extent Sellers LJ, conflated the test for determining when an assignee takes subject to claims arising after an assignment an equitable set-off. The essential reason for this error is that _Newfoundland_, an assignment case, itself draws analogies to a set-off decision: _Smith v Parkes_. It is necessary to summarise the _Newfoundland_ judgment.

The _Newfoundland_ case can be summarised shortly. The government of Newfoundland contracted with a railway company to build a railway line. In return, the government agreed to pay subsidies of land and money. The monetary subsidy would:

...attach in proportionate parts and form part of the assets of the said company, as and when each five-mile section is completed and operated, or fraction thereof, at terminus at Hall’s Bay.

Some of the subsidies had been assigned. Later, the railway company breached its contract by abandoning the line. Nonetheless, the railway company and the assignees of the subsidies sought to obtain an amount of the subsidy commensurate to the extent of the completed line. The government sought to claim for breach of contract against not only the railway company but also the assignees. Lord Hobhouse, at 210-11, assessed the relationship between the title to the subsidy and the completion of the railway. ⁷¹ It was held that since the latter obligation was the condition precedent to the former, ⁷² the two were interlinked. Thus the title to the subsidy could only be commensurate to the extent to which the railway was completed. Because the entitlement to the subsidy was contingent upon a continuing act, the construction of the railway, claims with respect to the railway would affect the subsidy even after their assignment.

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⁷⁰ Ibid 31.
⁷¹ _Government of Newfoundland v Newfoundland Railway Co_ (1888) 13 App Cas 199, 213.
⁷² Ibid 211.
There is debate as to whether the case decided that the claims of the government should be admitted against the assignees as counterclaims or substantive equitable set-offs. Spry attributes the confusion to the interchangeable use of the terms ‘set-off’ and ‘counter-claim’ in the judgment.\(^73\) In any event, the parties submitted questions to the Privy Council that confined the case the admissibility of counter-claims. On the other hand, Derham has written in concurrence with Lord Brandon: Lord Hobhouse permitted an equitable set-off against an assignee and in doing so merely restated the relevant test.\(^74\) Derham made two points. First, he argued that the alternative position, that the decision pertains to the admissibility of a counter-claim against an assignee, is erroneous.\(^75\) Second, *Newfoundland* is to be read as a set-off decision since the determinative principle came from a set-off authority: *Smith v Parkes*.\(^76\) The first point reads the term ‘equities’ outside of its context. The second misconceives the use of *Smith v Parkes*. The third point is covered in the subsequent section.

**C Subjecting an assignee to ‘equities’ does not alter the content of equitable defences**

Derham argues that to read *Newfoundland* as a counter-claim decision necessarily permits a debtor defendant to use a counter-claim as an equitable set-off against an assignee whether or not an equitable set-off would be available against the assignor.\(^77\) On this hypothesis, the mere assignment of the original claim imbibes the counter-claim with an equity sufficient for it to be set off. The premise is that *Newfoundland* is a set-off decision and the basis for that is the citation of *Smith v Parkes*, for its statement of principle.\(^78\) There are two points to be made. The first is that Derham appears to overstate the significance of the classification of the counter-claim as an equity. A counter-claim in this context is an equity: *Jepps v Day*.\(^79\) The term encompasses any defence as well.\(^80\) However, that cannot convert the former into the latter. Furthermore, Derham assumes that the result of admitting the counter-claim against the assignees entitled the government to use it as a defence but the case does not conclude that; it does conclude that the counter-claims could be used although

\(^{73}\) Spry, above n 2, 269.  
\(^{75}\) Ibid 334.  
\(^{76}\) Ibid.  
\(^{77}\) Derham, above n 74, 334–335.  
\(^{78}\) *Government of Newfoundland v Newfoundland Railway Co* (1888) 13 App Cas 199, 213.  
\(^{79}\) *Jepps v Day* (1866) LR 1 QB 372.  
they arose after the notice of the assignment because one was a condition precedent to the other. Ultimately, the decision provides a means of determining to which equities an assignee is subject. 81 Like set-off, the necessary equity is found in the nexus between the demands: In Re A Bankruptcy Notice. 82 Smith v Parkes was cited to demonstrate that point.

**D Smith v Parkes demonstrates, albeit in a different context, the reasoning appropriate to determine the admission of a counter-claim arising after notice of assignment**

Lord Brandon of Oakbrook has indicated that the citation of Smith v Parkes in Newfoundland was used to determine the case and hence it is a set-off decision.83 Derham concurs.84 To the contrary, it is used to illustrate the reasoning required to determine whether claims are inseparable by analogy to a set-off decision.

Smith v Parkes was about a partnership between Smith, Parkes and Brookfield that had dissolved.85 Their deed of dissolution recorded the sums to which Parkes was entitled for his share of the goodwill and profit. Later, Parkes assigned his interest and Brookfield and Smith issued bonds to Parkes in the amounts owed. Parkes’ assignee sued on the bonds in Parkes’ name. In December 1846, the parties entered a deed replacing the prior bonds and agreement. The parties arbitrated disputed aspects of the deed. Again in 1848, Parkes’ assignees sued on the agreement. Smith, the sole surviving member of the partnership, had made some payments in the intervening years. Now, Smith sought to set off various debts that Parkes owed to the partnership. Lord Romilly held that debts arising before the assignment could be set off but those arising after could not. There were only select claims that arose after the notice of assignment, namely those that: “flowed out of and were inseparably connected with Parkes’ previous dealings and transactions with the firm.”86

A debt of this kind was the costs of the arbitration under the deed. The report identifies neither the terms of the deed nor the reason that the connection could be classified as inseparable.

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82 In Re A Bankruptcy Notice [1934] Ch 431, 437.
84 Derham, above n 74, 334–5.
85 Smith v Parkes (1852) 16 Beav 115.
86 Ibid 119.
Assuming that the arbitration covered the same matters as the litigation, namely the account between Parkes and Smith, then a matter prior to the assignment triggered it: namely, the complex of transactions, of which a constituent element is the assigned debt. Similarly, in Newfoundland, the entitlement to the subsidy was contingent upon the completion (or not) of the railway and under the contract a claim for the former requires an evaluation of the latter. Whether the railway was completed was invariably a matter that arose after the assignment, although the entitlement to the subsidy was contingent upon it. Therefore, the claims were inseparably connected.

