

Equitable set-off under the new REINZ/ADLS Agreement for Sale and Purchase

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The latest edition of the REINZ/ADLS Agreement for Sale and Purchase (Ninth Edition 2012) ("ADLS Agreement") includes much needed provisions for the deduction on settlement of compensation for claims of equitable set-off. This article examines the potential application of these provisions, how they operate in practice, and the risks where a claim subsequently fails.

What is equitable set-off?

Equitable set-off is a defence to a claim by a plaintiff on the basis that there is a cross-complaint by the defendant that needs to be taken into account in determining the plaintiff's claim against the defendant. The leading case in New Zealand is the Court of Appeal decision in *Grant v NZMC Ltd*.¹

In that case, the Court of Appeal provided an often cited and succinct statement of the principle:

The principle is, we think, clear. The defendant may set-off a cross-claim which so affects the plaintiff's claim that it would be unjust to allow the plaintiff to have judgment without bringing the cross-claim to account. The link must be such that the two are in effect interdependent: judgment on one cannot fairly be given without regard to the other; the defendant's claim calls into question or impeaches the plaintiff's demand. It is neither necessary, nor decisive, that claim and cross-claim arise out of the same contract.

The doctrine of equitable set-off often arises in the context of contracts for the sale and purchase of property where the purchaser asserts a breach of a term of the contract, or misrepresentation as provided for in the Contractual Remedies Act 1979, and the purchaser determines that it either cannot, or will not, cancel the contract. In such a case, the purchaser may be able to claim a right to equitable set-off against the purchase price for the property.

By way of example, if agreed chattels are not provided on settlement the purchaser may claim a right to equitable set-off for the losses resulting from the failure to provide those chattels. Or, if the vendor of a property misrepresents the boundary of the property the purchaser may claim a right to equitable set-off for damages for the misrepresentation.

The right to equitable set-off may co-exist with a right of cancellation under section 7 of the Contractual Remedies Act 1979. In such a case, the purchaser will need to make an election as to whether to cancel or to affirm the contract.

In these circumstances, it is prudent to carefully consider the terms of the agreement and the surrounding facts to determine whether a right of cancellation arises. Wrongful cancellation may amount to repudiation entitling the vendor to seek damages from the purchaser.

¹ [1989] 1 NZLR 8.

Because the doctrine of equitable set-off is not constrained by any requirement that the claim and cross-claim must arise out of the same contract, it is also conceivable that a claim to equitable set-off against the purchase price could arise outside the terms of the contract, provided that there is a sufficient link between the two claims. Such a situation may arise where the Agreement for Sale and Purchase is incidental to other arrangements between the parties, such as a broader settlement agreement.

How do the provisions in the ADLS Agreement operate in practice?

If a purchaser elects to raise a claim to equitable set-off, clause 7.1 of the ADLS Agreement obliges the purchaser to give notice in writing of the particular matters in respect of which compensation is claimed; the purchaser must provide a genuine pre-estimate of the loss suffered by the purchaser; and the claim must be particularised and quantified to the extent reasonably possible as at the date of the notice. The notice must be served on the vendor prior to settlement.²

If the amount of the compensation is agreed between the parties then this is deducted on settlement. However, in the absence of agreement clause 7.4 provides a process to determine an interim amount as compensation to be deducted.

The interim amount is to be determined by an experienced property solicitor and if the parties cannot agree on one, the appointment is to be made by the President of the New Zealand Law Society on the application of either party.

The interim amount is to be held by a stakeholder on interest-bearing call deposit with a bank registered under the Reserve Bank of New Zealand Act 1989 in the joint names of the vendor and the purchaser. If the parties cannot agree on the stakeholder, the stakeholder is to be that person nominated on the application of either party by the President of the New Zealand Law Society.

The process laid out by clause 7.4 of the ADLS Agreement may in practice often need to happen within a very short time period and the ADLS Agreement is silent on any extension of time for settlement in the event that the interim amount has not yet been determined by the “experienced property solicitor”.

In such a case, two potential arguments are available, namely:

- a) That clause 3.15 of the ADLS Agreement operates to defer settlement on the basis that neither party is ready, willing and able to settle. Clause 3.15 states:

In every case, if neither party is ready, willing and able to settle on the settlement date, the settlement date shall be deferred to the third working day following the date upon which one of the parties gives notice that it has become ready, willing and able to settle.

- b) That the purchaser is in default of its obligation to settle and the vendor therefore has the available rights and remedies on default, including any right to issue a settlement notice

² The notice provisions in clause 1.3 of the ADLS Agreement must be adhered to.

and any right of cancellation that may arise, either under the express provisions of the ADLS Agreement, or under the Contractual Remedies Act 1979.

While the first argument appears the most immediately attractive, an interesting analysis arises where the purchaser raises a claim of equitable set-off, the vendor denies any entitlement, cancels the agreement while the interim amount is being determined, and it is subsequently determined that no interim amount ought to be deducted. For the purchaser, it may be argued that it was entitled to raise a claim to equitable set-off and have that determined under the contractual provisions with settlement being deferred accordingly. However, for the vendor it may be argued that because there was no right to equitable set-off, settlement was required to proceed on the scheduled settlement date and failure to do so gives rise to an entitlement to issue a settlement notice and/or gives rise to a right of cancellation.

