IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2009-404-000753

UNDER	the Companies Act 1993
IN THE MATTER OF	the liquidation of HARD TO FIND BUT WORTH THE EFFORT QUALITY SECOND HAND BOOKS (WELLINGTON) LIMITED
BETWEEN	PERI FINNIGAN AND JOHN TREVOR WHITTFIELD Applicants
AND	YONG QUAN HE, JUN YOU HE AND JUN HA HE Respondents

Hearing: 18 June 2009

Appearances: D G Smith for the Applicants
P S J Withnall for the Respondents

Judgment: 1 December 2009

JUDGMENT OF DUFFY J

This judgment was delivered by Justice Duffy
on 1 December 2009 at 12.00 pm, pursuant to
r 11.5 of the High Court Rules

Registrar/Deputy Registrar
Date:

Counsel: D G Smith P O Box 3799 Shortland Street Auckland 1140 for the Applicants
P S J Withnall P O Box 10201 The Terrace Wellington 6143 for the Respondents

Solicitors: Greg Dunning and Associates (G R Dunning) P O Box 31264 Milford North Shore City 0741 for the Applicants
P J Morahan P O Box 30913 Lower Hutt 5040 for the Respondents

[1] The applicants are the liquidators of the Hard to Find but Worth the Effort Quality Second Hand Books (Wellington) Limited (in liquidation). This company leased premises off the respondents. The company and the respondents engaged in litigation, each making claims against the other. They both enjoyed a measure of success. On a claim in conversion, the Court of Appeal gave judgment to the company against the respondents in the sum of $87,954.17, plus interest and costs. On a separate claim, the Court of Appeal gave judgment to the respondents against the company for the sum of $43,385.40, plus interest and costs and costs.

[2] The respondents have only paid the company the difference between the judgment debt they owe to it and the judgment debt the company owes to them. Despite the applicant's demand for full payment of the judgment debt owed to the company, the respondents contend that the unpaid balance of this debt should be set off against the judgment debt the company owes to them. Accordingly, they have paid the unpaid balance (the set-off portion) into the trust account of the applicants' solicitors. The parties now seek a determination from this Court on whether or not set-off in this way is permissible. If it is, then the set-off portion should be repaid to the respondents; but if not, then the set-off portion is available to the plaintiffs to reduce the judgment debt they are owed in full.

[3] The applicants contend that now the company is in liquidation, s 292 and s 310 of the Companies Act 1993 preclude set-off of these two debts. The applicants have given notice under s 294 of the Act to set aside the claimed set-off. The respondents have responded by filing a notice of objection. They contend that there is nothing to preclude the set-off.

Facts

[4] The company leased premises from the respondents under an agreement to lease (the agreement), which took effect from 28 May 2004. It was a term of this agreement that the company and the respondents would enter into a deed of lease on terms no more onerous than the standard form ADLS lease. Other relevant terms of the agreement were: that rent was payable on the first day of the month; and, on the company vacating the leased premises before the expiry of the agreement, the

company was liable to pay rent for the period during which the premises were un-let until the expiry date of the agreement.

[5] Rent was paid up to and including 1 January 2005. No rent was paid on 1 February 2005. By then, one of the company's directors had left New Zealand. This director had earlier agreed to provide a personal guarantee under a deed of lease which was yet to be executed. The respondents were not prepared to enter into a deed of lease without a personal guarantee from one of the company's directors. The remaining director was not prepared to provide a guarantee. Consequently, no deed of lease was ever executed.

[6] On 6 February 2005, the company closed its bookshop and ceased trading from the premises. On 7 February 2005, Warwick Jordan, a director of the company, wrote to the respondents' solicitors advising that the company had insufficient funds to pay the rent. The respondents issued a warrant to distrain. On 9 February 2005, the respondents' solicitors wrote to the company demanding the rent due and advised that if it were not paid by 14 February 2005, the lease would be terminated. They also sent a copy of the warrant to distrain and an inventory list. Then, on 22 February 2005, the respondents re-entered the premises and took possession of them. They also took possession of the stock of the company that remained on the premises.

[7] On 2 June 2005, the company went into liquidation. It was not until August 2005 that the respondents found a new tenant for the premises.

[8] The events in February 2005 led to legal proceedings that were ultimately determined by the Court of Appeal in *He & Ors v Hard to Find but Worth the Effort Quality Second Hand Books (Wellington) Ltd (in liquidation)* CA399/07 28 November 2008. As it turned out, neither the respondents' re-entry of the premises, nor their exercise of the power to distrain was lawful. Their actions in purporting to levy distress were found to constitute a conversion of the company's property. This was the foundation for the judgment of $87,954.17, plus interest and costs, awarded against the respondents in the Court of Appeal.