Thus, Smith v Parkes was used to illustrate the required connection.

E The Judicature Act does not alter the criteria for determining whether an equitable set-off arises

That the Judicature Act is a procedural facility forecloses its capacity to alter substantive defences. Thus, the inseparable connection approach is flawed insofar as it relies upon the Act to do so. In this regard, Morris LJ relied upon Bankes v Jarvis and Young v Kitchin. The former pertains to s24 (3) and the latter s25(6) Judicature Act. This author submits that neither alters the defence. It is appropriate to summarise these cases briefly.

The question in Bankes v Jarvis was similar: whether a counter-claim could be set off against a trustee. Bankes, before he emigrated, appointed his mother to sell his veterinary practice for £100, to be paid in two equal instalments. His mother sued for the second instalment and the purchaser counter-claimed on the lease of the property in which the business was conducted. There was claimed a breach of two covenants: one for indemnification in respect of rent and the other for repair of the premises. In the county court it was held that the mother was trustee for the son and that while she could recover the payment owing, she was not susceptible to any set-off. Lord Alverstone CJ was of the view that ss 24(2) and (3) Judicature Act 1873 permitted the establishment of a defence ‘in the same way as an equitable defence’. Were Bankes himself the plaintiff, he would have to account for the set-off. The principle that an assignee cannot be in a better position than the assignor was applicable. Willes J took a similar view. Channell J held that “the Judicature Act, and more particularly the rules, put an unliquidated claim on the same footing as a liquidated claim for the purpose of set-off”.

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87 Meagher, Gummow and Lehane, above n 41 [2-005].
88 Bankes v Jarvis [1913] 1 KB 549.
89 Young v Kitchin (1878) 3 Ex D 127.
90 Bankes v Jarvis [1913] 1 KB 549, 552.
91 Ibid 553.
Young v Kitchin concerned s 25(6) Judicature Act 1873 and the Ord XIX r 3 of the rules of court. Originally, Downs & Co agreed to build a grain silo for Kitchin and by the time that party took possession of the works, there was a sum owing on the contract. Downs & Co assigned that sum to Young and Kitchin was duly notified. Young sued for the sum owing. Kitchin pleaded ‘by set-off and counter-claim’ that the buildings were unfit for their stated purpose, the storage of hops. 92 According to counsel for the plaintiff, Ord XIX r 3 permitted only counter-claims to be raised against the assignee. By contrast, counsel for the defendant argued that the rule permitted the use of any cross-claim for the reason that the position of the assignee cannot be better than the assignor. 93 Cleasby B held that a ‘set-off or deduction’ was available 94 but that there was no claim to ‘recover anything’, only to ‘meet the plaintiff’s claim by a counter-claim of damages arising out of the same contract’. That matter, and the source of the title to the counter-claim, ought to have been pleaded. 95

This author argues that neither s 24(3) nor s 25(6) affect the substantive operation of classical equitable set-off.

**F Reading s 24(3) as altering equitable set-off fails to read the section as a whole**

Section 24 (3) provides that:

The said Courts respectively, and every Judge thereof, shall also have power to grant to any defendant in respect of any equitable estate or right, or other matter of equity, and also in respect of any legal estate, right or title claimed or asserted by him, all such relief against any plaintiff or petitioner as such defendant shall have properly claimed by his pleading, and as the said Courts respectively, or any Judge thereof, might have granted in any suit instituted for that purpose by the same defendant against the same plaintiff or petitioner; and also all such relief relating to or connected with the original subject of the cause or matter and in like manner claimed against any other person whether already a party to the same cause or matter or not, who shall have been duly served with notice in writing of such claim pursuant to any Rule of Court or Order of the Court as might properly have been granted against such person if he had been made a defendant to a cause duly instituted by the same defendant for the like purpose; and every person served with any such notice shall thenceforth be deemed a party to such cause or matter, with the same

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92 Above n 89, 128.
93 Ibid 129.
94 Ibid 130.
95 Ibid 131.
rights in respect of his defence against such claim, as if he had been duly sued in the ordinary way by such defendant.

Morris LJ in Hanak v Green relies upon Bankes v Jarvis as authority for the proposition that the Judicature Acts permitted the use of unliquidated cross-claims for equitable set-off. The question in Bankes was whether s 24(3) and its counterpart rule of court, Ord. XIX, r 3, permitted a defendant to raise an unliquidated counter-claim against a trustee. Lord Alverstone CJ held that the section permitted the use of matters, which prior to the Act would have been grounds for an injunction, as defences to the action. Furthermore, had the counter-claims been liquidated, they could have unquestionably been used against the trustee, who cannot be in a better position than the beneficiary. Therefore, the section was read as broadening the general principle and the set off was permitted. More controversially, Channell J held that the Act and Order XIX, r 3, equated unliquidated and liquidated claims for set-off. Derham remarks that the claims were distinct and the reason for a set-off is unclear. Similarly, this author submits that s 24 (3) simply provides for the prosecution of counter-claims and avails the defendant of the use of such claims against third parties. It cannot support the analysis above.

**G Section 24(3) does not require identical liquidity between cross-demands for there to be a set-off**

An ‘equitable estate or right or other matter of equity’ or ‘any estate right or title’ that is properly pleaded will be upheld against the plaintiff under s 24(3). Order XIX r 3 similarly provides that:

A defendant in an action may set-off, or set up, by way of counter-claim against the claims of the plaintiff, any right or claim, whether such set-off or counter-claim sound in damages or not, and such set-off or counter-claim shall have the same effect as a statement of claim in a cross action, so as to enable the Court to pronounce a final judgment in the same action, both on the original and on the cross claim. But the Court or a Judge may, on the application of the plaintiff before trial, if in the opinion of the Court or Judge such set-off or counter-claim cannot be conveniently disposed of in the pending action, or ought not to be allowed, refuse permission to the defendant to avail himself thereof.

