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C. W. Burt
Cornell Law School

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Recommended Citation
Burt, C. W., "The Doctrine of Set-Off in Equity as Effected by Insolvency" (1893). *Historical Theses and Dissertations Collection.* Paper 312.

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T H E S I S

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THE DOCTRINE OF SET-OFF IN EQUITY AS EFFECTED BY INSOLVENCY

-By-

C. W. B u r t

Cornell University Law School

1893

The right of a defendant when an action is begun against him to plead in bar some claim holden by him running against the complainant, upon which the complainant is liable in a present cause of action is known as the right or doctrine of set-off. This doctrine is essentially a doctrine of equity and existed in equity(though sometimes doubted)long before the statutes allowing set-off at law ; because, the courts of equity said :- "natural justice and equity dictate that the demands of parties mutually indebted should be set-off against each other and only the balance be recovered. But notwithstanding the fact that from early Common Law times the doctrine of set-off was applied with considerable liberality in equity and in spite of the fact that the analogous doctrine of compensation as applied in the Roman Law was continually before the judges, the Common Law courts did not recognize its existence and required that each claim must be prosecuted separately for the purpose of simplicity of procedure. "The natural sense of mankind", says Lord Mansfield, was first shocked at this in the case of bankrupts and it was provided by statutes passed during the reign of Anne that in case of bankruptcy set-off would

be allowed in law as well as in equity, and by statute of 5 Geo. II e 30 this right of set-off was extended to all cases of mutual debts. These statutes did not take away the original jurisdiction which equity had acquired but merely extended it to courts of law allowing them the right to set-off in many cases where it was not before allowed in equity.

In construing and interpreting these statutes the courts of law formulated a number of rules. They required that the demand sought to be set-off, 1st, a legal cause of action ex contractu existing at the commencement of the suit. 2nd, the set-off must be against the complainant in the same capacity in which he sues and 3rd, the demands must be liquidated. As "equity follows the law", courts of equity in construing the same statutes when they came before them observed and applied the same rules as were applied in the Common Law tribunals. Equity will not as a general rule allow a set-off in any case where it would have been denied at law. But to this there is an exception. A court of equity being a court of conscience will where by reason of some additional natural equity the law works injustice go beyond the

statute and allow a set-off without regard to the fixed rules of law. Insolvency in all jurisdictions is recognized as such an additional equity as will to a greater or less extent vary the legal rules as laid down by the courts in their respective states.

We will now proceed to examine how far equity has interfered and varied the legal rules in cases of insolvency and in so doing the first rule to be considered and the one of greatest importance is that the debt sought to be set-off must be an existing cause of action. This rule has been before the courts of this country the most frequently andthe conclusions arrived at differ more widely than the conclusions upon either of the other rules. In reference to this question the states may be said to divide themselves into two groups. The 1st group of which it may be said New York is a typical example, keeps very close to the legal rules, only allowing the set-off in such cases as it would be allowed at law while the 2nd group represented by Tennessee takes a very liberal view allowing a set-off in all cases whether the amount be due and an existing cause of action or not.

The cases which arise and in which it is sought to

obtain a set-off of an unmatured claim may also be said to be of two kinds :- 1st, where at the time of the insolvency the claim <u>against the defendant</u> was not yet due but the claim of the defendant <u>against the insolvent</u> which it is sought to off-set is due and 2nd, where the claim sued upon was due at the time of the insolvency but the claim sought to be set-off by the defendant is not yet due.