[9] The terms of the agreement, as found by the Court of Appeal, included a term requiring the company to pay rent for the period during which the premises were un-let. At [57] of the judgment, the Court of Appeal found that as rent was payable in advance, the respondents were entitled to rent for the month of February 2005. In addition, the respondents were found to be entitled, under an associated arrangement, to the February monthly payment for the tenant's fixtures and fittings. For the remainder of the period for which the premises remained un-let, being from March 2005 to August 2005, the respondents were found to be entitled to damages for the company's breach of the agreement's covenant to pay rent. The Court of Appeal determined that the damages for this breach should equate with the rent which the landlords would have earned but for the breach, as well as with the money payable under the associated agreement for the tenant's fixtures and fittings. The calculation of the amounts the parties owed to each other is set out at [60] of the Court of Appeal's judgment. Since the awards to the respondents are more complicated than the tort damages awarded against them, I will set out the details of the amounts found owing to the respondents:

a)	Rent owing for February 2005	$ 7,031.25 (inclusive of GST)
b)	Damages for the breach of the covenant to pay rent (1 March 2005 to 1 August 2005)	$31,250.00
c)	February payment owing under the chattels agreement	$ 937.50
d)	Damages for breach of the chattels agreement	$ 4,166.65

The applicants' case

[10] The applicants contend that, in addition to the payment they have already received, the company is entitled to the set-off portion currently held in their solicitors' trust account. They rely on three grounds to support this proposition. First, they argue that the set-off portion does not qualify as a set-off under s 310 of the Companies Act because the underlying judgment debts are caught by the

statutory exception in s 310(2). This argument is based on the view that both judgment debts arose within six months of the company's liquidation, which, if correct, would place the debts within the exclusionary period in s 310(2) for otherwise allowable set-offs. Secondly, they argue that the respondents' retention of the set-off portion would, in substance, constitute a voidable transaction falling within s 292 of the Companies Act (as it was prior to the amendment in 2006). Thirdly, they say that the judgment against the respondents in the company's favour resulted from the respondents' illegal actions in converting the company's stock, which must constitute a barrier to a set-off, as to allow a set-off would enable the respondents to benefit from the illegality of their actions.

The respondents' case

[11] The respondents contend that the set-off portion qualifies as a set-off under s 310(1). They argue that neither of the underlying judgment debts is caught by the exception in s 310(2) which precludes set-off. First, they say that the judgment debt for unpaid rent between February 2005 and August 2005 arises from a legal obligation that existed from the time the lease was executed, which was well before the six month exclusionary period in s 310(2). Secondly, they say that, despite the judgment debt for damages in conversion having arisen in s 310(2)'s exclusionary period, the character of the legal obligation underlying this debt removes it from the effect of s 310(2).

Section 310

[12] Section 310(1) sets out the circumstances in which a set-off must occur. The section provides:

> **310 Mutual credit and set-off**
>
> (1) Where there have been mutual credits, mutual debts, or other mutual dealings between a company and a person who seeks or, but for the operation of this section, would seek to have a claim admitted in the liquidation of the company,—
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> (a) An account must be taken of what is due from the one party to the other in respect of those credits, debts, or dealings; and

(b) An amount due from one party must be set off against an amount due from the other party; and

(c) Only the balance of the account may be claimed in the liquidation, or is payable to the company, as the case may be.

[13] Section 310(2) provides:

> (2) A person, other than a related person, is not entitled under this section to claim the benefit of a set-off arising from—
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> (a) A transaction made within the specified period, being a transaction by which the person gave credit to the company or the company gave credit to the person; or
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> (b) The assignment within the specified period to that person of a debt owed by the company to another person—
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> unless the person proves that, at the time of the transaction or assignment, the person did not have reason to suspect that the company was unable to pay its debts as they became due.