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97 Bankes v Jarvis [1913] 1 KB 549, 552.
98 Ibid.
99 Derham, above n 1, 135.
100 Supreme Court of Judicature Act 1873 (UK), s 24(3).
101 Rules of the High Court 1875 (UK) ord. XIX, r 3.
From 1881, s 24(3) and the rule above were understood to facilitate the prosecution of claims discrete from the initiating cause of action and not pleas in bar, such as equitable set-off.\textsuperscript{102} Counter-claim is the ‘way’ \textsuperscript{103} to prosecute ‘any right or claim’.\textsuperscript{104} However, Dixon J argued that ord XIX, r 3, requires that the liquidity of claims must match before there can be a set-off. The ground for that holding was a quote from the \textit{Newfoundland} decision:

\[\textit{Smith v Parkes} was a case of equitable set-off, and was decided in 1852, when unliquidated damages could not be the subject of set-off. That law…has been altered.\textsuperscript{105}\]

On this hypothesis, the matching liquidity requirement must be maintained lest a claim on a bill of exchange be used in defence of a personal injury action.\textsuperscript{106} However, Woodward J notes that his Honour omitted two words from the first sentence of the quote: ‘by law’. These words should fit between ‘damages’ and ‘could not’. As a result the dictum conflates equitable and legal set-off, since only the latter is bound by requirements of liquidity.\textsuperscript{107}

\textbf{H Section 24 (3) provides a method to join third parties to a suit that is unrelated to set-off}

Second, s 24(3) provides that a third party might be joined in an action where they are given notice and the claim ‘relate[s] to or connect[s] with’ the subject matter of the original claim. It is notable that this is reflected in the inseparable connection formula. However, it would be incongruous for one part of the section to alter a substantive defence and for the other to create a procedure. Thus, s 24(3) creates a joinder system.\textsuperscript{108}\textit{Smith v Buskell} is illustrative of the operation of the section.\textsuperscript{109} On an action for the price of goods sold, the defendant replied that the plaintiff dispatched goods that were in unsaleable condition. Additionally, they sought to join the railway company that transported the goods as they alleged negligence in their transportation. As the issue dispositive of both the claim and the counter-claim was the cause of the damage, the joinder was allowed.\textsuperscript{110} Viewed in this way, the counter-

\textsuperscript{102} \textit{Toke v Andrews} (1882) 8 QB 428, 431.
\textsuperscript{103} Ibid.
\textsuperscript{104} \textit{Rules of the High Court} 1875 (UK) ord. XIX, r 3.
\textsuperscript{105} \textit{McDonnell & East Ltd v McGregor} (1936) 56 CLR 50, 60.
\textsuperscript{106} \textit{Pellas v Neptune Marine Insurance} (1879) 5 CPD 34, 40–1.
\textsuperscript{107} \textit{D Galambos & Son Pty Ltd v McIntyre} (1974) 5 ACTR 10, 20.
\textsuperscript{108} \textit{McCheane v Gyles} [1901] 1 Ch D 287, 296–7.
\textsuperscript{109} \textit{Smith v Buskell} [1919] 2 KB 362.
\textsuperscript{110} Ibid 370.
claim in *Bankes v Jarvis* was admissible since it pertained to the subject matter of the original claim. However, it is too far to say, as Lord Alverstone CJ did, that it provides a right of defence.

**I Section 25(6) cannot alter equitable set-off since the section does not purport to alter the requirements of an equity but only its availability**

Section 25(6) facilitates the assignment of choses but leaves them ‘subject to equities’.

111 Tucker LJ in *Morgan & Son* relies on *Young v Kitchin* for the authority that s 25(6) operates to deduct all that ought be deducted.

112 Consequently, any counter-claim to which the assignor would have been subject is enforceable in equity as a defence so long as it arose from the same transaction.

113 As noted above, s 25(6) is no more than a statutory recitation of the principle that where the merits between the equities are equal, the first in time prevails.

114 First, *Young v Kitchin* decided the admission of a counter-claim against an assignee. Second, s 25(6) operates independently of equitable set-off. Third, if s 25(6) did alter equitable set-off, it would require an absurd method of determining its availability that would in fact convert the defence into a procedure. Fourth, s 25(6) places equitable set-off in a position inconsistent to the doctrine of repudiation.

**J Young v Kitchin does not establish that s 25(6) alters the doctrine of equitable set-off**

Spry observes that *Young v Kitchin* pertained to the admissibility of a counter-claim.

115 There, a builder constructed a grain silo. The defendant did not pay and the builder assigned the debt to the plaintiff. The assignee sued on the debt and in defence the defendant sought to raise the defaults of the builder as a counter-claim. Cleasby B held that the defendant was entitled to ‘this defence’, which the defendant sought to ‘deduct’ or ‘set off’ against the claim.

116 A ‘deduction’ is not an equitable set-off: *Gilbert Ash v Modern Engineering*.

117 Therefore, the case does not provide any basis for an altered criterion of equitable set-off. Accordingly, the holding that ‘equity will

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111 *Supreme Court of Judicature Act 1873 (UK)* s 25(6).


113 *Roadshow Entertainment Pty Ltd v ACN 053 006 269 Pty Ltd (Receiver & Manager Appointed)* (1997) 42 NSWLR 462, 482.

114 Meagher, Gummow and Lehnke, above n 41, [6-490], [8-235].

115 Spry, above n 2, 269.

116 *Young v Kitchin* (1878) 3 Ex D 127, 131–2.

deduct all that ought be deducted’ refers to the susceptibility of an assignee to counter-claims arising before the notice of assignment.

K Section 25(6) operates independently of classical equitable set-off

*Roxburgh v Cox* demonstrates that s 25(6) is a threshold that a counter-claimant must overcome in order to establish an equitable set-off against an assignee but it does not affect the set-off itself. James LJ, with whom Baggallay and Lush LJJ agreed, first determined that the set-off applied between the original parties and then determined whether it operated before the assignment. 118 Since it did, the assignee was susceptible to it under s 25(6). 119 Consistent with this position, Darling J held that s 25(6) did not affect set-off, the only remedy that followed under it as of right was for the enforcement of the assigned chose. 120 Therefore, s 25(6) only ever acted as a threshold. Once it a claim had passed through it, the question of whether the claim constituted a set-off had to be considered afresh. Put another way, satisfying s 25(63) did not automatically establish that the claim was an equitable set-off. 121

I If s 25(6) did alter equitable set-off, it would require circular reasoning to establish a set-off

In *Roadshow Entertainment* the New South Wales Court of Appeal interpreted s 25(6) to affect the criterion determining the availability of equitable set-off. With great respect, it appears that the reasoning applied may be circular.

