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Abatements, set-offs and counterclaims in arbitration proceedings

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INTRODUCTION

The scope for jurisdictional disputes is a major weakness of arbitration when compared to litigation. Such disputes frequently arise when one party to a reference seeks to raise matters that are not apparent on the face of the submission to arbitration in order to reduce or extinguish the other's claim or to advance a claim of its own.

It might be thought that agreement would readily be reached to extend the arbitrator's jurisdiction so that all disputes between the parties could be resolved. This is not always the case. There may be tactical advantages in limiting the scope of the arbitration and in forcing the other party to bring its cross-claims in separate proceedings. A quick resolution and a favourable result may be possible if the dispute is fought on a narrow front. The other party may lack the will or resources to pursue its allegations in separate proceedings. It may be more willing to compromise. Its allegations may be time-barred under the contract or by statute unless they can be raised in the current proceedings.[1]

Today, such jurisdictional disputes are unique to arbitration. This was not always the case. At common law the defendant to an action at law could not raise cross-claims against the plaintiff. These had to be the subject of a separate cross-action.

This rule was somewhat ameliorated by the Insolvent Debtors' Acts of 1729 and 1735 (the Set-Off Acts). It was abolished by the Judicature Act 1873 and the subsequent rules of court. Under section 24 of that Act, the new Supreme Court was given wide powers to resolve all matters of law or equity in dispute between the parties to an action so as to avoid multiplicity of litigation.[2] Henceforth, a defendant could, in its defence, raise matters of complaint against the plaintiff, whether or not these were within the ambit of the dispute defined by the originating process.

These procedural reforms are now embodied in section 49 of the Supreme Court Act 1981 and the current Rules of the Supreme Court. They do not apply to arbitration proceedings.

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[1] See, for example, *The Standard Ardour* [1988] 2 Lloyd's Rep. 159.
[2] There were similar reforms in the county courts.

An arbitrator's jurisdiction derives solely from the arbitration agreement and/or the submission of a particular dispute to him as arbitrator. Without the agreement of all the parties, he has no jurisdiction to consider other matters in dispute between the parties, even if this makes commercial sense or one of the parties wishes him to widen the reference.

For a dispute to be referable to arbitration, there must be a demand and a denial of liability founded on some principle of law or equity[3] and, in adjudicating on that dispute, the arbitrator must act in accordance with the principles of law and equity.[4]

It follows that an arbitrator has jurisdiction to hear any allegation made by the respondent against the claimant, whether or not the allegation was apparent on the face of the submission to arbitration, provided that it raises a legal or an equitable defence to the claim (a "substantive" defence). Where the allegation does not amount to a substantive defence, the arbitrator has no jurisdiction to hear it, unless it has been referred to him as a separate dispute in the submission to arbitration. The fact that it might amount to a "procedural" defence, admissible in court proceedings as a result of the Judicature Acts and subsequent legislation, is immaterial.

Thus, to identify when a dispute is referable to arbitration and to establish the scope of the arbitrator's jurisdiction over that dispute, it is necessary to distinguish between substantive and procedural defences. Unfortunately, this distinction has become blurred because of its reduced significance in court proceedings, following the procedural reforms discussed above.

There is no difficulty where the respondent simply denies the factual or legal basis of the claimant's case. This is a substantive defence. The claimant must prove its case.

Where, however, a party makes positive allegations against the other so as to reduce or extinguish the latter's claim, or to advance a cross-claim of its own, it becomes more difficult to identify whether these allegations give rise to a substantive or a procedural defence. The difference is best understood by considering the extent to which the common law allowed positive allegations against a plaintiff to be raised as defences prior to the Judicature Act 1873.

The common law rule that cross-claims could not be relied on as defences to an action, but had to be raised in separate proceedings, was subject to exceptions. A court of law allowed certain cross-claims to be relied on in abatement of the claim. By statute, some cross-claims could be set off against a claim. In a court of equity, a defendant could set up certain cross-claims to defeat a claim brought by bill in Chancery, or could rely on these as grounds for obtaining an injunction to restrain a claim at law until such time as they had been determined by the court.

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[3] *The Aries* [1977] 1 W.L.R. 185.
[4] *Leon Corporation v. Atlantic Lines* [1985] 2 Lloyd's Rep. 470.

This article discusses the nature of these common law exceptions and, by examining their characteristics as defences, seeks to identify those which can be relied upon as substantive defences in arbitration proceedings. It concludes by considering the place of the counterclaim in arbitration proceedings. Neither contractual rights of set-off, nor set-off in the event of insolvency under the Insolvency Act *1986,* are considered.

ABATEMENT AT LAW

Abatement developed as an exception to the principle that a court of law would not hear a defendant's cross-claim in the plaintiff's action. By the early nineteenth century it was established that in some cases a defendant to an action at law could raise, as a defence in that action, allegations of breach of contract against the plaintiff.