[14] Section 310(6) defines the "specified period" in s 310(2):

> (6) For the purposes of subsection (2) of this section, **specified period** means—
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> (a) The period of 6 months before the date of commencement of the liquidation together with the period commencing on that date and ending at the time at which the liquidator is appointed; and
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> (b) In the case of a company that was put into liquidation by the Court, the period of 6 months before the making of the application to the Court together with the period commencing on the date of the making of that application and ending on the date on which**[**, and at the time at which,**]** the order of the Court was made**[**; and**]**
>
> (c) If—
>
> (i) An application was made to the Court to put a company into liquidation; and
>
> (ii) After the making of the application to the Court a liquidator was appointed under paragraph (a) or paragraph (b) of section 241(2),—
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> the period of 6 months before the making of the application to the Court together with the period commencing on the date of the making of that application and ending on the date **[**and at the time**]** of the commencement of the liquidation.

[15] The respondents are not related persons as defined in s 310(5) and so to this extent there is no question that s 310 applies. No assignment is involved; hence s 310(2)(b) is not relevant. The live questions are around s 310(1), s 310(2)(a) and the proviso to s 310(2) provided for in s 310(6).

[16] An examination of the historical and philosophical context of s 310 and comparable legislation in Australia and in England is helpful in gaining an understanding of how s 310 is intended to operate. The history and philosophy behind legislation having the effect of s 310 is discussed in *Stein v Blake* [1995] 2 All ER 961, *Gye v McIntyre* (1991) 171 CLR 609, *Day & Dent Constructions Pty Ltd v North Australian Properties Pty Ltd* (1982) 150 CLR 85, and in Derham *The Law of Set-Off* (3rd ed 2003). Legislation of this type goes back to the time of Queen Anne. It gives rise to a form of set-off known in England as "bankruptcy set-off", which is a term I shall adopt.

[17] A discrete and well established body of law on bankruptcy set-off has developed in England, Australia and New Zealand. The relevant legislation of those countries is much the same in terms of the criteria imposed before bankruptcy set-off can occur. Whilst it started as something applied in personal bankruptcies, it was later extended to company liquidations.

[18] Bankruptcy set-off is very different from legal and equitable set-off both in purpose and effect: see *Stein* at 964. A general account of the features of all three forms of set-off can be found in *Popular Homes Ltd v Circuit Developments Ltd* [1979] 2 NZLR 642 at 655-659.

[19] A fundamental difference between bankruptcy set-off, on the one hand, and legal and equitable set-off, on the other, is that, on the making of a bankruptcy or winding up order, bankruptcy set-off operates automatically to extinguish the credits, debts and dealings that fall within its scope. A detailed explanation of the difference between bankruptcy set-off and legal set-off is given in *Stein* by Lord Hoffman. After reviewing earlier cases decided in the High Court of Australia on the topic, Lord Hoffman concluded that, unlike other forms of set-off, with bankruptcy set-off there is no need for action from the parties, including no need for proof of debt in the

bankruptcy process, or from the Court. Lord Hoffman found that bankruptcy set-off acts automatically; on the bankrupting of a natural person or the liquidation of a company; debts that are the subject of bankruptcy set-off will be automatically extinguished. At p 966 Lord Hoffman said:

> Once one has eliminated any need for a proof in order to activate the operation of the section, it ceases to be linked to any step in the procedure of bankruptcy or litigation. This is a sharp contrast with legal set off,...Section 323 [the English equivalent of s 310] ... operates at the time of bankruptcy without any step having to be taken by either of the parties.

[20] Later, at p 966, Lord Hoffman emphasised the self-executing nature of s 323 when he cited a passage from the High Court of Australia in *Gye v McIntyre* (1991) 171 CLR 609 (at 622):

> Section [323] is a statutory directive ("shall be set off") which operates as at the time the bankruptcy takes effect. It produces a balance upon the basis of which the bankruptcy administration can proceed. Only that balance can be claimed in the bankruptcy. ... The section is self-executing in the sense that its operation is automatic and not dependent upon "the option of either party".

[21] The reference in s 310 to "account must be taken" might be understood to suggest a procedure must be followed to achieve the set-off. However, in *Stein*, when this aspect of the English equivalent of s 310 was discussed, Lord Hoffman described the reference to this taking of account as being no more than the calculation of the balance due. At p 965 he said:

> In what circumstances must the account be taken? The language of ...[s 310] suggests an image of a trustee and creditor sitting down together, perhaps before a judge, and debating how the balance between them should be calculated. But the taking of the account really means no more than the calculation of the balance due in accordance with the principles of insolvency law. ...Indeed, it might have been thought from the words 'any creditor of the bankrupt proving or claiming to prove from a bankruptcy debt' in [s 310] that the operation of the section actually depended on the lodging of a proof. But it has long been held that this is unnecessary and that the words should be construed to mean 'any creditor of the bankrupt who ...would have been entitled to prove for a bankruptcy debt'.