The respondent entered into a sole distributorship with the appellant. When the respondent became insolvent and its business was sold to a third party the appellant treated that conduct as a repudiation of the distributorship agreement. The appellant thereafter sought to set off, against the debts that it owed the respondent, the damages that would compensate it for the repudiation. The appellant did this by withholding the sums that third parties had paid to it for the products sold pursuant to the distributorship. 122 Plainly, the appellant was withholding that sum as it believed it was the only way to recover against the insolvent respondent. The basis for the repudiation claim was that the parties which had licensed their products to the respondent withdrew those licences and consequently could not supply the

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118 *Roxburgh v Cox & Co* (1881) 17 Ch D 520, 526.
119 Ibid.
120 *Bennett v White* [1910] 2 KB 1, 6.
121 Derham, above n 1, 815.
122 *Roadshow Entertainment Pty Ltd v ACN 053 006 269 Pty Ltd (Receiver & Manager Appointed)* (1997) 42 NSWLR 462, 466.
appellant with products to distribute. The Court of Appeal accepted that this was a
repudatory breach sounding in damages.\footnote{Ibid 477.}

The Court of Appeal reasoned as follows to determine that a set-off was available. The
starting point was that had the appellant’s debt been assigned, the assignees
would have taken subject to the equities between the original parties including
unliquidated claims.\footnote{Ibid 482.} An unliquidated cross-claim is available to be set off against
an assignee provided it originates from the transactions inseparably connected to the
subject of the assignment.\footnote{Ibid 482.} The authority for that proposition was \textit{Newfoundland}:
unliquidated damages may be set-off against an assignee if flowing out of and
inseparably connected to the transaction that is the source of the debt.\footnote{Ibid 482.} It does not
appear that \textit{Hanak v Green} was cited to the court although plainly the interpretation
of \textit{Newfoundland} accords with it. Parenthetically it should be observed that this
criterion, first applied in \textit{Smith v Parkes} was germane only to claims arising after the
notice of assignment. As the counter-claim sought to be set off arose under the same
contract as the debt and before the entry of the respondent into receivership\footnote{Ibid 482.} there
was a prima facie entitlement to set-off its claims against the debt that the respondent
claimed.\footnote{Ibid 482.} For these purposes the position of receiver was held not to be relevantly
distinguishable from an assignee and thus took subject to the set-off.\footnote{Ibid 482.} The Court of
Appeal further held that the set off was permissible since Roadshow would suffer
‘irreparable injury’ if it were left to prosecute its claim as an unsecured creditor and
consequently should have its set-off.\footnote{Ibid 482.}

There are two aspects of the reasoning to address. The first is whether a counter-
claim can be a set-off if it originates in the same transaction as a debt that has been
assigned and exists separately to that counter-claim between the debtor and the
assignor. The second is the ‘irreparable injury’ criterion.

As to the first aspect, it is submitted that, respectfully, the reasoning is circular
because the necessary equity in the counter-claim is found in the fact that it is now
raised against an assignee who must take ‘subject to equities’. Put another way,
because the counter-claim is recognised in equity, it takes on the necessary
characteristics for equity to recognise it as a set-off. Lord Brandon has reasoned in the
\begin{itemize}
\item \footnote{Ibid 477.}
\item \footnote{Ibid 482.}
\item \footnote{Ibid 482.}
\item \footnote{Ibid 482.}
\item \footnote{Ibid 485.}
\item \footnote{Ibid 482–3.}
\item \footnote{Ibid 484.}
\item \footnote{Ibid 477, 489.}
\end{itemize}
same way, on the authority of *Newfoundland*, that a counter-claim may be used as a set-off where that counter-claim has a common transactional basis to the assigned claim. Derham seeks to reconcile the reasons of the Court of Appeal to accepted equitable principles in this country. Derham holds that an assignee is answerable for counter-claims arising under the same contract as the debt, whether or not it would amount to an equitable set-off. That reasoning proceeds from a false premise since the appellant expressly disclaimed any case based on counter-claim; Roadshow argued for an equitable set-off only. The clearest position on the point is found in the judgment of Gummow J, sitting in the Federal Court, that no part of the Judicature system whatsoever alters substantive rights, including the availability of equitable set-off. *Ex hypothesi*, the Judicature Act did not elevate counter-claims to the status of equitable set-offs on account of the assignment of a distinct debt arising from the same contract. It is submitted, with respect, that the reasoning of Gummow J is to be preferred for three reasons. The first is that an assignee is to be placed in no better and certainly never in a worse position than an assignor. That principle is abrogated where a counter-claim becomes a defence as against the assignee, but not the assignor, on account of the assignment of a distinct claim. The assignee is in a worse position as that party is automatically subject to the set-off, which did not exist prior to the assignment but on account of it. The second difficulty is that this approach diminishes equitable set-off to a mere procedure. The consequence of this approach is that set-off is reduced to the status of a procedure, as has been held in Canada. The result is that legal and equitable set-off merge, achieving substantive fusion. With great respect, it is submitted that the most cogent view, propounded by Meagher Gummow and Lehane, is that the assigned counter-claim must still impeach the initial demand.

On the other hand, the decision is defensible insofar as it was supported by the ‘irreparable injury’ argument. A set-off is available where there would be a ground

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132 Derham, above n 1, 98.
133 *Roadshow Entertainment Pty Ltd v ACN 053 006 269 Pty Ltd (Receiver & Manager Appointed)* (1997) 42 NSWLR 462, 481.
137 *Kaps Transport Ltd v McGregor Telephone & Power Construction Co Ltd* (1970) 73 WWR 549, [14].
138 Meagher, Gummow and Lehane, above n 41, [6-500].
entitling the applicant to an injunction\textsuperscript{139} and irreparable injury is such a ground.\textsuperscript{140} That said, the better interpretation of the phrase ‘irreparable injury’ is that it refers to the unlikelihood that the appellant, as an unsecured creditor, will ever receive repayment. In any event, the decision has only been applied in this State once in respect of set-off.\textsuperscript{141}

Ultimately the case illustrates the difficulties involved in reasoning that s 25(6) and its successors alter or expand the requirements for a substantive equitable set-off.