The nature of abatement at law

Abatement was, and remains, an extremely narrow defence. It appears to derive from a doctrine of partial failure of consideration.[5] It can only be relied on as a defence to liquidated claims arising out of contracts for the sale of goods or the supply of work and labour.[6] It does not, for instance, apply to contracts of carriage such as a voyage charterparty.[7]

For contracts for the sale of goods, this defence is now codified in section 53 of the Sale of Goods Act 1979. For contracts for work and materials, the common law continues[8] to apply.

Abatement is a shield, not a sword. The gist of the complaint is that, because of the supplier's breach of contract, the value of the goods or services supplied has been reduced at the date of supply. Other losses resulting from the plaintiff's default, for instance, costs incurred in repairing defects, cannot be set up to reduce the plaintiff's entitlement. They must be recovered in a separate cross-action.[9]

Breach of a collateral obligation, such as that resulting from a delay in delivery of goods sold or from a failure to enter into a maintenance contract relating to work previously supplied, cannot found an abatement at law.[10]

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[5] Chitty's *The Law of Contracts* (2nd Ed., London, 1834), at page 575; *Allen v. Cameron* (1833) 1 Cr. & M. 832.

[6] *Mondel v. Steel* (1841) 8 M.& W. 858 at pp. 871-872. "Work" is apparently a synonym for "materials", see *Bamford v. Harris* (1816) 1 Stark. 343.

[7] *The Aries* [1977] 1 W.L.R. 185 at p. 190. There is a related principle in the law of landlord and tenant, *Lee Parker v. Izzett* [1971] 1 W.L.R. 1673, *British Anzani v. International Marine* [1979] 2 All E.R. 1063 but *contra* see *Weigall v. Waiters* (1795) 6 T.R. 488.

[8] *Modern Engineering v. Gilbert-Ash* [1974] A.C. 689 at p. 717.

[9] *Mondel v. Steel*, n. 6 above.

[10] *Oastler v. Pound* (1863) 7 L.T. 832, *Re Asphaltic Wood Pavement Company* (1885) 30 Ch. D. 216.

The characteristics of abatement at law

Abatement has all the characteristics of a substantive defence. It reduces or extinguishes a debt otherwise payable. It is a "self help" remedy that can be exercised before court proceedings have commenced. For a time, it was suggested that abatement was a matter of court practice, not legal principle, but this does not reflect the present law and is at odds with the conceptual roots of abatement as a partial failure of consideration.[11]

A debt can be discharged after deducting a reasonable amount to allow for the diminution in value of the goods or services resulting from the matters giving rise to the abatement. Faced with such a tender, the payee cannot exercise its contractual or common law rights of forfeiture or termination. If the payor's reasonable estimate is shown to be incorrect, then arguably the payee's only remedy is recovery of the over-deduction.[12]

Abatement is a perpetual defence. It can be relied on whether or not a separate action based on the same allegations would be time barred under the contract or by the Statutes of Limitation.[13]

Because it has these characteristics of a substantive defence, allegations that give rise to an abatement create a dispute that is referable to arbitration. They can also be raised in arbitration proceedings, irrespective of whether or not they appear on the face of the submission to arbitration. The arbitrator's jurisdiction over such matters is implicit in the fact that disputes over the claimant's entitlement have been submitted to him.

STATUTORY SET-OFF

Under section 13 of the Act of 1729, as amended and made perpetual by sections 4 and 5 of the Act of 1735, a defendant to an action in debt could set off in that action debts owing to it by the plaintiff, in reduction or extinction of the judgment which would otherwise have been obtained by the plaintiff. But where the sums owed by the plaintiff to the defendant exceeded those owed to the plaintiff by the defendant, the excess had to be recovered in separate proceedings. This legislation was passed to remove the injustice whereby a defendant might be imprisoned for non-payment of a debt, while in fact being owed money by the plaintiff.[14]

Previously, equity had declined to interfere with the law where the debts were founded on unconnected transactions. Subsequently, equity followed the law and allowed statutory set-off against claims for liquidated sums commenced by bill in Chancery.[15]

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11 *Modern Engineering v. Gilbert Ash* [1974] A.C. 689 at p. 717, *Bow McLachloain v. Ship Camosun* [1909] A.C. 597, Lord Gorrell at p. 610

12 *The Nanfri* [1978] 2 Lloyd's Rep. 132, in particular Lord Denning M.R. at pp. 139-140 and Goff LJ. at p. 144. The discussion relates to equitable set-off but, arguably, the principles are equally applicable to abatement. Denning's judgment has been followed in later cases, such as *The Chrysovalandou Dyo* [1981] 1 Lloyd's Rep. 159.

13 *Henriksens Rederi v. Rolimpex, The Brede* [1974] 1 QB. 233 at p. 245.

14 *Stoke v. Taylor* (1880) 5 Q.B.D. 569, *Green v. Farmer* (1786) 4 Burr. 2214.