[22] I see no reason why s 310 cannot be understood to have the same self-executing extinguishment of subject debts as s 323 of the English Act, or the Australian equivalent. For a start, both sections are expressed in much the same language. As with the English provision, the language of s 310 is mandatory; it

directs that an account *must be taken* of what is due to each of the parties and then that the amount due from one party *must be set-off* against the amount due from the other party. The obligatory nature of s 310 was recognised by the Supreme Court in *Trans Otway Ltd v Shephard* [2006] 2 NZLR 289, though how s 310 took effect was not discussed. This Court had already recognised the obligatory nature of bankruptcy set-off when considering the equivalent of s 310 in the Companies Act 1955. In *Rendell v Doors and Doors Ltd (in liquidation)* [1975] 2 NZLR 191, Chilwell J found (at p 199) that s 93 of the Insolvency Act 1967, which was brought into the Companies Act 1955 by s 307 of that Act, prescribed statutory rules which must be complied with and could not be bargained away.

[23] It follows from the obligatory nature of s 310 that once the section's requirements are met, it will mandate the outcome. This, in turn, must result in the automatic extinguishment of the debts, or parts thereof, that are the subject of set-off. The question, therefore, is whether the subject debts in this case meet the requirements of s 310. If they do, set-off must follow.

[24] The first requirement of s 310(1) is that there must be mutual credits, mutual debts or other mutual dealings between a company and a person who seeks (or but for the section would seek to have) a claim admitted in the liquidation of the company. In *Gye v McIntyre*, the High Court of Australia at p 623 identified three aspects of the requirement for mutuality. First, the credits, debts or claims arising from other dealings must be between the same persons. This is the case here. Secondly, the benefit or burden of the debts, credits or other dealings must lie in the same interest. That is so here. The judgment debts and the underlying claims on which they are based involve the same parties acting in the same capacity towards each other. Thirdly, the debts, credits and other dealings must ultimately "mature into pecuniary demands that are susceptible of set-off": *Gye* at p 624. This has already happened with the entry of judgment in respect of each party's claims. Hence, in the present case, the requirement for mutuality is met.

[25] What has occurred here are mutual dealings in the form of mutual claims the respondents and the company had against each other that have subsequently matured into mutual debts through the entry of judgment each has obtained against the other.

The underlying nature of one of the judgment debts (damages for the tort of conversion) and part of the other (damages for breach of contract) is of no concern. In *Gye* (at p 629), the High Court of Australia rejected the argument that the credits, debts or other dealings must arise out of contract and accepted that "mutual dealings" could include events giving rise to a potential damages claim in tort. In that case, one of the claims forming part of the bankruptcy set-off was a contingent liability based on an unliquidated claim of the bankrupts in tort for damages. The High Court of Australia considered that the word "dealings" in s 86 of the Bankruptcy Act 1996 (Cth), the equivalent of s 310, was used in a non-technical sense. The Court said that the word "dealings" had been construed as referring to matters having a commercial or business flavour but that the word was, nonetheless, one of very wide scope, which embraced far more than a legally binding contract or "deal". In *Gye*, the Court saw the fraudulent representation, on which the tort claim was based, as having been part of the relevant "dealings" between the respective sides. *Gye* is a case where the bankrupts alleged that they had entered into the purchase of a hotel in reliance on a fraudulent representation made by a Mrs McIntyre. At the time of the purchase, the bankrupts, Messrs Gye and Perkes, borrowed $200,000 from Mrs McIntyre. They later defaulted on the loan, and Mrs McIntyre obtained a default judgment against them for the non-payment. In turn, they cross-claimed in deceit for damages caused by Mrs McIntyre's fraudulent misrepresentations about the takings and profitability of the hotel.

[26] In *Secretary of State for Trade & Industry v Frid* [2004] 2 AC 506 at 514, Lord Hoffman referred to the recognition given in *Gye* to the broad meaning of the phrase "mutual credits, mutual debts and mutual dealings" and adopted the meaning that was given to those words in *Gye*. At 513 para [18], Lord Hoffman also referred with approval to a statement by Brightman J in *In re D H Curtis (Builders) Ltd* [1978] Ch 162 at 171 to the effect that:

> … the type of acts or events giving rise to the liabilities were immaterial provided that those liabilities were "commensurable", that is to say capable of being expressed in money.