An express right of cancellation under the ADLS Agreement is available where a settlement notice has been issued by either party and has not been complied with. However, a settlement notice is only effective if the party serving it is, at the time of service, either in all material respects ready, able and willing to proceed to settle in accordance with this agreement, or is not so ready, able and willing to settle only by reason of the default or omission of the other party. Accordingly, the issue will turn on whether a vendor, who denies any right to equitable set-off by the purchaser, is deemed to be ready, willing and able to settle notwithstanding that there is a process in place for determination of an interim amount on settlement.

Because the cancellation provisions in the ADLS Agreement are without prejudice to existing rights or remedies, a right of cancellation may also arise under section 7 of the Contractual Remedies Act 1979.

If the vendor purports to cancel the contract and such cancellation is subsequently determined to be without right, the vendor may find itself facing a claim for damages. A wrongful cancellation will amount to a repudiation of the contract and the purchaser can either cancel the agreement and seek damages, or seek an order for specific performance (compelling the vendor to complete the sale). Of course, if the vendor subsequently attempts to sell the property to another purchaser, this adds another layer of difficulty due to the competing interests in the property.

Cancelling any contract carries with it substantial risk, and all available options and the potential outcomes ought to be considered before doing so. In many cases, it is likely to be prudent to determine an interim amount to be deducted and then seek to resolve that dispute as a collateral issue.

The determination of the interim amount should be resolved as soon as possible, whether or not there is agreement between the parties as to the amount to be deducted. Absent agreement, an application to the President of the New Zealand Law Society ought to be made for the appointment of an “experienced property lawyer” and stakeholder.

The Law Society requires certain information before it will make such an appointment and also charges a fee for the service. The Law Society ought to be advised of the settlement date and requested to make an appointment with sufficient time to enable the interim amount to be determined by the “experienced property lawyer”.

The “experienced property lawyer” then appointed should be advised of the pending settlement date and requested to make a determination as to the interim amount before settlement.

What are the risks if a claim subsequently fails?

If there is agreement between the parties as to the amount to be deducted then this is the end of the matter. However, where an interim amount has been deducted and is being held by a stakeholder in accordance with the provisions of clause 7.4, it is up to either party to initiate a further process in order to fix the amount (if any) that the purchaser is entitled to set-off against the vendor.

Available processes may include arbitration or expert determination (where the parties agree), court proceedings (including a claim in the Disputes Tribunal), or even adjudication proceedings where the ADLS Agreement extends to the definition of a construction contract under the Construction Contracts Act 2002.

The effect of a deduction on the purchase price for a property can sometimes have far-reaching consequences, such as preventing a vendor from being able to repay its mortgage liability, or an inability to settle the purchase of another property. Accordingly, the likely foreseeable losses in the event of a wrongful attempt at equitable set-off can be broad and significant.

If a purchaser makes a claim to equitable set-off that is eventually determined to be without basis, the purchaser is in breach of the ADLS Agreement by not paying the purchase price without deduction. Accordingly, the purchaser will be liable to the vendor for damages to the extent that, provided such damage is not too remote, the vendor is to be placed in the position it would have been in had the purchaser not breached the agreement. The same principles will apply in the event that the purchaser exercises a right of cancellation without justification.

The extent of the losses will be governed by the principles of remoteness of damage and the traditional view is that these are determined on the basis of the two limbs as expressed in *Hadley v Baxendale*.³ The first limb deals with the normal damage that occurs in the usual course of events; the second with abnormal damage that arises because of special or exceptional circumstances. However, the defendant is only taken to have contemplated abnormal damage if there was knowledge of the special circumstances at the time of the contract.

When acting for a vendor, it would be of benefit if, before entering into the agreement, the purchaser was specifically advised of the intentions on settlement of the property transaction, such as if the vendor intended to purchase another property, or if the vendor intended to place the funds in a particular investment.

Such knowledge would assist with a claim that any loss that resulted was within the actual knowledge of purchaser and therefore recoverable.

If acting for a purchaser, however, care ought to be taken to ensure that there is merit before raising a claim to equitable set-off, as an unsuccessful claim can expose a purchaser to a claim for damages, or even cancellation of the agreement.

In that event, any claimed losses ought to be examined to determine whether they are too remote and are therefore unrecoverable.

³(1854) 9 Exch 341.

Main points to remember

When acting for a purchaser:

- Be prepared in the event that the purchaser wishes to raise a claim to equitable set-off. Ensure that the required notice is prepared and served well before settlement. Make enquiries with the Law Society as to the process for appointment of an “experienced property lawyer” and stakeholder to determine the interim amount and be prepared to seek appointment in the event that agreement cannot be reached on the interim amount.
- Seek to have the interim amount determined before settlement to avoid any potential argument that the purchaser is in default.
- Give careful consideration to the merits of a claim to equitable set-off as an unsuccessful claim can expose the purchaser to damages.
- In the event of a claim for damages against the purchaser, consider whether such damages are too remote and are therefore unrecoverable.

When acting for a vendor:

- If possible, prior to entering into the agreement, ensure that the purchaser is specifically advised of the vendor’s intentions following settlement of the property transaction.
- If a claim to equitable set-off is raised, consider whether the claim is so unmeritorious that it gives rise to a right to issue a settlement notice and/or a right of cancellation. If so, consider all options and potential outcomes before exercising any right of cancellation.



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