15 *Green v. Farmer* (1786) 4 Burr. at p. 2221, *Pellas v. Neptune Marine Insurance* (1879) 42 L.T. Rep. 35, *per* Bramwell L.J. at p. 37.

The nature of statutory set-off

Statutory set-off does not require a connection between the transactions underlying the two debts, provided that these subsist between the same parties in the same right, or in equity are regarded as doing so. The sum to be set off must, however, be due and payable at the date of commencement of the plaintiff's action and enforceable by cross action at that date. It must also be capable of being liquidated or ascertained with precision at the time of pleading.[16]

It has recently been held by the Court of Appeal that a statutory set-off can be raised against a claim for specific performance.[17] With respect, this decision cannot be supported, either on a construction of the relevant sections of the Set-Off Acts, or by the authorities on those sections prior to their repeal. The dissenting judgment by Kerr L.J., that, at most, the existence of a cross-debt only goes to the equity of granting specific performance, is to be preferred.

The characteristics of statutory set-off

The Statutes of Set-Off expressly created a procedural defence by enabling the defendant to raise a cross-claim for a debt in the plaintiff's action. Statutory set-off never acquired the characteristics of a substantive defence. The set-off only crystallises in the judgment of the court. Until then, there remain two distinct and separate debts. Statutory set-off is not a self help remedy. A debtor cannot discharge its obligations after deducting independent cross-debts owed by the creditor from the amount tendered.[18] It follows that, faced with such a tender, the creditor can, in principle, exercise any contractual or common law rights of forfeiture or termination available to it.

Statutory set-off is not a perpetual defence. Once the right to recover a debt is time-barred by contract or statute it cannot be relied upon as a set-off in subsequent court proceedings.[19]

The Statutes of Set-Off were progressively repealed during the nineteenth century, lastly by the Statute Law Revision and Civil Procedure Act 1883. These repeals were subject to savings for any principle or rule of law or equity previously established under the repealed legislation. The repealing statutes were subsequently repealed by the Supreme Court of Judicative (Consolidation) Act 1925, which, in turn, was repealed by the Supreme Court Act 1981. The saving was preserved.[20]

Neither the wording of the Statutes of Set-Off, nor judicial consideration of the relevant sections prior to their repeal, nor the history of their repeal,

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[16] *Walker v. Clements* (1850) 1 Q.B.D. 460, *Francis v. Dodsworth* (1847) 4 C.B. 202, *Weigall v. Walters* (1795) 6 T.R. 488, *Morley v. Inglis* (1837) 4 Bing. N.C. 58, *Axel Johnson v. M. G. Mineral Group* [1992] 2 All E.R. 163.
[17] *BICC v. Burndy* [1985] 1 All E.R. 417.
[18] *Re Hiram Maxim Lamp Company* [1903] 1 Ch. 70.
[19] *Smith v. Betty* [1903] 2 K.B. 317; *Walker v. Clements*, n. 16, above, *Francis v. Dodsworth*, n. 16, above.
[20] See s. 39 of the Act of 1925 and ss. 49 and 84(2) of the Act of 1981.

supports the view expressed by Mustill and Boyd[21] that a statutory set-off is a substantive defence that can be relied upon in arbitration proceedings.

Since a debt cannot be validly discharged after deducting cross-debts owed by the creditor to the debtor, there is, at the date of the creditor's demand, no dispute over its entitlement to the full sum claimed. If there is no dispute at that stage, there is nothing to submit to arbitration. The Statutes of Set-Off only created a right to have the sum awarded to the plaintiff in a judgment diminished or extinguished by a cross-debt which was pleaded in the action. For this right to extend to arbitration proceedings "judgment" would have to be construed widely to encompass any award by an arbitrator.

If statutory set-off could be relied upon as a substantive defence in arbitration proceedings, this would, in itself, lead to jurisdictional complications. An arbitrator would have no jurisdiction over the transaction underlying the cross-debt. This is, by definition, a separate transaction from that from which he derives jurisdiction. It may not contain an arbitration clause. There would be no jurisdiction to resolve disputes concerning the respondent's entitlement to the cross-debt, or to determine whether it was due and payable at the date of the submission to arbitration.[22]

It is submitted, therefore, that the better view is that statutory set-off cannot be raised as a substantive defence in arbitration proceedings. Any statutory set-off might, however, be grounds for resisting any *enforcement* of the award, provided that the cross-debt was payable prior to the commencement of the arbitration.[23]

EQUITABLE SET-OFF

Equity allowed a defendant to set up various equitable defences in opposition to a claim brought by bill in Chancery, allegations of misrepresentation or breach of trust being well-known examples. Thus, in certain circumstances, a defendant in equity could set up a cross-claim alleging that it had suffered loss because of the plaintiff's breach of contract as a defence to a claim arising out of the same contract. This particular equitable defence became known, somewhat unhappily, as equitable set-off.

