

Set-off

WHAT IS SET-OFF?

A right of set-off is a personal right, rather than a security interest, that arises between two parties who owe each other monetary claims. Where two parties owe each other a liability, set-off allows the parties to deduct one debt from the other so that only the balance of the liability is due.

By way of example, Party A owes Party B £10. Party B owes Party A £20. A set-off of the two claims results in Party B owing Party A £10.

WHY IS IT IMPORTANT?

Rights of set-off can materially reduce the value of receivables that are financed. It is therefore important for financiers to understand the set-off rights that may affect the value of the receivables.

Set-off is, however, a complex area of law and this note is only intended to provide a high level introduction to the issues.

HOW DOES IT ARISE?

Set-off rights may arise by way of contract, or by law. The different forms of set-off rights are set out below.

CONTRACTUAL SET-OFF

Parties to a contract can expressly agree that where payments are due from two parties, instead of both parties making separate payments, the party due to make the larger payment should pay the difference.

A financier should review the sale/supply contracts to determine whether they contain any express set-off rights between the debtor and the customer. The extent

of the set-off right will vary from contract to contract and will be subject to contractual interpretation. While set-off usually only applies to mutual debts, contractual set-off can be agreed in relation to claims which are not mutual (i.e. not owing between the same parties in the same capacities) or in relation to permitted types of claim that wouldn't typically be eligible to be set-off (e.g. contingent claims).

A financier is generally considered to only be bound by a claim for contractual set-off that has arisen before notice of assignment (in the case of a receivables purchase facility) or notice of fixed security/crystallised floating charge (in the case of a secured borrowing based facility) has been delivered to the debtor (although that position is the subject of some academic debate). Many transactions will, in any event, prevent the financier from notifying the debtor of the assignment/security until a trigger event. In addition, other rights of set-off, such as equitable set-off, may still be available to be exercised post-notification.

If there is a contractual set-off right, the financier may consider (i) designating any receivables that are subject to set-off rights as ineligible (in whole or, more commonly, only to the extent of such set-off) or (ii) setting a reserve to mitigate the risk of that set-off.

LEGAL SET-OFF

This is a procedural remedy, available only during the course of litigation. It allows a court to give one judgement for the balance due between parties. It is available for mutual liquidated debts which are both due and payable at the commencement of the action. The two claims do not have to arise from the same transaction or closely connected transactions but must be between the same parties.

A financier will generally only be affected by cross-claims between the debtor and the customer which arise prior to the date on which the debtor received notice of assignment.

EQUITABLE SET-OFF

Equitable set-off is available in situations where the claim and cross-claim are so closely connected that it would be manifestly unjust to enforce one without taking the other into account. The sums in question must be due and payable or, in the case of unliquidated damages, must be a reasonable assessment of the loss made in good faith.

A financier will take subject to equitable set-off rights even if the cross-claim arises after the date on which the debtor received notice of assignment.

INSOLVENCY SET-OFF

Insolvency set-off arises automatically, as a matter of statute, and cannot be varied by contract. It supersedes any contractual set-off rights that may exist.

Under insolvency set-off, all sums (including contingent and unascertained liabilities) due between the insolvent party and its creditors under all mutual dealings are set-off to create a final balance. That balance is determined, in the case of liquidation, by reference to the point a company goes into liquidation and, in the case of administration, at the time the administrator gives notice of an intended distribution.

The rules regarding insolvency set-off are particularly complex and have to be considered on a case-by-case basis. For example, in certain circumstances, the mutuality required for insolvency set-off may be defeated by the presence of an intervening party, such as a financier who has the benefit of an assignment (in the case of a receivables purchase facility) or fixed security/a crystallised floating charge (in the case of a secured borrowing based facility).

BANKERS' SET-OFF

Bankers' set-off (sometimes known as the right of combination of accounts) is the right of an account bank to set-off between a customer's bank accounts where the bank account balances, if negative, are payable on demand or on reasonably short notice. It is a self-help remedy and is therefore available without litigation.

WHAT ABOUT CROWN SET-OFF?

It is important to note that under English law, the Crown in the UK is viewed as one and indivisible. The availability of set-off rights in respect of claims and counterclaims between different Crown departments, however, depends on whether the customer is solvent or insolvent.

As mentioned above, insolvency set-off requires mutuality of claims and debts. English law provides that there is mutuality between an insolvent customer and all departments of the Crown. As a result, a Crown entity can set-off any amounts owed to it by the customer against any amounts that may be owed by the customer to any other Crown entity (the particular concern for financiers being tax owed to HMRC).

The position differs when the customer is solvent. In those circumstances, if the claim and counterclaim relate to different Crown departments, set-off can only be exercised by or against the Crown if the permission of the court has been obtained.

CAN SET-OFF RIGHTS BE EXCLUDED?

Contractual terms excluding or restricting the right of set-off (other than insolvency set-off) are enforceable as a matter of English law. The courts have held that clear, express wording is required to exclude a right to set-off.

Although provisions excluding set-off have not been deemed to offend public policy, legislation to protect against unfair contract terms (such as the Unfair Contract Terms Act 1977), where applicable, may restrict the use and effect of contractual provisions.