[27] At 514 para [23], Lord Hoffman said:

> That court [in *Gye*] gave a clear answer:

> "credits" and "debits" will ordinarily represent the outcome of dealings rather than the dealings themselves. Conversely, "dealings" commonly do not of themselves, as distinct from their outcome, represent credits or debts susceptible of direct set-off ... The requirement of mutuality in respect of "other ...dealings", as distinct from "credits" or "debts" susceptible of immediate set-off, is directed not so much to the relationship between the dealings as such but to the relationship between the claims which have arisen from them.

[28] And then at para [24], Lord Hoffman said in relation to what can constitute "dealings":

> All that is necessary therefore is that there should have been "dealings" (in an extended sense which includes the commission of a tort ...) which give rise to commensurable cross-claims. In *Gye* ... itself, the one party was liable to the other for money lent and the cross-claim was for damages in tort for fraudulently inducing the borrower to enter into a separate contract to which the lender was not a party.

[29] With the present case, the circumstances that underlie the conversion claim are inextricably linked with the company's failure to pay rent. The company's failure to pay rent in February 2005 led to the respondents' ill-judged attempt at levying distress, which, in turn, has led to the claim in conversion and the eventual damages award. In this way, the conversion claim and the events giving rise to it are part of the dealings between the company and the respondent as landlord and tenant. Here, there are claims arising from the failure to pay rent and the claim arising from the landlord's reaction to that failure. I consider that those claims can be said to arise out of mutual dealings.

[30] The case law makes it clear that in the case of company liquidations, the claims giving rise to the mutual credits, mutual debts and other mutual dealings must exist at the date of liquidation. But no money need be payable by that date. Provided the liability or obligation exists at the date of liquidation, it can mature into a debt at a later stage: see *Day & Dent* at p 90. Indeed, for bankruptcy set-off, it will be enough, even if the liabilities to be set off are not yet payable, unascertained in amount or subject to a contingency: see *Gye* at p 624 and *Stein* at p 964. There is a full discussion of this aspect of bankruptcy set-off in *McCullough & Anor v Base Control Ltd (in liquidation)* HC AK CIV-2008-404-3375 24 November 2008 Allan J, at [35] to [40]. Furthermore, in *Stein*, at p 965 Lord Hoffman said:

> The claims may have been contingent at the bankruptcy date and the creditor's claim against the bankrupt may remain contingent at the time of the calculation, but they are nevertheless included in the account.

[31] With this case, the events giving rise to all the claims underlying both judgment debts had arisen before the company's liquidation.

[32] It follows that the debts and underlying claims of each party meet all of s 310(1)'s requirements. The next question is whether or not set-off is, nonetheless, excluded by s 310(2).

[33] Only transactions that arose within the specified period in s 310(2) will be caught by the subsection. Since the liquidation order was made on 22 June 2005, the specified period for the purpose of s 310(2) ran backwards from this date to 22 December 2004. For the purpose of assessing when a transaction occurred, time is calculated from the time of the event which gives rise to the potential claim to assert a set-off: see *Trans Otway* at footnote 11 ([17]).

[34] The damages to compensate the respondents for unpaid rent between March 2005 and August 2005 follow the termination of the agreement to lease in February 2005. The applicants contend that the events giving rise to the potential liability to pay those damages can only eventuate from the time of the termination of the lease. Thus, they argue that the liability for those damages occurred within the specified period in s 310(2).

[35] The respondents argue that the obligation to pay rent while the premises were un-let had existed from the time the parties entered into the agreement to lease. They contend, therefore, that the damages award they obtained against the company can be seen to have originated at a time well outside the specified period in s 310(2).

[36] In *Secretary of State for Trade and Industry*, Lord Hoffman treated an obligation to pay damages for breach of contract as arising at the time the contract was made, rather than the time when the breach occurred. At para [9] his Lordship reviewed the case law to this effect:

> It is sufficient that there should have been an obligation arising out of the terms of a contract ... by which a debt sounding in money would become payable upon the occurrence of some future event or events. The principle has typically been applied to claims for breach of contract where the contract was made before the insolvency date but the breach occurred afterwards (*In re Asphaltic Wood Pavement Co* (1885) 30 Ch D 216).