Prior to the merger of the jurisdictions of law and equity, these equitable defences were not recognised by a court of law. Instead, a defendant at law had to apply by bill in Chancery for an injunction to restrain the action in law, or the enforcement of any judgment in that action, until such time

[21] Mustill and Boyd, *Commercial Arbitration* at p. 130.
[22] These difficulties are well illustrated by *Man v. Société Anonoyme Tripolitaine* [1970] 2 Lloyd's Rep. 416.
[23] Consider *Richards v. James* (1848) 2 Ex. 471.

as the matters alleged in that application had been determined in Chancery.[24]

The nature of equitable set-off

Not all cross-claims were recognised as equitable defences. In order to give rise to an equitable set-off the cross-claim had to raise an equity in the defendant's favour, which impeached the plaintiff's title to the claim.[25]

Piggott v. Williams[26] provides a good example of what was required. In that case an allegation of negligence against the plaintiff was recognised by the court as a good equitable defence to the plaintiff's action for foreclosure on property secured against unpaid fees and, by implication, as a good equitable defence to any action on the debt itself. The equity on which the defendant successfully relied was that the outstanding fees would not have been incurred, but for the plaintiff's negligence.

These strict requirements still find favour, particularly in the Commercial Court. For instance, in *The Nanfri*[27] the court held, in the context of a time charter, that, to give rise to an equitable set-off, the owner's neglect or default had to deprive the charterers of the use of the vessel or prejudice or hinder their use of it. This test for equitable set-off has been followed in subsequent cases.[28]

There is, however, a more nebulous test that is sometimes cited as allowing any counterclaim to be set off that arises out of and is inseparably connected with the dealings which give rise to the claim. From this test, it is but a short step to the proposition that any breach of contract can be set off in equity against a claim brought under the same contract.[29] Support for this more liberal test ultimately derives from three cases decided in the years following the judicature Act 1873. It is submitted that these cases are, in fact, of doubtful authority for the nature of equitable set-off prior to the merging of the jurisdictions of law and equity.

The first of these cases is *Young v. Kitchin.*[30] In a short judgment Cleasby B. stated that equity would not have allowed a claim by an assignee of a debt due for construction work to be enforced without taking into account the defendant's claims for damages for defects and delays in the assignor's performance of the contract.

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[24] *Mapleson v. Masini* (1879) 5 Q.B.D. 144; *Freeman v. Lomas* (1851) 9 Hare 109; *Bankes v. Jarvis* [1903] 1 K.B. 549.
[25] *Rawson v. Samuel* (1841) Cr. & Ph. 161, Lord Cottenham L.C. at p. 179. There is no suggestion that this equity arose out of an implied term of the contract, as suggested by the Court of Appeal in *Hermcrest v. Percy Trentham* (1991) 53 B.L.R. 104.
[26] (1821) 6 Madd. 95.
[27] [1978]2 Lloyd's Rep. 132, see, in particular, Lord Denning M.R. at p. 141 and Goff L.J. at p. 144.
[28] *The Leon* [1985] 2 Lloyd's Rep. 470, *British Anzani v. International Marine* [1980] Q.B. 137.
[29] *Douglas v. Bass Leisure* (1990) 53 B.L.R. 119.
[30] (1878) 3 Ex. D. 127.

The only case cited in support of this proposition was *Tooth v. Hallett.*[31] In that case a construction contract expressly gave the defendant the right to engage others to complete work left unfinished at the contract completion date. One issue was whether sums expended in completing the work pursuant to that clause could be set up in diminution of a claim for payment by an assignee of the builder. Not surprisingly, the court decided that they could. Such a complaint could have been relied on as an abatement had the claim been brought by the assignor. The principles of equitable set-off were not in issue. The case does not provide authority for the proposition that cross-claims for defects and delay can, without more, give rise to an equitable defence in an action between the original parties to a contract.

In consequence, *Young v. Kitchin is* of doubtful authority when considering the principles which a court of equity would have applied prior to the judicature Act *1873* in deciding whether or not matters alleged by a defendant gave rise to an equitable set-off.

The second case is *Banks v. Jarvis.*[32] The plaintiff brought an action as trustee on behalf of a beneficiary, her son, to recover sums due under a contract for sale of the son's leasehold estate and business entered into between her and the defendant. The defendant sought to defend the claim by relying on a counterclaim against the son for breach of repairing and indemnity covenants relating to the property. There was authority for the proposition that liquidated sums due from the beneficiary could be set off in an action for a debt brought by a trustee on behalf of that beneficiary. But no authority was cited which suggested that unliquidated claims against the beneficiary could be relied on in this way.