\textit{M The inseparable connection criterion is incompatible with the doctrine of repudiation and in this manifestation equitable set-off does not follow the law}

The application of the inseparable connection criterion in \textit{Parsons v Sovereign Bank of Canada} indicates that it cannot operate consistently with the law.\textsuperscript{142} It was assumed there\textsuperscript{143}, that a counter-claim for repudiation of a contract could be set-off against a debt arising on the contract for goods delivered but for which the price was unpaid.\textsuperscript{144} Derham disputes whether the set-off should have applied to the repudiation with respect to sums due before but not after the repudiation.\textsuperscript{145} Moreover, the judgment is inconsistent with the principle that repudiation is a prospective action that does not affect the rights accrued before it.\textsuperscript{146} Therefore, damage arising subsequent to the completion of acts creative of title to a demand cannot affect it. To hold otherwise on the basis of the inseparable connection doctrine is incongruent to the doctrine of repudiation.

\textsuperscript{139} Above n 14, 710.
\textsuperscript{140} \textit{Australian Broadcasting Corporation v O’Neill} (2007) 226 CLR 57, 111.
\textsuperscript{141} \textit{Concrete Equipment Australia Pty Ltd v Bonfiglioli Transmission (Aust) Pty Ltd} [2010] NSWSC 393, [24].
\textsuperscript{142} \textit{Parsons v Sovereign Bank of Canada} [1913] AC 160.
\textsuperscript{143} Ibid 166.
\textsuperscript{144} Ibid 171–2.
\textsuperscript{145} Derham, above n 1, 148.
\textsuperscript{146} \textit{McDonald v Denny’s Lascelles Ltd} (1933) 48 CLR 457, 476–7.
**N Morgan & Son Ltd v S Martin Johnson & Company Ltd** is a genuine set-off decision but it reflects the impeachment conception and requires more than a common contract or transaction

Morris LJ cited *Morgan & Son* as a case where the requisite nexus between the demands was present.\(^{147}\) This author submits that conclusion was correct but the case involved much more than the common contractual nexus that Morris and Sellers LJ concluded to be necessary.\(^{148}\) In *Morgan*, the plaintiffs claimed a sum of money for storing the defendant’s vehicles.\(^{149}\) The defendant claimed for the loss of one of those vehicles in a sum greater than the value of the storage fees. The primary judge gave judgment for the plaintiff but granted a stay of execution for the trial of the counterclaim. The defendant appealed on the basis that an equitable set-off was the proper form of the order. Tucker LJ noted that counsel for the plaintiffs conceded that on the basis of the authorities an equitable set-off would have been available in a court of equity. For Tucker LJ himself, the case was analogous to *Piggott v Williams*. The reason for that is self-evident: the basis for the payment was the proper storage of the vehicles but the cross-demand contradicted the assumption on which that claim was based, that the vehicles had been properly stored. The claims satisfy the undemanding ‘inseparable connection’ criterion in that both claims arose under the same transaction but also the impeachment test. Spry considers that the two bases upon which the case as decided are erroneous. The concession was improperly made and *Piggott* is distinguishable because the costs there were incurred on account of the negligence, not despite it.\(^{150}\) Similarly, Meagher Gummow and Lehane consider the analogy to be ‘hardly apposite’.\(^{151}\) The correctness of the concession is contingent upon the applicability of *Piggott*. With respect, Spry takes a myopic view of the concept of impeachment. The basis of the demand is that the services have been performed, and that is undercut by the allegation that the vehicle was wrongfully released or lost. A causal nexus might be absent but equitable set-off has never been that stringent. Accordingly the concession was appropriately made. Therefore it should be noted that at least one case of the ‘inseparable connection’ line is a true set-off decision but that it truly reflects impeachment.

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\(^{147}\) *Hanak v Green* [1958] 2 QB 9, 20–1.

\(^{148}\) Ibid 26, 31.

\(^{149}\) *Morgan & Son Ltd v S Martin Johnson Co Ltd* [1949] 1 KB 107.

\(^{150}\) Spry, above n 2, 269–270.

\(^{151}\) Meagher, Gummow and Lehane, above n 41, [37-050].

111
O Conclusion

The inseparable connection approach is untenable, since it is based on a misinterpretation of the Judicature Act. In its stead, courts in this state appear to apply the ‘manifest injustice’ test, first propounded in Henriksens Rederi A/S v T H Z Rolimpex (The Brede).152

V THE INJUSTICE APPROACH IS ACCEPTABLE TO THE EXTENT THAT IT IS EQUIVALENT TO IMPEACHMENT

One line of cases holds that a set-off arises whenever one demand cannot ‘fairly’ be made without accounting for another. *D Galambos & Son Pty Ltd v MacIntyre*153 was the first Australian decision to adopt this approach, which has been taken up in New Zealand. This section covers New Zealand decisions that apply the injustice test in terms but accord in practice with the impeachment test; the English and New South Wales decisions that apply a unique ‘injustice’ criterion; and the analysis of the English and New South Wales decisions.

A New Zealand decisions

Under the New Zealand approach, a set-off will be available where the two claims are ‘interdependent’ such that one cannot justly be satisfied without the other: *Grant v NZMC*.154 It is submitted that these cases reflect the impeachment doctrine as it has been propounded above. In NZMC, the defendant owned a car dealership and offered the Grants a leasehold property within their complex from which to conduct their panel beating business. The parties entered into a collateral contract: if NZMC supplied continual work to the Grants for eighteen years, they would enter the lease. That ceased after six months, when NZMC moved their business. Afterwards, NZMC sued for arrears. It was held that the breach of the collateral contract could be set off since it was the basis of the lease.155 As in *Beasley* above, the wrongful conduct of the plaintiff gave rise to the situation of which that party complained. Similarly in *Gough v Timbalok*, a claim for progress payments on houses built for the appellant developer could be set-off against the cost of remedial works so as to render those homes habitable, which was an implied condition of the building contract.156 The claim of the defendant contradicted the assumption on which the claim of the plaintiff was

154 *Grant v NZMC Ltd* [1989] 1 NZLR 8, 12.
155 Ibid.
based: that the homes had been completed to a requisite standard. *Edmonds v Westland Bank* is also a paradigm case. There it was held that a set-off was arguable in favour of a guarantor who claimed that a bank had negligently failed to realise the value of the secured asset, before having recourse to the guarantee.\(^{157}\) The claim of the bank in *Edmonds* is analogous to the claim of the solicitor in *Piggott* in that both were produced by the negligence of the claiming party. Again, the plaintiff facilitated the wrong of which he now complains. In all cases then, the ‘injustice’ is in the prosecution of a claim, the conditions for which have been fostered by the plaintiff. It is submitted that these cases are consistent with the impeachment cases and illustrate the real nature of the test.