And first in reference to the decisions in states where the rules of law are strictly followed. This first question was decided early in New York state in the case of Lindsay v. Paige and has since been passed upon several times the last being the case of Richards v. LaTourette In this case the complainant was an assignee in insolvency of a bank. The bank at the time of its failure owned a bond and mortgage upon which the defendant was liable but which was not due at the time of the assignment. The defendant also had a sum of money on deposit in the bank at the time of the assignment and now claims in this action to foreclose the mortgage the right to set-off the amount of the deposit against the amount of the bond. The lower court in this case denied the right

upon the sole ground that at the time of the assignment to the plaintiff the debt due to the plaintiff was not yet matured. But upon appeal to the highest court the set-off was allowed and the reason and justice of the decision is evident. Here "A" had a claim against "B" and transferred it to "C" as assignee in insolvency. At the time of the assignement to "C" by "A" the claim against "B" was not yet due but the claim in favor of "B" against "A" is due. When the claim matures "C" sues "B" and the debt sought to be set-off by "B" was due at the time of the assignment. Consequently there is no contract which is being interfered with so far as the claim sought to be set-off is concerned, that is the claim owing <u>by</u> the plaintiff. But it is the claim owing <u>to</u> the plaintiff which was not due at the time of the assignment and it is the defendant who is prejudiced if any one by the set-off, waiving the credit to which he was still entitled. Consequently if he insists on the payment he is merely relinquishing a right to delay payment of that which he will owe and the contract and rights of the other party are in no way interfered with.

The 2nd class of cases to be considered is where the

claim sued upon was due at the time of the assignment in insolvency, but the claim sought to be set-off by the defendant has not yet matured or had not matured at the time of the insolvency. This question arose in the early New York case of Bradley v. Angell. In this case a ~~sint~~ suit was brought by the assignees in insolvency upon a book account and it was sought to set-off in this action three notes of the defendant which were not yet matured because of the insolvency of the complainant and it was sought by the defendant to justify this set-off upon the reasoning applied in the first class of cases already considered. But the court said :- "There is no analogy between the case cited and the present. Where a debt is due from the insolvent debtor the right of the creditor to payment is absolute. Natural equity and law unite in binding the debtor to a fulfillment of his obligation. Equity by compelling a set-off under such circumstances with the consent of the person entitled to the credit and where 3rd, persons are not injured follows the law. It creates no new obligation and deprives the insolvent of no right or privelege which he could justly exercise. By allowing a set-off in this case the assignee would be

deprived of a legal right secured to the assignor by contract and the complainants would obtain payment of their debt before it became due and to the prejudice of other creditors of the insolvent". It would seem as though this case would have settled the question as to the right of a defendant to set-off an unmatured obligation on the ground of insolvency in New York but notwithstanding the apparent plainness of the decision we find the Supreme Court as late as 42 Hun. holding that insolvency is a sufficient equity to justify set-off of an unmatured note. This was a very peculiar case and led to a great deal of uncertainty as to what the law was upon this point. In this case the plaintiffs became liable upon a note of the defendant relying upon the representation of the defendant that the note was "as good as gold". Upon the maturity of the note the complainants were compelled to pay it. At the time the note was given the firm was and has since been insolvent and upon a day subsequent but <u>prior to the maturity of the note made an assignment for the benefit of creditors</u>. The complainant asks to have the amount of this note set-off against an indebtedness owing from him to the firm and strange to say in spite of

Bradley v. Angell the court allowed the set-off. The judge in his opinion basing his decision upon the following reasoning, says "The court as we have seen has found the makers of this note were at the time of the delivery of the note to the plaintiff insolvent and that all that was necessary to make the complainants liable as indorsers upon the note was the presentation of the note at its maturity, demanding payment,and serving of notice of non-payment. This contingency did not depend upon any act of the makers or the defendants. A court of equity has the power to permit an equitable set-off in cases not within the statute, if from the nature of the claim or the situation of the parties justice cannot be obtained by a cross action, and that even though the debt of the complainant to the defendant is not due if the defendant is insolvent". This case was carried to the court of appeals and was there affirmed but upon an entirely different ground. When the court looked over the situation they said while we will not depart from the will[1] that the debt must be an existing cause of action yet we will affirm the decision of the lower court because the debt sought to be set-off is actually due. When the complain-

