In certain circumstances, if a claim is proven, the defendant will be able to offset monies that are due to it from the claimant - this is known as set off.

Here, we cover the basics of set off, including the different types of set off and key points you need to know.

- What is set off?
- Contractual set off
- Banking set off
- Insolvency set off
- Legal set off
- Equitable set off
- Is set off the same as a counterclaim?
- Set off is complex: what do I really need to know?

What is set off?

Where the right of set off arises, it can act as a defence to part or the whole of a claim.

Example: when the right of set off arises, if B owes A £800,000, but A in fact owes B
£200,000, B can set off that £200,000 when A claims its £800,000, and pay to A only the balance of £600,000.

The maths is simple, but the more difficult area is usually the issue of determining when (in what circumstances) and if the right of set-off arises in the first place.

There are different types of set off, summarised below.

**Contractual set off**

Parties sometimes agree a contractual right of set off, for example, when they have an ongoing business relationship; alternatively, they may agree to exclude set-off rights.

So, taking the example above, if B owes A £800,000 under a contract which excludes set off rights, B would have to pay to A the whole £800,000, even though A separately owes B £200,000.

**Banking set off**

Where a party has more than one account, a bank is entitled to set off one credit balance against another debit balance.

**Insolvency set off**

This is an important right to be aware of in the context of insolvency.

Mandatory statutory rights of set off for the insolvent debtor company against its creditor can arise under the Insolvency (England and Wales) Rules 2016 (IR 16) where (in summary):

- there have been mutual dealings between the insolvent company and that creditor; and
- the creditor’s claim is provable and quantifiable and;
- the debt was incurred or agreed before the date of insolvency (be that liquidation or administration).

If such a right applies under IR 16, it cannot be restricted or extinguished by agreement.

In the case of liquidation, the right will take effect automatically from the date of the liquidation. In administration, the right will only take effect if and when the administrator gives notice of distribution to the creditors.
Insolvency set off is complex, and therefore it is wise to take specialist legal advice.

**Legal set off**

Where legal proceedings have been commenced, it may be possible to set off mutual undisputed debts arising from unrelated transactions (known as legal set off), but bear in mind the wording of any contractual exclusion which may preclude legal set off.

**Example:** X commences proceedings against Y for payment due of £500,000 for the purchase by Y of industrial machinery. However, three months ago, Y provided 8 boilers to X and X has not yet paid the agreed price of £16,000. Y can exercise a legal right of set off, and in effect only owes X £484,000.

**Equitable set off (also sometimes known as transaction set off)**

This only applies to closely connected claims, where it would be manifestly unjust for the claim to be enforced without taking account of the cross-claim (subject to any contractual exclusion that may apply).

**Example:** Z has also bought industrial machinery from X and still owes X £50,000 of the purchase price. Some of the machinery purchased is, however, damaged on arrival and Z has to pay £3,000 for repair works; this amount of £3,000 can be set-off against the £50,000.

**Is set off the same as a counterclaim?**

No. Set off can only be used defensively, to reduce or extinguish a claim. It provides the defendant with protection against a claim, acting like a shield.

In contrast, a counterclaim acts like a sword, it is used offensively - it can be a separate claim that exists independently, and may result in a net gain to the defendant.

Where there is a counterclaim, a court fee will be payable, calculated in the same way as the court fee for a claim - so, on a sliding scale up to £10,000 for counterclaims over £200,000. Also, for the most part, the [Civil Procedure Rules](https://www.legislation.gov.uk/uksi/2010/3459) apply to a counterclaim in the same way as to a claim. For example, a formal defence to counterclaim will be required. However, if set off is used by a defendant as a defence to all or part of the claim in legal proceedings, no separate
court fee will apply.

It is quite usual to plead a set off in a defence, with the cross claim as a separate counterclaim. If so however (as above), a court fee will apply, so it is always worth considering whether the counterclaim is required, or if the set off defence alone will suffice.

Different considerations apply when disputes arise out of construction contracts where there is a statutory right to adjudicate. In adjudication proceedings, it is not possible for the respondent to make a counterclaim as of right (as it is a separate claim) whereas a defence of set-off can be used to set-off against or extinguish additional sums claimed (but not where sums have been certified unless a pay less notice has been served).

**Set off is complex: what do I really need to know?**

This area of law is complex but keep in mind this potential right. Here are some practical points:

- If you are defending a claim, consider whether there may be a right of set off that may be relevant.
- If the dispute arises out of a contract, check if there is a contractual provision relating to set off - either specifically providing for and allowing set off, or seeking to exclude that right.
- In the context of a construction contract, specific statutory rules govern payment in addition to the contract. Remember that a deduction (whether by way of set off or otherwise) can only be made if a valid pay less notice has been served. In the event of an adjudication, a defence of set off can be raised absent a pay less notice in defence of a claim for payment of additional non-certified sums.
- In the event that a counterparty to a contract is likely to become insolvent, review monies owed to that company and amounts owed to you so that you can be ready to validate any rights of set off that arise.

If you have any queries on this or related topics, please contact Sue Ryan or Ian Weatherall.
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