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Set-off and Crown departments

KEY POINTS

- When a company goes into liquidation, an account is taken of mutual dealings between it and a creditor: r. 4.90 of the Insolvency Rules 1986.
- As a matter of fundamental constitutional doctrine, the Crown is indivisible.
- Therefore, in the normal course, there should simply be an aggregation of all debts owed to and from the Crown as at the date of liquidation to reach a net balance.

This short article examines some key principles in relation to set-off involving Crown departments in the context of liquidation. The subject often arises for consideration in a liquidation, normally with regard to tax debits and credits, but from time to time non-tax claims will be involved too.

Before going further, it is worth emphasising something this article is *not* about: namely, the operation of pleas of set-off in proceedings involving the Crown where a company is not in any form of insolvency. The most commonly encountered statutory provision is probably s 35(2)(g)(i) of the Crown Proceedings Act 1947 (CPA 1947), which allows the creation of court rules providing that:

> "[A] person shall not be entitled to avail himself of any set-off or counterclaim in any proceedings by the Crown for the recovery of taxes, duties or penalties, or to avail himself in proceedings of any other nature by the Crown of any set-off or counterclaim arising out of a right or claim to repayment in respect of any taxes, duties or penalties."

The corresponding rules are in CPR 66.4(1) and (2):

> "(1) In a claim by the Crown for taxes, duties or penalties, the defendant cannot make a counterclaim or other Pt 20 claim or raise a defence of set-off.

> "(2) In any other claim by the Crown, the defendant cannot make a counterclaim or other Pt 20 claim or raise a defence of set-off which is based on a claim for repayment of taxes, duties or penalties."

These provisions are of significant practical value to the Crown in speedily obtaining enforceable judgments for tax debts. Leaving aside tax, there are further provisions (see s 35(2)(g)(ii) and (iii) and CPR 66.4(3) and (4)) limiting the circumstances in which there can be set-off of debts and credits involving different government departments.

The existence of the CPA 1947 provisions can occasionally cloud thinking in relation to insolvency set-off in liquidation. In fact, those provisions are essentially irrelevant from the time a company goes into liquidation.

INSOLVENCY RULES 1986, RULE 4.90

The reason for that is the way in which r 4.90 of the Insolvency Rules 1986 operates. It has evolved over recent years as a result of an attempt by Parliament to combat perceived abuses (eg, changes to put a stop to companies which were indebted to the company in liquidation taking cheap assignments of debts for the purpose of claiming set-off at the full value of the debts). At its core, however, is a simple statement, found in r 4.90(1), as to when insolvency set-off applies:

> "This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation."

This is the latest in a line of provisions stretching back centuries: see, for example, s 28 of "An Act to prevent the Committing of Frauds by Bankrupts" 5 Geo II cap 30 (1732):

> "Where it shall appear…that there hath been mutual credit given by the bankrupt and any other person, or mutual debts between the bankrupt and any other person, at any time before such person became bankrupt, the… Commissioners [of Bankrupt]…shall state the account between them, and one debt may be set against another; and what shall appear to be due on either side on the balance of such account, and on setting such debts against one another, and no more, shall be claimed or paid on either side respectively."

Insolvency set-off is, and always has been, quite unlike the procedural set-off referred to in CPA 1947 (which has to be claimed, and can only be claimed in certain circumstances). Even though the language seemingly suggests that insolvency set-off depends on a claim to prove, it is beyond doubt that insolvency set-off is in fact "mandatory and self-executing": *Stein v Blake* [1996] 1 AC 243 at 255A-B (House of Lords, per Lord Hoffmann). By "mandatory", Lord Hoffmann meant something which could not be excluded by the prior agreement of the parties; by "self-executing" he meant that it did not need to be pleaded to take effect. The consequence was that separate cross-claims were netted off, with a single net balance being owed one way or another. One way of looking at this is as a form of exception to the *pari passu* rule: to the extent of the claim to set-off, a creditor can in effect get 100p in the £ on his claim. The English courts have said that the purpose of insolvency set-off is "to do substantial justice" (*Stein* at 251I).