ant obtained the endorsement by means of a false representation a right of action in the nature of assumpsit was created and such claim is a proper subject of set-off in an action brought by a party against whom it exists. The judge says :- "This money thus obtained is in contemplation of law money received for the use of the party who is defrauded and the law implies a promise on the part of the person who obtains it to return it to the rightful owner". It was this decision which misled the business men of the state and not only the business men but the courts were also in doubt as to what was supposed would be the attitude of the higher court when the question as to whether the set-off of an unmatured claim would be allowed came fairly before the court for its decision. From the result reached by the Court of Appeals in Rothchilds v. Mack the Supreme Court came to the conclusion that the Court of Appeals would uphold the doctrine as unqualifiedly laid down by them in that case and accordingly when the question again came before them in Fera v. Wickleam they again held (relying upon the statement of the Court of Appeals in Rothchilds v. Mack that the correctness of the decision was not intended to be denied

and that it was left without either affirming or disaffirming the view expressed by the general term) under a similar statement of fact that the set-off should be allowed. This last case was however also taken to the Court of Appeals and this time the question was squarely passed upon and decided that the debt sought to be set-off must be an existing cause of action irrespective of the equity of insolvency. The judge says :-"When a party asks to have set-off against a demand upon him held by an assignee in insolvency for the benefit of creditors a claim against the insolvent estate it will be allowed, provided his was a claim upon the estate which was due when the assignment was made upon the ground that by reason of the existence of cross demands at the time of the assignment which were due(or might have been due at the creditors election) an equitable adjustment by set-off is made without interfering with the equities of others. But after the estate has passed to an assignee upon a trust to hold for and to distribute among creditors the former and natural equity disappears in superior equities vesting in the general body of creditors. They are then interested in having equality of distribution and if a

creditor who when the assignment was made had no right to an offset may be allowed it afterwards he gains a preference. By the intervention of the rights of third parties under the assignment the equities change with the change in the situation of the original parties to the misfortune of the creditor holding the demand against the insolvent estate but nevertheless in accordance with equitable principles as I deduce them from the decisions".

Thus far we have considered cases where insolvency was the sole equity upon which it was sought to uphold the defendants right to a set-off of a yet unmatured claim, but there is a modification of this rule found in the New York cases which tends to soften the apparent rigidity of the legal rules of set-off and that is that wherever the court can say that there is an express or implied agreement that the unmatured debt shall be set-off against the debt due such set-off will be allowed and the courts it would seem are very liberal in trying to find an agreement especially where injustice would arise if the set-off were not allowed. As to the nature of this agreement and what is necessary in order to enoble the defendant to set-off the unmatured liability there is a

good deal of uncertainty. In Coates v. Donnell the only case which the question has been squarely before the court it was held that an oral agreement was sufficient. But in this case the facts were peculiar : Donnell Lawson & Co. bankers in New York incurred liability as acceptors on certain drafts drawn by the Mastin Bank on agreement of the latter's cashier that the Mastin Bank would keep a deposit with Donnell Lawson & Co. and that Donnell Lawson & Co. could keep so much of the deposit as was necessary to pay acceptances or prevent loss thereon. The Mastin Bank failed before the acceptance matured. A suit by the assignee of the Mastin Bank was brought to recover the amount of the deposit for the benefit of the creditors in general and this oral agreement was set up as a defense to the action and as the grounds for allowing the set-off. It is to be noted that in this case the property to be set-off and upon which the lien was created was actually transferred to the pledgee so that the objection as to a secret lien being created the property meanwhile remaining in the general owner was avoided. The conclusion to be drawn from this case would seem to be that 1st, the agreement must not be of such a nature

as to violate the statute against preferences in voluntary general assignments and 2nd, it must not be liable to attack on the ground of a secret lien in fraud of creditors. The form of the agreement must of necessity vary with the circumstances of the transaction. Where the debt sought to be set-off is transferred to the party seeking the set-off in pledge the presumption of fraud is negatived by the transfer of the possession in other cases the chattel mortgage duly filed would accomplish the same result.