Both Lord Alverstone C.J. and Channell J. placed reliance on the wording of the Judicature Acts and, in particular subsection (3) of section 24 and Order XIX, rule 3, of the then current rules of court, in reaching the conclusion that unliquidated claims could be relied on in this way. Channell J. was quite explicit that Order XIX, rule 3, put unliquidated claims on the same footing as liquidated claims for the purposes *of* set-off Lord Alverstone C.J.'s judgment is more difficult to interpret. Nevertheless, in reaching his conclusion, he clearly relied on both section 24(3) and Order XIX, rule 3, in concluding that a counterclaim or equitable claim against the beneficiary could be relied on by the defendant to an action by the trustee, indicating a degree of agreement with Channell J.'s opinion on the substantive effect of these reforms.[33]

The court therefore reached its decision, at least in part, on the basis that the Judicature Act 1873 and Order XIX, rule 3, had altered the rights of the parties. This may be surprising given that the contrary view, namely, that these reforms were only procedural, had been adopted by the Court of Appeal some years previously.[34] Nevertheless, the possibility that Order

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[31] (1869) 4 Ch. App. 242.
[32] [1903] 1 K.B. 549; (1903) 88 L.T. 20.
[33] With respect, Lord Averstone C.J.'s reasoning does not appear to have been fully explored by Morris L.J. in *Hanak v. Green* [1958] 2 Q.B. 1.
[34] *Stunmore v. Campbell* [1892] 1 Q.B. 314 (CA).

XIX, rule 3, had altered rights, and not just procedure, was still an issue several years later when *Banks v. Jarvis* was cited in *Baker v. Adam*[35] as authority for such a proposition. The issue was side-stepped in that case.

Today, the orthodox position is that the reforms introduced by the Judicature Act 1873 and the related rules of court did not create new rights. They merely gave effect in the same proceedings to existing legal and equitable rights. In consequence, *Banks v. Jarvis* should be treated with caution as an authority for the nature of equitable defences prior to these reforms.

The third case is *Government of Newfoundland v. Newfoundland Railway*[36] where, at page *213,* Lord Hobhouse stated that:

> "Unliquidated damages may now be set off as between the original parties, and also against an assignee if flowing out of and inseparably connected with the dealings and transactions which also give rise to the subject of the assignment."

This passage was considered by Lord Brandon in *The Dominique.*[37] He expressed the view that it set out identical criteria for equitable set-off and for the "equities" which bound an assignee by virtue of subsection (6) of section 25 of the Judicature Act 1873, now section 136 of the Law of Property Act 1925. Thus, the suggested test for equitable set-off was: Did the defendant's cross-claim flow out of, and was it inseparably connected with, the dealings and transactions which gave rise to the claim?

With respect, this reading of the passage confuses the two separate issues being considered by Lord Hobhouse. The first part *of* the passage deals with set-off in actions between the parties to a contract. The thinking is clearly based on the, now discredited, *Banks v. Jarvis* reading of subsection (3) of section 24 of the Judicature Act 1873 and Order XIX, rule 3. The second part deals with a quite separate issue, namely, what equities bind an assignee under subsection (6) of section 25 of the judicature Act 1873? It is a quotation from Sir John Romilly M.R.'s judgment in *Smith v. Parkes*[38] concerning the extent to which a defendant can set off, in an action by the assignee of a debt, debts due to the defendant from the assignor which have not accrued at the date of the assignment. Read in context, this quotation has nothing to do with the characteristics of equitable set-off. In an action between the assignor and the defendant, such debts could have been relied on as a statutory set-off, provided that they were payable at the time the action was brought.

Recent cases that are generally regarded as supporting a less stringent test for equitable set-off than that laid down in *Rawson v. Samuel* rely on

[35] (1910) 102 L.T. Rep. 248, see also *McCreagh v. Judd* [1923] W.N. 174.
[36] (1888) 13 App. Cas. 199.
[37] [1989] 1 Lloyd's Rep. 431 at p. 438.
[38] (1852) 16 Beav. 115.

one or more of the above three authorities.[39] For the reasons outlined above, it is respectfully submitted that they are flawed and of doubtful value.

It is submitted that only those cases, or lines of reasoning, which derive their authority from *Rawson v. Samuel* are authoritative as to the true nature of equitable set-off. Such cases establish the principle that an equitable set-off can be relied upon where the allegations raised give rise to an equity which impeaches the plaintiff's tide to the demand; or, to put the test in more modem language, where the cross-claim alleges matters which can be identified as depriving the defendant of the benefit for which the plaintiff was demanding payment, or hinder or prejudice the defendant in the enjoyment of that benefit.[40]

Irrespective of whether a narrow or a wide view of equitable set-off is taken, it is incorrect to describe this defence as an equitable abatement. It is not restricted to showing how much less valuable the benefit obtained from the plaintiff has become by reason of the plaintiff's default. The defendant can set up, in diminution of the claim, losses incurred by reason of that default. The fact that such losses are difficult to ascertain may however, provide grounds for denying an equity to the defendant.[41]

The scope of equitable set-off is also wider than common law abatement. First, because it is not restricted to contracts for the sale of goods or for materials and labour. Secondly, because it may provide a defence to liquidated, as well as unliquidated, claims. Thirdly, because matters giving rise to this defence can, in principle, arise after the plaintiff's entitlement has accrued.