Later at para [10], following his review of the relevant authorities, his Lordship said:

> The effect of these and similar cases was summed up by Millet J in *In re Charge Card Services Ltd* [1987] Ch 150, 182:
>
> > By the turn of the [20th] century, therefore, the authorities showed that debts whose *existence and amount were alike contingent* at the date of the receiving order, and *claims to damages for future breaches of contracts existing at that date* were capable of proof and, being capable of proof, could be set off under the section provided that they arose from mutual credits or mutual dealings. The only requirement was that they must in fact have resulted in quantified money claims by the time the claim to set off was made. (emphasis added)

[37] In *In re Charge Card Services*, Millet J traversed the authorities which had dealt with bankruptcy set-off of contingent debts. This was in part due to the need to consider an argument before him in which it was asserted that the scope of bankruptcy set-off for contingent debts was limited to those debts where liability was certain and the only contingency was in relation to when payment was made (*debitum in praesenti solvendum in futuro*). At pp 189 to 190 of the judgment, Millet J rejected this argument; he found that the weight of the authorities before him supported the view that wholly contingent liabilities could be the subject of bankruptcy set-off. Hence, he saw nothing wrong in principle with bankruptcy set-off being available in circumstances where a contract existed before the date of bankruptcy or liquidation, but the breach, on which the money claim is based, has occurred after bankruptcy or liquidation.

[38] Millet J considered that the availability of such a broad scope of contingent debts and liabilities for bankruptcy set-off was consistent with the purpose and policy of the legislation (s 31 of the Bankruptcy Act 1914, and s 95 of the Companies Act 1948). At p 190, Millet J described the purpose and policy of the legislation as being based on the principle that it would be unjust to require someone who has had mutual dealings with a bankrupt to pay the full amount of what was due

to the bankrupt, but to be limited to receiving in return a payment that was in parity with the amount received by the bankrupt's other unsecured creditors:

> The object of that section [s 31, Bankruptcy Act] like its predecessors, is to prevent the injustice to a man who has had mutual dealings with a bankrupt from having to pay in full what he owes to the bankrupt while having to rest content with a dividend on what the bankrupt owes him. Of course, a debtor to the bankrupt must not be allowed, after the date of the receiving order, to gain an advantage by buying up the bankrupt's liabilities in order to obtain the benefit of a set off. But to disallow the set off of a provable debt merely because it was still contingent at the date of the receiving order, where the contingency has since occurred and the liability which has arisen is exclusively referable to and has resulted in natural course of events from a transaction between the same parties entered into before the receiving order, would in my judgment be productive of the very injustice the section and its predecessors were designed to prevent.

[39] The substance of Millet J's dictum commenting on the object of bankruptcy set-off and the recognised unfairness of requiring someone who is both a creditor and a debtor of a bankrupt to pay his or her debt to the bankrupt in full, whilst at the same time only receiving a dividend, or nothing as payment of the debt owed by the bankrupt, has been said in many cases, including by the Supreme Court in *Trans Otway* at [15].

[40] When the approach described in Millet J's dictum is applied to the present case, it would follow that the obligation in respect of the respondents' damages claim against the applicants for breach of the covenant to pay rent under the agreement to lease would go back to the time the agreement was made. As at that time, a damages claim for breach of the agreement would be a contingency that followed from the assumption of binding contractual obligations. This view of when the company's liability for breach of the covenant to pay rent first arose fits with the principle identified by Millet J in *In re Charge Card Services*, and by Lord Hoffman in *Secretary of State for Trade and Industry*.

[41] Once the concept of contingent liabilities and obligations is accepted as a basis for set-off to the point where the very existence of a debt (and not just its payment) can be contingent, it opens the door to a range of contingencies which might not otherwise have been recognised as capable of supporting a set-off. The principle goes so far as to recognise that at the time a contract is entered into, there is

then in existence a potential liability for future breaches of that contract. I was not referred to any authority on this point binding on this Court that contradicts this principle.

[42] The principle recognising contingent liabilities as capable of supporting a bankruptcy set-off is well established and it is of long standing. It fits with the recognised justice on which bankruptcy set-off rests. I consider, therefore, that I should apply this principle. This means that, as regards the judgment debt the respondent has obtained against the applicants, the underlying foundation for that debt eventuated at the time the agreement to lease was entered into, which is a time outside the specified period.

[43] One of the mutual dealings, the damages award for conversion, has occurred within the specified period. But this does not of itself preclude set-off. More is required. To be disqualified under s 310(2) from set-off, the damages award would have to qualify as a transaction by which the respondents gave credit to the company, or the company gave credit to the respondents. The next question is, therefore, whether or not the damages for conversion are such a transaction.