We now come to consider the second group of states of which it may be said Tennessee is a typical example and in which state the question has been carefully considered in a recent case of Nashville Trust Co. & Bank and an opposite conclusion reached to the one arrived at by the New York courts. In this case a manufacturing company made a general assignment to the complainant for the benefit of creditors. At the date of the assignment the assignor company had on deposit in the bank a large sum of money and the bank held its four notes for borrowed money none of which were due at the time the assignment was made. In a suit brought by the assignee in

insolvency to recover the deposit the defendant claimed the right to set-off these unmatured notes and the court allowed the set-off to be made upon the exactly opposite reasoning to that adopted by the courts of New York. The court in this case says "this is not preference to one creditor over another . It is only the balance remaining in favor of the estate after all joint settlements with debtors that gives into the fund for distribution". This view of the Tennessee courts is also the probable view of the United States courts as is seen in the case of Schuler v. Israel where a bank was garnished by the creditors of an insolvent depositor. The depositor was indebted to the bank in various sums some of which had and others had not matured at the time of the garnishment The supreme court says "As Israel(the depositor) was insolvent at the time of the service ofthe garnishee process we are of the opinion that the bank had a right to appropriate any money in its hands to the security and payment of these obligations <u>whether</u> <u>due</u> <u>or</u> <u>not</u>". "And while it may be true that in a suit brought by Israel against the bank it could in an ordinary action at law only make plea of set-off of so much of Israel's debt to

the bank as was then due it could by filing a bill in chancery in such case alleging Israel's insolvency and that it was compelled to pay its own debt to Israel the debt which Israel owed it but which was not due would be lost be relieved by a proper decree in equity".

From these cases it is apparent that the tendency of the courts in those jurisdictions where the law has not been settled is to adopt the more liberal view and to allow the set-off with greater freedom. This view would seem to be supported by the most equitable course of reasoning not only as regards the rights of the parties to the controversy themselves but also as to the rights of 3rd parties. In the first place we have the general principle of equity that a set-off will be allowed when the party appears in good conscience to be entitled to it and there are no opposing equal or superior equities which will be defeated. If both parties were solvent so that both debts might ultimately be collected the law would afford adequate relief and there would be no injustice wrought to either. One party would not suffer by being compelled to pay his debt if he might ultimately compel the other to pay his debt according to his contract

But in this case if the one pays the debt due from him he cannot compel payment of the debt due to him and will thereby suffer irreparible loss and this taken together with the fact of his inability to protect himself by set-off at law because his debt is not due create a necessity for equitable relief. If equity will not grant the set-off it will allow the insolvent to say that his contract is violated and thereby defeat the manifest equity of the defendant. It would seem that a court of equity which looks at the "substance of things rather than the form" ought not to be so careful of the rights of one party to the contract as to refuse to permit a slight variance as to him when it can be plainly seen that thereby it will wholly destroy the contract as to the other party. 2nd, so far as the creditors in case of a voluntary general assignment are concerned it would seem that the defendant seeking to off set an unmatured obligation also has the greater equity. The object of the voluntary general assignment is to do equal justice to all the creditors by dividing the assets amongst them. The assets of insolvent persons are only the balance due the insolvent estate after deducting all proper credits

and set-offs. To refuse the right would be to give other creditors a preference over the creditor seeking the set-off and would work injustice to the latter by compelling him to pay in full what he owes to the insolvent and take a pro. rata on what the insolvent owes him.

The distinction between the cases arising under the statutes of bankruptcy and those arising under the general statutes of set-off is to be kept in mind. Under the statute of 4 Anne it was provided that in case of bankruptcy a set-off of all claim should be allowed wherever there were mutual debts <u>or mutual credits</u>. The expression mutual credits is a term of broader significance than mutual debts and includes cases which did not come within the ordinary statute of set-off. By mutual credit is meant "a knowledge on both sides of an existing debt due to one party and a credit by the other party founded upon and trusting to such debt as a means of discharging it". In construing this statute of 4 Anne the courts were very liberal and it was held to include cases where the debt from the defendant was not yet due. In some states a statute of mutual debts and credits has been enacted corresponding to the English statute. Thus