The application of equitable set-off to contracts other than those for goods or for materials and labour is well-established.[42] It has, however, been held by the House of Lords that it does not apply to an action for accrued freight under a voyage charterparty.[43] It is, however, available as a defence to an action for hire under a time charter.[44] It is difficult to find a theoretical justification for these distinctions.

The availability of equitable set-off against unliquidated claims is somewhat more controversial. In *Pellas v. Neptune Marine Insurance,*[45] Bramwell L.J. stated that equity would not allow set off of a liquidated demand against an action for damages. A similar position was adopted by the Divisional Court in *McCreagh v. Judd*.[46]

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[39] See, for example, *Hanak v. Green* [1958] 2 Q.B. 1, in particular the judgment of Sellers L.J. in *Dole Dried Fruit & Nut Co. v. Trustin Kirkwood* [1990] 2 Lloyd's Rep. *309, Modern Engineering v. Gilbert Ash* [1974] A.C. 689.
[40] *The Nanfri,* n. 12, above; *The Leon,* n. *28,* above; *British Anzani v. International Marine,* n. 28, above. See also, the alternative line of reasoning adopted by Lord Brandon in *The Dominique,* n. *37,* above.
[41] *Rawson v. Samuel*, n. 25, above.
[42] *Sim v. Rotherham MBC* [1986] 3 W.L.R. 851 at p. 885, *Piggott v. Williams*, n. 26, above.
[43] *The Aries*, n. 32, above; *The Dominique*, n. 37, above.
[44] *The Nanfri*, n. 12, above.
[45] (1879) 42 L.T. Rep. 32, at p. 37.
[46] [1923] W.N. 174.

The latter case was cited in argument in *Hanak v. Green*[47] where, however, the Court of Appeal allowed an unliquidated cross-claim to be relied on as an equitable set-off against a claim for damages for defective work.

Morris L.J. (with whom Hodson L.J. agreed) stated that, except for the counterclaim for trespass, which could not be set-off, the defendant's counterclaim was, in effect, a claim for extras to the contract. Since the question of what was an equitable set-off was a matter of law and not dependent upon the language used in the pleadings, the counterclaim and the plaintiff's claim relating to defects in the work could be set off against each other. It appears that the court circumvented *McCreagh v. Judd.* by, in effect, setting off the plaintiff's claim in diminution of the defendant's counterclaim for remuneration.[48]

Interpreted in this way this decision is consistent with *Rawson v. Samuel.* The issue is not whether the claim by one of the parties to an action is liquidated or unliquidated, but whether or not matters raised by the other party give rise to an equity which impeaches the title to that demand. This requirement is more likely to be satisfied where the claim is for remuneration for goods sold or hired, or for services, but there is no rule of equity which requires the claim to be for a liquidated amount. In fact, *Rawson v. Samuel* concerned a claim for damages and it was not suggested that this alone was sufficient reason to preclude the possibility of an equitable set-off.

The third issue concerns the timing of the matters which are relied upon by way of equitable set-off. It has recently been suggested in the Court of Appeal that matters giving rise to an equitable set-off can arise at any time up to the commencement of the plaintiff's action, but not thereafter.[49] This restriction, it is respectfully submitted, appears to rest on a misreading of *Richards v. James*.[50] In that case it was stated that, where matters giving rise to a set-off occurred after the close of pleadings, these could be pleaded *puis darrien countinuance,* in bar of the further continuance of the action.[51]

This possibility was also recognised by counsel in *Bedall v. Maitland*[52] and is consistent with the principle that equity would only grant an injunction to restrain an action, or enforcement of a judgment, at law where the matters relied upon for this relief had arisen before judgment was given in the action at law.[53]

The characteristics of equitable set-off

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[47] [1958] 2 Q.B. 1.
[48] *Hanak v. Green* [1958] 2 Q.B. 1 at p. 26.
[49] *Edmunds v. Lloyd Italico* [1986] 2 All E.R. 249.
[50] (1848) 2 Exch. 471.
[51] See *Le Bret v. Papillon* (1804) 4 East. 502 for the procedure, and ss. 83 and 84 of the Common Law Procedure Act 1854. Contrast *Richards v. James* (1848) 2 Ex. 471, which concerned statutory set-off.
[52] (1881) 17 Ch. D. 174.
[53] *Whyte v. O'Brien* (1824) 1 Sim. & St. 551, *Maw v. Ulyatt* (1861) 31 LJ.Ch. 33.