[44] The legislature cannot have intended the exclusion in s 310(2) to apply to every mutual debt credit, mutual debt or mutual dealing that would otherwise qualify under s 310(1) simply because it arose within the specified period because, if this had been the legislature's intention, it would have used language in s 310(2) which specifically referred to those items. The legislature's use of different words to identify what is excluded by s 310(2) from what is permitted in s 310(1) suggests the exclusion was intended to apply to something narrower than the items referred to in s 310(1). The reference to "transactions" and giving credit suggests an arrangement which the company and the other party have intentionally reached between themselves. Seen in this way, unilateral actions of one party towards the company, which result in the commission of a tort, would be outside of s 310(2). Hence, the respondents' conversion of the company's stock would not qualify under s 310(2) as something that was excluded from bankruptcy set-off. Viewing the respondents' conduct in this way fits the purpose the authorities have attributed to s 310(2) and its equivalents in the overseas legislation.

[45] In *McCullough* at [48], Allan J rejected an argument that the words "transaction" and "assignment" in s 310(2) should be given the widest possible meaning. His reason for doing so was the need for balance between the competing interests of bankruptcy set-off claimants and unsecured creditors. He referred to the discussions in *Day & Dent* and in *Stein* on the principles relating to how each group is to be treated under insolvency legislation. He rejected the argument that the primary purpose of this legislation is confined to protection of unsecured creditors.

[46] In *Trans Otway* at [17], the Supreme Court described the purpose of s 310(2) in this way:

> The reason for this qualification of the general rule in s 310(1) is to prevent a creditor from taking opportunistic advantage over other creditors by engineering a situation in which it also becomes a debtor of the company at a time when it must be taken to have appreciated the company's insolvent position.
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> Derham [*The Law of Set-Off*] comments that the qualification, which is of longstanding, has the effect:
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>> "… of discouraging dealings in debts owing by the bankrupt or the company as the case may be, in a way that would negate the principle of a pari passu distribution of the bankrupt's or the company's property.

[47] Much the same view was taken in the High Court of Australia of the Australian equivalent of s 310(2): see *Day & Dent* at 95 and *Gye* at 619.

[48] In *Trans Otway* the bankruptcy set-off claim was found to be disqualified by s 310(2). Trans Otway claimed to be owed $90,000 by Newman Carrying Limited. Trans Otway served Newman with a statutory demand. Newman then entered into an agreement with Trans Otway whereby Newman sold its business to Trans Otway. The agreement included Newman acknowledging it was in debt to Trans Otway for $90,000, and Newman agreeing that it would sell its client list to Trans Otway for the same amount. In return, Trans Otway acknowledged that it had received full payment from Newman. The arrangement occurred within the specified period in s 310(2). On Newman's liquidation, the liquidators sought to have the payment by Newman set aside. The Supreme Court found that the arrangement between Newman and Trans Otway had occurred at a time when Trans Otway knew that

Newman was unable to pay its debts. The purpose of the arrangement was seen as achieving an outcome for Trans Otway that enabled it to enjoy an advantage over Newman's other creditors. Whilst Trans Otway did not receive a money payment for the $90,000 it was owed, it received, instead, consideration in the form of Newman's business and client list payment, which seemingly was more than it would have received as one of Newman's unsecured creditors. The Supreme Court was satisfied that Trans Otway had the requisite degree of knowledge for s 310(2) to apply and that the arrangement between Trans Otway and Newman was the type of transaction s 310(2) affected.

[49] The actions of the respondents that led to the damages in conversion are markedly different from those of Trans Otway. The arrangement Trans Otway entered into with Newman benefited Trans Otway, whereas in the present case the respondents' actions have had a detrimental result. Far from improving their financial position by entering into an arrangement that reduced the debt owing to them, the respondents have made their position worse by incurring a liability for damages. Furthermore, this result was not intended. The respondents did not set out to incur a damages liability for conversion. This was the unforeseen consequence of their ill-judged attempt at re-entry of the premises and distraining for unpaid rent. By the time this action was completed, the respondents had increased their financial risk vis-à-vis the company; they were still out of pocket for the rent they were owed, and they now also suffered the contingent liability of a damages claim in conversion. There was nothing here to advantage the respondents. I do not see how what has happened can be described literally as a transaction by which either the company gave the respondents credit or they gave the company credit. Nor can what has happened be said to offend the purpose of s 310(2). When the discussions on this topic in the authorities are considered, it is clear that s 310(2) is aimed at very different circumstances.

[50] Since I have found that the damages for conversion are not transactions within s 310(2), it is unnecessary to consider the other aspect of s 310(2); that is, the respondents' knowledge of the company's inability to pay its debts as they became due.