The following sections outline the development of the manifest injustice test in England and this country and provide three arguments against its acceptance as the criterion by which equitable set-offs are to be allowed. The first is that it presumes the fusion of law and equity. The second is that it locates the basis for the defence outside the facts upon which the demand and cross-demand are based. Third, there is little regard for the requirement that the prosecution of the demand be unconscionable.

### B English decisions

In *The Brede*, Lord Denning first expressly pronounced that a set-off arises between demands when one party cannot press a demand against another without ‘fairly’ taking into account loss that party has itself occasioned.\(^{158}\) The test was repeated in similar terms in *Federal Commerce and Navigation v Molena Alpha (The Nanfri)* and, in the course of deciding the case, Lord Denning exposed the reasoning behind the test.\(^{159}\) It is necessary to briefly summarise the facts of the case. The charterparty between the charterer and the shipper stipulated that the charter make payments in full for a period of hire in advance of that period. The charterer purported to make deductions from hire payments made in advance for wrongs arising in the previous hire period. The shipper disputed whether this was permissible. As a result of persistent deductions, the ship owners conditioned the acceptance of cargo on full payment in advance. The charterers treated this as a repudiation and accepted it. At the outset of the reasoning, Lord Denning considered that equitable set-off originated to mitigate the stringency of common law abatement, although unlike abatement the grounds for its grant were ‘never precisely formulated’.\(^{160}\) Further, after the passage

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160 Ibid 974.
of the Judicature Act, law and equity fused and so it is only necessary to inquire as to whether it would be manifestly unjust to allow one claim without the other to answer whether an equitable set-off lies in respect of the cross-claim.\textsuperscript{161} Thus, it is manifestly unjust to allow a claim for the hire without accounting for the deduction for the shipowner prejudicing the use of the vessel. That deduction may be applied to the next advance payment.\textsuperscript{162} The broadest statement of the principle is found in an analogy Lord Denning gave as representative of the manifest injustice approach: a window cleaner cannot demand payment for his works without accounting for the chair that he broke in the process.\textsuperscript{163}

In the last twenty years, the test has been most notably applied in England in the context of agreements that are connected by the commercial dealings of the parties. In \textit{Dole Dried Fruit v Trustin Kerwood}, a principal and distributor entered into a sole distributorship agreement and afterward a contract for the sale of certain goods. When the principal repudiated the distributorship agreement, the distributor declined to pay for the goods under the sale of goods contract and accordingly a debt arose against that party. Lloyd and Beldam LJ held that since one agreement was, factually, entered in pursuance to the other, the repudiation could be set-off against the debt, despite the independence of the agreements in their terms.\textsuperscript{164} A similar result obtained most recently in \textit{Geldof Metaalconstructie v Simon Carves Ltd.}\textsuperscript{165} There, one party contracted with another for the supply of gas tanks. The vendor also agreed to install the tanks. The purchaser did not pay for the tanks and the constructor refused to continue the installation until payment was made for them. The contractor held that to be a repudiatory breach and sought to set it off when the seller of the tanks sued for the purchase price. Rix LJ allowed the set-off, assuming that the supplier’s conduct constituted a repudiation. Once the pendency of the obligations was established, the benefit of the set-off went to the party who bore the greatest risk in the contract. That case is now taken to have finally disposed of the impeachment requirement in favour of manifest injustice.\textsuperscript{166}

\begin{footnotes}
\footnotetext[161]{Ibid.}
\footnotetext[162]{Ibid.}
\footnotetext[163]{\textit{Enriksens Rederi A/S}, above 158 at 248.}
\footnotetext[164]{\textit{Dole Dried Fruit and Nut Co. v Trustin Kerwood Ltd} [1990] 2 Lloyd’s Rep 309, 311.}
\footnotetext[165]{\textit{Geldof Metaalconstructie B.V v Simon Carves Ltd} [2010] EWCA Civ 667.}
\footnotetext[166]{\textit{Moondance Maritime Enterprises SA v Carbofer Maritime Trading APS} (‘The Moondance II’) [2013] 1 Lloyd’s Rep 269, 272.}
\end{footnotes}
C New South Wales decisions

Tooth & Co v Smith is the first application of the manifest injustice test in New South Wales.\(^{167}\) The plaintiff claimed the adjusted price of a hotel sold to the defendant. The defendant sought to set off a claim of fraud on the part of a third party from whom the plaintiff had bought the licence to operate the hotel initially. The plaintiff was said to have knowledge of the fraud. Clarke J held that the claims were distinct so that the allowance of one without regard to the other would not be unjust.\(^{168}\) AWA v Exicom\(^{169}\) was the first reported decision in New South Wales applying the injustice criterion. AWA sued Exicom for the recovery of sums defined under contract as adjustments to the purchase price for a business. Exicom sought to defend the claims by setting off damages due for breached warranties. AWA sought to have that defence struck out. The adjustments accounted for amounts expended in performing contracts, the benefit of which Exicom was to receive and the dividends from securities that AWA had acquired for the business. The warranties related to the state of the business at the time of sale.\(^{170}\) Giles J held that although neither augmented nor diminished the sale price itself, both affected the total that Exicom would ultimately pay to AWA.\(^{171}\) Moreover, had the adjustments not been separated from the sale price, they ‘presumably’ would have been incorporated into it.\(^{172}\) Therefore, both claims apparently affected the sale price and so it would be unjust to allow one claim without regard to the other and hence the set-off lay.\(^{173}\) Giles J concludes that since both claims affected the amounts each party owed one another, in a loose sense, one might be set off from the other.\(^{174}\) It is a method of ‘work[ing] out the bargain’.\(^{175}\) It arose again in AMP v Specialist Funding Consultants.\(^{176}\) There, AMP loaned a sum to the defendants to facilitate their sale of its insurance products. On determining the arrangement, the plaintiff sued for the recovery of the loan. The defendants sought to set off against it a claim that AMP had deceived them as to the competitiveness of

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\(^{167}\) Tooth & Co v Smith (Unreported, Supreme Court of New South Wales, Clarke J, 5 September 1984).