for instance in Massachusetts under the state bankrupt law it is held that a balance should be struck and all claims be allowed to be set-off whether due or not while in the same state in case of voluntary general assignment the debt sought to be set-off in an action by an assignee in insolvency must have been due at the time of the assignment. The New York statute prior to the adoption of the code was also of a similar nature. But this provision of the English statute has practically become a matter of history as the modern statutes have extended the right of set-off much further than could have been done formerly under the statutes of bankruptcy. Most if not all of them allowing the set-off of any cause of action existing at the commencement of the suit irrespective of the doctrine of mutual credit as for example the New York code provision sec. 502. But there is one important jurisdiction where the doctrine is still applied and that is in the United States courts. In these courts there being no statute of set-off the courts are left to the Common Law. And in cases where the justice of the situation demands the court will apply the doctrine of mutual credits and allow the set-off even though not yet

due. Thus in a recent case the court held "although the debt sought to be set-off was not yet due yet as the one debt was contracted upon the faith of the other and one of the parties being insolvent they would apply the doctrine of mutual credits and allow the debt to be set-off".

We now come to consider the second rule as laid down by the courts of law in construing the statutes of set-off and that is that the debts must be mutual. By this is meant the debt sought to be set-off must be due from the complainant in the same right in which he sued. Thus a set-off arising out of affairs in which not only the parties to the suit but others are interested cannot be made available as a defense. If "A" bring an action against "B" the defendant cannot plead a note executed by "A" and "C" jointly. This rule was applied with great strictness at the common law and equity in cases where no other additional natural equity will apply the same rule. But notwithstanding this fact in most jurisdictions when insolvency intervenes equity will allow a set-off of a joint of legation against a separate one and vice versa. Thus in Brewer v. Norcross 2 CEG. a bill was filed by one partner against another for an account-

ing. The defendant partner set up by way of defense several outside accounts against the complainant alleging his insolvency. The court laid down the rule that "courts of equity look beyond the form of the contract to its real character and beyond the nominal parties, to the parties to be affected by the decree.Wherever it is necessary to effect a clear equity or to prevent irremediable injustice the set-off will be allowed though the debts are not mutual. In cases of insolvency or of joint credit given on account of individual indebtedness or where the joint debt is a mere security for the separate debt of the principal the equity is obvious and the set-off will be allowed". It may be said that the courts are in harmony upon this rule whether they follow the common law rules strictly or not and where insolvency intervenes all allow the set-off.(I)

We must here note two exceptions to the last rule 1st, in the case of savings banks where it is sought in a suit by the assignee in insolvency of the bank to set-off the amount of a deposit in the insolvent bank, and

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(I)Williams v. Noble, 3 Mer. 618 ; Dale v. Cooke, 4 Jh. Ch. R. 13 ; Blake v. Langdon, 19 Vt. 494 Receivers V. Pat. Gas Co., 283.

2nd, in case of set-off in a suit brought by the receiver of a corporation to recover the amount of an unpaid subscription in both cases the right to set-off is denied in all jurisdictions. In the case of an insolvent savings bank the set-off is denied because of the peculiar character of the corporation itself. The assets of the banks are its invested funds ; the common contributions of all the depositors in which they all have a common interest, as each depositor is entitled to his prpportionate share of the profits so in equity should each bear his proportionate share of the losses. In case of insolvency to allow the set-off to be made would give an unjust preference to debtor depositors over all the others.(I) In the case of the suit by a receiver to recover the balance unpaid upon a stock subscription the right to set-off is denied upon the familiar theory that the capital stock is a trust fund for the benefit of creditors.(2)

After a consideration of the recent cases which have been decided the conclusion is inevitable that in all

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(I) Osborn v. Bryne, 43 Conn. 155.
(2) Williams v. Traphager, 38 N J. E.57.

jurisdictions where the law is not yet settled the tendency of the courts is to depart from the narrow view taken by such states as New York where the questions were early settled according to the English rule and to broaden the doctrine step by step until it assumes a similarity to the Roman "compensation" where the mere fact that cross demands exist works their extinguishment by operation of law. Probably no state will apply the Roman doctrine to its fullest extent but it should at least be liberally expounded to advance justice and prevent circuity of action.