[51] The findings I have reached mean that the mutual dealings of the company and the respondents meet the requirements of s 310(1) and are unaffected by s 310(2). Consequently, the requirements for bankruptcy set-off are met. The consequence is that the set-off portion of the mutual debt must be treated as having been extinguished by the set-off.

Section 292

[52] The applicants contend that any set-off would amount to a payment under s 292 of the Companies Act. This is what was found by the Court of Appeal in *Trans Otway* [2005] 3 NZLR 678. However, the Court of Appeal dealt with the set-off as if it were a legal set-off, and not a bankruptcy set-off. The Court of Appeal was never referred to s 310 of the Companies Act. Its focus was on whether or not a set-off in circumstances where the parties had agreed a set-off was a payment under s 292(3)(e) and, therefore, a voidable transaction. It was not until the case went to the Supreme Court that the application of bankruptcy set-off to the circumstances was considered for the first time. The decision in the Court of Appeal must now be treated as *per in curiam*, insofar as there is any argument that it can be applied to circumstances that come within s 310(1).

[53] Section 292(1) defines "transaction" in relation to a company to include (s 292(3)(e)), the payment of money by the company under a judgment or order of the court. The applicants contend that if the respondents are entitled to retain the set-off portion, the substantive outcome will be to pay them the judgment debt they are owed for damages and in debt, as a result of the unpaid rent and the associated payments owing in relation to the tenant's chattels and fixtures agreement. But this argument overlooks the legal effect of bankruptcy set-off under s 310. The set-off portion has been automatically extinguished through the self-executing nature of bankruptcy set-off. This means that the set-off portion is unavailable for use as a payment under s 292. It follows that having been found to qualify under s 310, the set-off portion no longer exists and, for this reason alone, it cannot be attacked as a voidable transaction under s 292.

Reliance on illegal conduct

[54] The final ground of the applicant's argument is that there should be no set-off because for that to occur would enable the respondents to profit from their unlawful conversion of the company's property. The applicant relies upon a statement of the Court of Appeal in *Duncan v McDonald* [1997] 3 NZLR 669 at 677 where it was said that it is the duty of a Judge to take note of illegal conduct, even if it has not been pleaded, and further that the Court may decline to assist a plaintiff who has been guilty of illegal or immoral conduct. However, those statements were made in the context of a case where the Court was recognised to have jurisdiction to grant or refuse relief on the ground of illegal conduct.

[55] The applicants' attempt to raise an argument based on *Duncan v McDonald* presupposes that, in the present case, the Court has discretion when it comes to finding if bankruptcy set-off can apply. The applicants' argument overlooks the legal character of bankruptcy set-off, which is that the set-off occurs automatically once the requirements of the legislation are established. This Court cannot intrude on automatic statutory consequences. Nor does this Court have any discretion when it comes to making factual findings on the circumstances that establish the requirements of s 310. In any case, the subject credits, debts or dealings either meet the three requirements of mutuality or they do not. The Court's decision in this regard cannot be influenced by the view it has taken on the honesty or otherwise of a claimant's conduct. Section 310(2) enables a Court to consider if circumstances coming within the specified period are a transaction of the type excluded from bankruptcy set-off. But this decision must be based on the legal principles that have developed in the law of bankruptcy set-off.

[56] The cases in which those principles have been developed reveal that a contingent liability for damages arising from the commission of an intentional tort can be a mutual dealing which allows a set-off. In *Gye* at p 629, the High Court of Australia saw nothing wrong with a bankruptcy set-off involving a creditor of a bankrupt setting off a liquidated claim in debt against an unliquidated tort claim that the bankrupt could make against the creditor:

> ... there is no convincing reason why a liquidated claim of a creditor of the bankrupt should not be set-off against an unliquidated claim in tort of the bankrupt which vests in the trustee in circumstances where the three criteria of mutuality are present.

Gye is a case that has subsequently been approved of by the highest authorities on bankruptcy set-off. The same as was said in *Gye* can be said here. It follows that there is neither anything wrong with the bankruptcy set-off in this case, nor is there any power available to the Court that would enable it to override a set-off that meets the requirements of s 310(1).

Result

[57] The respondents have established that s 310(1) entitles them to the set-off portion of the amount owing in consequence of their mutual dealings with the company.

[58] The applicants have failed to establish the three grounds on which they relied to support their application.

[59] Leave is reserved to the parties to apply for costs.

Duffy J