\(^{168}\) Ibid 7, 9.

\(^{169}\) AWA Ltd v Exicom Australia Pty Ltd (1990) 19 NSWLR 705.

\(^{170}\) Ibid 710.

\(^{171}\) Ibid 713.

\(^{172}\) Ibid.

\(^{173}\) Ibid 715.

\(^{174}\) Ibid 713.

\(^{175}\) Ibid 713.

\(^{176}\) Australian Mutual Provident Society v Specialist Funding Consultants Pty Ltd (1991) 24 NSWLR 326.
their policies and Rogers CJ Comm D allowed it.\textsuperscript{177} Similarly in \textit{Murphy v Zamonex} a misrepresentation as to the meaning of a withholding of finance clause in a mortgage contract could be set-off against a demand for the sum owing on that contract.\textsuperscript{178} More recently, in \textit{Gilsan v Optus} (No 3), McDougall J held that a counter-claim for services could be set-off against another claim for services since the former facilitated the latter.\textsuperscript{179} Despite the similarities in \textit{AMP}, \textit{Murphy} and \textit{Gilsan} to the impeachment line of cases, the approach is not without difficulties and these are outlined below.

\textbf{D Analysis of English and Australian ‘manifest injustice’ decisions}

\textit{1 The manifest injustice approach is premised on the fusion of law and equity and so it should not be accepted}

Lord Denning in \textit{The Nanfri} premised the introduction of the manifest injustice approach on the fusion of law and equity.\textsuperscript{180} For that reason the case should not be accepted in this country. The corollary of that premise and the assertion that abatement and classical equitable set-off are related is that the two have become one. That is demonstrated in Derham’s analysis of \textit{Exicom} where he reasoned that the breaches of the warranties impugned the adjustment claims since those were analogous to a claim for the purchase price.\textsuperscript{181} It is submitted that Derham’s analysis accurately reflects the decision itself. The premise is a significant impediment to the acceptance of the test and McCracken accepts this.\textsuperscript{182} Furthermore, abatement and classical equitable set-off have always been distinct, classical equitable set-off predating abatement.\textsuperscript{183} Therefore, equitable set-off was not a response to the stringency of abatement. The two are similar but unrelated. These arguments militate against the acceptance of the manifest injustice test.

\textsuperscript{177} Ibid 329.
\textsuperscript{179} \textit{Gilsan v Optus} (No 3) [2005] NSWSC 518, [45].
\textsuperscript{181} Derham, above n 1, 99.
\textsuperscript{182} McCracken, above n 56, 78.
\textsuperscript{183} The first classical equitable set-off decision was decided in 1792, whereas the first abatement decision, \textit{Mondel v Steel}, was decided in 1841.
2 The requisite connection between the two demands is found in matters extraneous to the basis for the claim

The example of the operation of the injustice approach that Lord Denning gave of the window cleaner who breaks a chair in The Brede is emblematic of the problem of the manifest injustice approach. This approach effectively holds that the extent to which one promise is fulfilled determines the extent to which the other must be completed.184 Were that so, the obligations within the contract would specify the maximum performance one party could expect. Such an approach diminishes the certainty of contract and, as Aitken observes, imperils the doctrine of pacta sunt servanda.185 Accordingly, there should be some relationship of contingency between the demands, whether as expressed in the contract or as demonstrated by the impeachment cases. Scots law, by its doctrine of retention that is cognate to classical equitable set-off, strikes that balance by stipulating that the contract on its true construction disclose that relationship of pendency.186

The contemporary English decisions summarised section 4.b. above take a much broader approach by stipulating that because the commercial value of one agreement is dependent upon the other, there is a sufficient connection between the demands for one to be set off against the other. This is so notwithstanding that the counter-claim does not in any way question whether it is consistent with conscience to prosecute the claim. The point is illustrated in Dole Dried Fruit. The entitlement to payment of the goods was established under one contract and the repudiation of the distributorship agreement did not call into question, say, the quality of the goods, such as to make the prosecution of that debt unconscionable. One agreement might have been entered pursuant to the other but the repudiation did not make it unconscionable for the debt to be enforced, the produce could still be sold. The Geldof decision is similar. The underlying commercial relationship between the parties links the claims. The sale and installation contracts were entirely separate and so a claim under one had no effect on title to the benefit conferred by the other. The English Court of Appeal appears to have recognised this logic in Youell’s case where a set-off was held not to arise because the agreements were separate.187 Nonetheless, the concern to preserve the commercial position of the party at the greatest risk is


dispositive when there are claims under two separate contracts linked by the commercial relationship between the parties. Viewed in this way, the manifest injustice approach is not a true defence but its application in recent years has taken a more commercial approach to the problem than the impeachment test.

3 The Australian and English approaches are not concerned with unconscionability

The third difficulty with manifest injustice approach as it appears in the Australian and English authorities is that it is not concerned to identify the unconscionability in the demand of the plaintiff. This is best illustrated by Evans in the latest edition of his text.\(^{188}\) There, he provides a learned argument that on the Exicom formulation, a set-off would arise in favour of a trustee, whom a beneficiary sues for the sale of a trust asset at an undervalue to an associate, in respect of expenses incurred in the administration of the trust.\(^{189}\) It would be inequitable were some allowance not made for the expenses of administration.\(^{190}\) Evans asks, rhetorically, for the reader to locate the harm in this outcome. It is suggested that the answer is that the result does violence to the unconscionability principle. It is fundamental that it must be unconscionable for the demand of the plaintiff to be pressed without accounting for the cross-demand of the defendant.\(^{191}\) There are three points militating against a finding of unconscionability in this instance. First, there is no connection between the sale claim and the expenses cross-claim; they are utterly distinct aspects of the relationship.\(^{192}\) Furthermore, and second, the expenses claim does not act as a defence to the sale claim because the subject matter of the former is unrelated to the latter. Equitable set-off is a substantive defence.\(^{193}\) As such the cross-claim must affect the demand made upon the defendant\(^{194}\) and there is no relationship between the demands. The basis for Evans’ argument is the maxim, ‘he who seeks equity must do equity’. The applications of the maxim are ostensibly limitless.\(^{195}\) Yet, “[the maxim] decided nothing in itself: for you must first inquire what are the equities


\(^{189}\) Ibid 692.