The characteristics of equitable set-off are suggestive of a substantive rather than a procedural defence. Equitable set-off is a shield, not a sword. The losses suffered by the defendant can be set up in diminution or extinction of the plaintiffs claim. It is a self-help remedy. A debt can be validly discharged after deduction of a reasonable sum to reflect the loss suffered because of the matters giving rise to the set-off. Faced with such a tender, the creditor cannot enforce any contractual or common law rights of termination or forfeiture which might otherwise be available to it.

Provided that the deduction was reasonable and made in good faith, the tender is valid even if, in fact, a lesser sum should have been deducted. The creditor's only remedy is recovery of the over-deduction.[54]

Nevertheless, because the matters giving rise to the set-off can be raised by a separate cross-action and, in law, prior to the Judicature Act 1873, had to be raised in this way, it has been suggested that equitable set-off is a procedural defence created by that legislation. Although this view is difficult to reconcile with the self-help nature of the defence, support for it is sometimes found in the suggestion that equitable set-off is not a perpetual defence, but is a remedy by way of action which can become statute-barred.

The general rule is that equitable remedies cannot be statute-barred.[55] Furthermore, merely by advancing such a defence, a defendant does not lose its character as defendant.[56] Arguably, however, an equitable set-off can become time-barred under section 35 of the Limitation Act 1980. This section provides that any claim, whether by way of set-off or counterclaim, is deemed to commence on the same day as the original action.

Despite the wording of this section, it is submitted that the better view is that equitable set-off is a perpetual defence. "Set-off" used in the context of section 35 of the Limitation Act 1980 should be construed as a reference to statutory set-off and as a codification of the rule in *Walker v. Clements,* discussed above. The confusion arises because of the inaccurate description of this particular equitable defence as a set-off.[57]

This construction is supported by consideration of the wording of section *24* of the Judicature Act 1873 and its successor, section 41 of the Supreme Court of Judicature (Consolidation) Act 1925.[58] These sections enabled matters which could formerly have been set up as defences in a court of equity, or relied upon in equity as grounds for restraining an action at law, to be raised as defences in actions commenced in the new Supreme Court. The word "set-off " does not appear in these sections. In

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[54] *Sim v. Rotherham M.B.C.* [1986] 3 W.L.R. 851, *The Nanfri* [1978] 2 Lloyd's Rep. 132, *The Chrysovalandou Dyo* [1981] 1 Lloyd's Rep. 159, *The Kostas Melas* [1981] 1 Lloyd's Rep. 18 at p. 26.
[55] See s. 36 of the Limitation Act 1980.
[56] *Mapleson v. Masini* (1879) 5 Q.B.D. 144.
[57] *The Brede* [1974] 1 Q.B. 233, in particular, Lord Denning M.R. at p. 245; *Aries Tanker v. Total Transport* [1977] 1 W.L.R. 185, in particular Lord Wilberforce at p. 189 and Lord Salmon at p. 196.
[58] See now sub-s. (2) of s. 49 of the Supreme Court Act 1981.

enacting the predecessor to section 35 of the Limitation Act 1980, namely section 29 of the Limitation Act 1939, Parliament must be taken to have been aware of the language used in this earlier legislation and to have used "set-off" to mean something other than the equitable defence of the same name.

If an equitable set-off could become statute-barred this would create an artificial distinction between this defence and abatement at law. This would be difficult to reconcile with the self-help nature of both remedies. It would prove a trap to the unwary debtor who has, quite legitimately, allowed for the set-off in discharging his debt, only to discover in a subsequent action by the creditor that the matters relied on by way of set off have become statute-barred.

If, as is suggested, equitable set-off has the characteristics of a substantive defence, allegations that give rise to this defence will create a dispute that is referable to arbitration. Furthermore, an arbitrator has jurisdiction to consider such allegations even where they are not expressly referred to in the submission to arbitration. They are implicit in the fact that a dispute over the claimant's entitlement has been referred to his jurisdiction.

Mustill and Boyd[59] appear to support the view that equitable set-off is a procedural defence and that, in consequence, cross-claims which give rise to this defence are not within an arbitrator's jurisdiction, unless expressly referred to in the submission to arbitration. It is submitted that this statement is unsupported by authority and, for the reasons discussed above, is wrong.

Difficulties may arise where the facts giving rise to the set-off occur after the reference to arbitration. The equitable principle that such matters can be relied on in bar of the further maintenance of the action, is at odds with the rule that an arbitrator has no jurisdiction over disputes which were not in existence at the date of the submission.[60]

This difficulty is not unique to equitable set-off. There are other matters, such as release, which could be relied on at common law as bars to the further maintenance of the plaintiff's action despite having arisen after the commencement of that action.[61] 61 If "dispute" is construed widely so as to include all denials of liability on legal and equitable grounds, such matters should come within the arbitrator's jurisdiction. If construed narrowly, as referring only to allegations which could have been raised at the time of the submission, such matters would be excluded. If the latter view is favoured they might, however, provide grounds for obtaining a court injunction to restrain further proceedings in the arbitration or for resisting the enforcement of any award.[62]

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[59] Mustill and Boyd, *Commercial Arbitration* at p. 130.
[60] *London and North Western Railway v. Billington* [1899] A.C. 79.
[61] For a modern example, see *Morrison v. Hillman* [1961] 2 All E.R. 891.
[62] Mustill and Boyd at p. 522.