OPERATION OF RULE 4.90 IN RELATION TO THE CROWN

The points made above will be well known to any practitioner who has a broad familiarity with insolvency. What can be somewhat less well known is how r 4.90 operates in relation to the Crown. On liquidation, the procedural complications of the 1947 Act,

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in effect, evaporate. What then comes to the fore is the "fundamental constitutional doctrine that the Crown in the UK is one and indivisible": see the House of Lords decision in *Town Investments v Department of the Environment* [1978] AC 359 at 400B (per Lord Simon). The incorporation for administrative convenience of a minister or secretary of state does not make that corporation an entity separate from the Crown. As Lord Simon went on to say (at 400C):

> "If such terms as 'aspects of the Crown' or 'emanations of (or from) the Crown' or 'participants of royal authority' are considered to be too cloudy for legal usage, the legal concept which seems to me to fit best the contemporary situation is to consider the Crown as a corporation aggregate headed by the Queen. The departments of state including the ministers at their head (whether or not either the department or the minister has been incorporated) are then themselves members of the corporation aggregate of the Crown."

The position in relation to direct taxes (eg, corporation tax) and indirect taxes (eg, VAT) used to be somewhat obscured by the distinction between HM Commissioners of Inland Revenue (CIR) and HM Commissioners of Customs and Excise (HMCE). That distinction was abolished when the two departments were merged by the effect of the Commissioners for Revenue and Customs Act 2005 in April 2005. HM Revenue and Customs (HMRC) has since then been responsible for the "collection and management" of the taxes that were the responsibility of its predecessor bodies. However, the legal position in relation to insolvency set-off involving direct and indirect taxes was just the same before April 2005 as it has been since. The CIR, HMCE and HMRC have all simply at their relevant times collected revenue for the Crown. But, of course, the point goes wider than in relation to tax debts and credits: because every other government department is also part of the indivisible Crown.

SECRETARY OF STATE FOR TRADE AND INDUSTRY V FRID

Any doubt about that proposition, and the full extent of its consequences, should have been dispelled by the decision of the House of Lords in *Secretary of State for Trade and Industry v Frid* [2004] 2 AC 506, but its implications may not always be fully appreciated. The facts in *Frid* were relatively straightforward. As at the date of a company's liquidation, there was a VAT credit due to it. At that date, it had obligations to pay compensatory notice and redundancy payments to employees under the Employment Rights Act 1996. Where such obligations were not paid, the secretary of state became liable to pay the employees (under the same Act), the secretary of state made the payment, and was as a result subrogated to the employees' rights against the company. HMCE applied the VAT credit rateably between the secretary of state's claim and HMRC's claims for PAYE and for NI.

The secretary of state then put in a proof for her subrogated claim, having reduced the claim by the amount of the credit received from HMCE. The liquidator rejected the proof, asserting that the secretary of state ought to have proved for the full subrogated claim, because she was not entitled to be allocated any of the VAT credit. He asserted a lack of mutuality, on the basis that the credit was owed to the company by HMCE, and the claim against the company was made by the secretary of state on behalf of the National Insurance Fund.

The liquidator lost. The case is mainly known as authority for the proposition that even though the secretary of state only acquired her subrogated rights after and as a result of the liquidation, that did not matter. "[W]here before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings" was not intended to refer solely to debts which were due and payable at the date of insolvency: "it is sufficient that there should have been an obligation arising out of the terms of a contract or statute by which a debt sounding in money would become payable upon the occurrence of some future event or events" (per Lord Hoffmann at 511A).

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Perhaps more important for current purposes is that he regarded the general law as so clear that he spent very little time on either: (a) set-off between the VAT credit and the direct tax debts; and (b) the liquidator's lack of mutuality argument (which he dismissed out of hand at 515C-G). In particular, he stated:

> "In private law the Crown though its various emanations is the beneficial owner of all central funds."

There may, of course, be the need to spend time on factual twists: for example, it may only be possible to strike a final account following a quantification process if (say) the company has a claim for unliquidated damages against the Crown which it wants to set against a liquidated tax debt. However, concentrating on the big picture, what the practitioner must keep in mind is that the intended operation of Crown set-off on liquidation is that all debts to and from the Crown get totted up, with the result that there should be simply a final net balance one way or the other (albeit any net claim by the Crown could as a matter of process be divided between two or more departments). Any suggested departure in a particular situation from that general approach would require critical examination. ■