\(^{190}\) Ibid.

\(^{191}\) *Westpac Banking Corporation v Gilio* [2011] NSWSC 1309, [21].

\(^{192}\) Distinct claims do not generate a set-off under the impeachment test: *Rawson v Samuel*. Furthermore, on the *Hanak v Green* test such claims are not ‘inseparably connected’.

\(^{193}\) *Aries Tanker Corporation v Total Transport Ltd* [1977] 1 WLR 185, 192B.

\(^{194}\) Derham, above n 1, 100; *MEK Nominees Pty Ltd v Billboard Entertainments Pty Ltd* (1993) V Conv R 54-468.

\(^{195}\) Meagher, Gummow and Lehane, above n 41, [3-055].
which the defendant must do and what the plaintiff ought to have”. The mere invocation of the maxim cannot provide *ipso facto* the necessary equity.

**F Conclusion**

Recently Keane JA, as he then was, held that the injustice approach is equivalent to impeachment. His Honour defends the determinant on the basis that it is ‘open textured’ and is thereby consistent with the flexible techniques of Equity. It is respectfully submitted that these are desirable characteristics but the manifest injustice doctrine, as applied in New South Wales and England assumes the fusion of law and equity, requires a connection between the demands that is not related to the basis of the demand and an arbitrary approach to unconscionability. As a consequence of these faults, it is submitted, with respect, that it is incorrect to stipulate that injustice, under the *Exicom* authority, constitutes the definitive criterion for set-off, as some have done. It is patent that the impeachment test is strict and the alternative tests respond to that strictness to give parties the benefit of set-off where it would normally be unavailable. However, where that is the concern, the practice to which Tucker LJ adverted in *Morgan & Son Ltd* should be applied: a stay of execution should be given on the claim until the counter-claim is prosecuted. The result would be that parties would take the commercial advantages of an equitable set-off without the effect of depriving them of their rights in law to which they are entitled.

**VI FROM THE FOREGOING, IT IS POSSIBLE TO DETERMINE THE REQUISITE ELEMENTS OF SET-OFF**

If the foregoing critiques of the injustice and common transaction approaches are correct, the author submits that the following are the requisite facts that must be proven in order to establish a set-off.

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196 *Necsom v Clarkson* (1845) 4 Hare 97, 101.
198 Ibid 404.
A  The parties must be those who entered into the original transaction or their successors in title or personal representatives

As indicated in Hamilton Ice Arena it is essential that the parties be identical.\(^201\) This has been accepted in Forsyth v Gibbs and appears to be assumed in all cases.\(^202\) However, the litigants may be assignees of the original parties\(^203\) or personal representatives such as trustees.\(^204\)

B  The counter-claim must contradict an assumption that is necessary to the establishment of the case of the plaintiff or reveal that wrongful actions of the plaintiff have facilitated, fostered or contributed to the claim which that party prosecutes

It is of fundamental importance that the counter-claim assert some wrongful conduct attributable to, or a debt owing by, the plaintiff. Hence a petition for an account was not a counter-claim that could be set-off.\(^205\) It appears that there are two relationships between the claims that will satisfy this element. Ultimately, the defendant must demonstrate that the plaintiff is responsible for the loss sustained. The counter-claim must disclose facts that indicate the plaintiff procured the acts of which he complains: Edmonds v Westland Bank, The Teno, Beasley v Darcy, Gilsan v Optus, Re Just Juice, Forestry Enterprises, Commonwealth Bank of Australia v GS Developments.

Alternatively, the counter-claim must contradict or qualify the premise underlying the demand: Gough v Timbalok, AMP v Specialist Funding Consultants, Piggott v Williams and Murphy v Zamonex.

C  The counter claim must not be on a cheque, bill of exchange or contract for freight

Set-off has been unavailable where one claim arises under a cheque\(^206\) or a bill of exchange\(^207\). The justification is that these constitute contracts separate to that upon which the debt arises. Additionally, a set-off is unavailable where both claims arise in

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\(^{201}\) Hamilton Ice Arena Ltd v Perry Developments Ltd [2002] 1 NZLR 309, 312.
\(^{202}\) (2006) 1 Qd R 403, 406.
\(^{203}\) Roadshow Entertainment Pty Ltd v ACN 053 006 269 Pty Ltd (Receiver & Manager Appointed) (1997) 42 NSWLR 462.
\(^{204}\) Bankes v Jarvis [1913] 1 KB 549.
\(^{205}\) Rawson v Samuel (1841) Cr & Ph 161.
\(^{206}\) Hofer v Strawson [1999] 2 BCLC 336, 361; In Re Bayoil [1999] 1 WLR 147, 156.
\(^{207}\) Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GmbH [1977] 1 WLR 713, 721.
the context of a freight shipping contract. That exception is a recognised historical, indefensible anomaly.

At this stage, an equitable set-off should issue, unless:

D Discretionary considerations apply, including:

1 A poor history of performance of contractual obligations throughout the life of the contract;

In Blacksheep Productions v Waks, Young J held that the decision to grant a set-off was in the discretion of the court. Since the plaintiff lessee had been an ‘unsatisfactory tenant’ and ‘extremely dilatory’ in paying rent to that point that mediation was required, the set-off was declined. Thus the party seeking the benefit of the set-off must have performed their obligations in the broader temporal context of the parties’ relation.

2 Futility;

Although a set-off was declined in Eagle Star Nominees v Merrill, Tadgell J indicated that were it available, he would not have permitted it since it would not redeem the defendant from arrears. Consideration ought be given as to whether this holding is consistent with the character of set-off as both a complete and partial defence.

It is these criteria that bind the conscience of the plaintiff, subject to the application of factors militating against the exercise of the discretion in that way.

VII CONCLUSION

To conclude, it is only the concept of impeachment that binds the conscience of the plaintiff. This is evident where the counter-claim contradicts a necessary assumption supporting a claim or a demonstration that the plaintiff has facilitated or contributed to the wrong of which he complains. The use of the inseparable connection approach instead arises from a misunderstanding of the Judicature Act. The ascendancy of the

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211 Ibid [25].
212 Ibid [2].
'injustice' criterion is attributable to the fusion doctrine. Furthermore, it proceeds on an out-dated understanding of the relationship between contractual obligations. Therefore, impeachment remains, as it must, the only criterion of equitable set-off.