COUNTERCLAIMS

A defendant could not, at common law, raise cross-claims in the plaintiff's action that did not fall within one or other of the exceptions discussed above. This right was created by section 24 subsection (3) of the judicature Act 1873 and Order XIX, rule 3, of the associated rules of court.[63] A cross-claim which could, under these provisions and their successors, be raised in the plaintiff's action is known as a counterclaim.

A counterclaim is not simply a shield. For all purposes except execution of judgment the claim and the counterclaim remain independent actions with separate judgments and separate cost orders. They are heard together, where convenient, simply as a matter of procedure and in order to prevent circularity of action.[64]

As discussed above, these procedural reforms do not apply to arbitrations. In such proceedings the concept of the counterclaim has no place. The arbitrator has jurisdiction only over those disputes which have been submitted to him. Where a claim is met by a cross-claim that does not amount to a substantive defence, there is no denial, either in law or equity, of the claimant's entitlement and no dispute about that entitlement that can be referred to arbitration. Similarly, where such matters are raised for the first time after the submission to arbitration, the arbitrator has no jurisdiction to hear them, unless they were expressly referred to as a separate dispute within the submission to arbitration.

A wider interpretation of "dispute" than that suggested above was adopted in *Russell v. Pelligrini*.[65] In that case the court held that a stay to arbitration could be ordered under section 11 of the Common Law Procedure Act 1854, the predecessor to subsection (1) of section 4 of the Arbitration Act 1950, even though it was accepted that the defendant's cross-claim alleging unseaworthiness did not amount to a defence at law to the plaintiffs claim for hire under a time charter. The court considered that there was, nevertheless, a dispute capable of submission to arbitration. The possibility that the defendant's allegation of unseaworthiness could give rise to a defence in equity was not considered. In a later case, similar reasoning was adopted where the claim was for freight under a voyage charterparty, where there was not even the possibility of an equitable set-off.[66]

The opposite view was taken in *Daunt v. Lazand*,[67] where Bramwell B. criticised the decision in *Russell v. Pelligrini* and suggested that his court would not allow a reference to arbitration if the matter was not available as a defence to, or in reduction of damages in, the action, but could only be raised by a cross-claim in another action.

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[63] See also, s. 25 of the Supreme Court of Judicature (Consolidation) Act 1925 and now s. 49 of the Supreme Court Act 1981 and R.S.C. Ord. 15, rr. 2 and 5, and Order 18, r. 17.
[64] *Stunmore v. Campbell* [1892] 1 Q.B. 314, *Stoke v. Taylor* (1880) 5 QB.D. 569.
[65] (1856) 6 E. & B. 1020.
[66] *Seligmann v. Le Boutillier* (1866) L.R. 1 C.P. 681.
[67] (1858) 27 L.J. Ex. 399.

It is the latter view which has prevailed. *Russell v. Pelligrini* has been distinguished on its facts, and is regarded as of doubtful authority. It is now generally accepted that only matters amounting to a denial of liability in law or in equity constitute a dispute capable of reference to arbitration.[68]

CONCLUSION

Where disputes concerning a contractual entitlement are submitted to arbitration, an arbitrator has no jurisdiction to hear cross-claims advanced by the respondent against the claimant, unless he is expressly given this jurisdiction by the parties. Nevertheless he has jurisdiction to hear cross-claims, even in the absence of such agreement, where they amount to substantive defences in law or equity.

Both abatement at law and equitable set-off are substantive defences. They have narrow, but well-defined, limits. Where the facts and matters relied upon by the respondent come within these limits, an arbitrator should consider them; but only in so far as they are relied upon as a shield to reduce or extinguish the claimant's entitlement.

An arbitrator has no jurisdiction to hear cross-claims that are admissible in court proceedings only as a result of the statutory reform of court procedure.

Both statutory set-off and the counterclaim are procedural defences which can be raised in a court of law only because of the reforms introduced by the Set-Off Acts 1729 and 1735 and the Judicature Act 1873, respectively. These reforms do not extend to arbitration proceedings. An arbitrator has no jurisdiction to consider such cross-claims unless his jurisdiction has been expressly extended by the parties to cover such matters; for instance, by appropriate wording in the submission to arbitration, by the choice of suitable rules of procedure, or by an *ad hoc* written agreement.

[68] *The Alfa Nord* [1977] 2 Lloyd's Rep. 434, *Nova (Jersey) Knit v. Kammgarn* [1977] 1 Lloyd's Rep. 463.