Case No: B2/2002/2265

Neutral Citation Number: [2003] EWCA Civ 962
IN THE SUPREME COURT OF JUDICATURE
COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM BROMLEY COUNTY COURT
(HIS HONOUR JUDGE DAVID MITCHELL)

Royal Courts of Justice
Strand,
London, WC2A 2LL

Thursday 10 July 2003

Before :

LORD JUSTICE WARD
LORD JUSTICE BUXTON
and
LORD JUSTICE SEDLEY

- -

Between :

JOHN SMITH	Appellant/ Defendant
- and -	
JOSEPH SAMUEL MUSCAT	Respondent/ Claimant

- -

(Transcript of the Handed Down Judgment of
Smith Bernal Wordwave Limited, 190 Fleet Street
London EC4A 2AG
Tel No: 020 7421 4040, Fax No: 020 7831 8838
Official Shorthand Writers to the Court)

- -

NICHOLAS NICOL (instructed by Balogun Kirvan, London, SE20 7DT) for the Appellant
EDWIN JOHNSON (instructed by asb law, Croydon, CR0 1SQ) for the Respondent

- -

Judgment
As Approved by the Court

Crown Copyright ©

Lord Justice Sedley:

SMITH V MUSCAT

The issue

1. This appeal, which is brought by leave of the trial judge, comes before the court under CPR 52.14 which enables a case raising an important point of principle to be assigned directly to the Court of Appeal where it would otherwise be allocated to the High Court. The point of principle is whether a tenant who is sued by his landlord for arrears of rent may have an equitable set-off for damages for disrepair accruing under the previous landlord.

The history

2. Mr Smith, now in his seventies, has been the tenant of a small end-of-terrace house in Eden Road, Beckenham, for well over 40 years under what is now a statutory tenancy. He has been reliant for many years on housing benefit to make up his rent payments. The lessor was initially his brother, who sold the freehold to a Mr Walker about 10 years ago. The house had suffered for many years from damp, but in 1995 the local authority served a disrepair notice under s.189 of the Housing Act 1985. From June 1995 to February 1997 - "far longer than any reasonable person would expect", said the judge – the lessor's builders did remedial work in the house, causing major disruption and inconvenience. In December 1995 Mr Smith began withholding rent.

3. On 12 October 1999 the freehold was purchased by Mr Muscat. By then £3,860.13 - 128 weeks' rent – was outstanding and by operation of law became owed to Mr Muscat. It was also, according to Mr Muscat's evidence, separately assigned to him by deed and reflected in the purchase price. Mr Smith continued to withhold rent, and on 6 March 2001 notice to quit was served on him, followed on 3 September 2001 by possession proceedings. Only then did Mr Smith resume rent payments. As a result, by the time of trial in the Bromley County Court before His Honour Judge David Mitchell on 28 August 2002, the arrears stood at £5,232.06.

4. By virtue of s.98(1) of the Rent Act 1977 and Case 1 of Schedule 15 to that Act, no possession order may be made against a statutory tenant unless there are rent arrears and it is reasonable to make an order. Judge Mitchell held Mr Muscat liable to Mr Smith in the sum of £2000 for disrepair since he became the lessor in October 1999. But he held that no right of set-off existed at law or, inferentially, in equity against Mr Muscat in relation to similar breaches of covenant by his predecessor in title, Mr Walker. In consequence he found that Mr Smith remained indebted to Mr Muscat for arrears of £3,232.06 which he had no prospect of paying off, and made an outright possession order which he stayed pending appeal. He also held that, had a right of equitable set-off existed, he would not have allowed it because of Mr Smith's delay in asserting it and the availability to him of an action against Mr Walker.

The issues

5. It is accepted by Nicholas Nicol for Mr Smith that if the arrears were what the judge held them to be, an outright possession order is unappealable, even though (as the judge noted) Mr Smith would almost certainly be treated as intentionally homeless thereafter. It is accepted by Edwin Johnson on Mr Muscat's behalf that if in principle an equitable set-off was available in respect of damages for breaches of covenant on Mr Walker's part, the amount of these and the appropriateness of an outright possession order will have to go back for trial.

6. The major issue is therefore the availability of an equitable set-off. But if it is available, we have also to decide whether the judge's two contingent grounds for denying it in the present case are sustainable. In short, Mr Nicol contends that these grounds were adopted by the judge without notice or argument and so should fall without more; and that in any event, on the facts, neither delay on Mr Smith's part nor the possibility of his suing Mr Walker directly was a proper ground for refusing an equitable set-off.

The fallback grounds

7. The judge's reasoning about this part of the case was brief. He wrote:

> "If I am wrong [about set-off] it seems to me that by reason of the tenant's delay and his remedy elsewhere that he should not be entitled to any equitable relief prior to Mr Muscat's acquisition of the property."

The judge can only mean that because Mr Smith had endured years of neglect by Mr Walker without suing him, it would be unfair now to let him assert his claim against Mr Muscat instead. If so, the reasoning is untenable. Its necessary premise is that Mr Smith has an equitable set-off against the rent arrears inherited by Mr Muscat from Mr Walker. The whole point of such a set-off – assuming that it was available - is that it entitled Mr Smith to await a claim for arrears and to plead his damage in answer to it.

8. The single question for this court is therefore whether a set-off of unliquidated damages for a previous lessor's breach of a repairing covenant is available to the lessee against a claim for rent arrears which have been assigned by the previous lessor to the claimant lessor.

The law: setting off damages for a previous lessor's breach of covenant.

9. In modern times it was not until the decision of Goff J in *Lee-Parker v Izzett* [1971] 1 WLR 1688 that it was recognised that any deduction could be made from the rent due under a lease. The decision of Goff J reasserted the ancient common law right of recoupment established in *Taylor v Beal* (1591) Cro. Eliz. 222. The right was fleshed out by the decision of Forbes J in *British Anzani (Felixstowe) Ltd v International Marine Management (UK) Ltd* [1980] QB 137. The principle amounts to this: that money expended by a tenant on discharging his landlord's covenants will in appropriate circumstances operate as a partial or a complete discharge so as to furnish a defence at law to a claim for unpaid rent; and where

the tenant has suffered damage by the breach rather than paid money to remedy it, an equitable set-off is in appropriate circumstances available. Appropriate circumstances in the latter case include (to paraphrase Forbes J) a close reciprocity in the subject-matter of the cross-claims. It is accepted that damages for breach of a repairing covenant and rent payable under the same agreement are an instance of such reciprocity.

10. The reason why this position had to be reached by the slow stages recounted by Forbes J in his judgment was the view which the common law had come to take of the special nature of rent, a view well illustrated by the argument of Jeremiah Harman QC for the lessor (at 140) that rent "is invested with something in the nature of an aura" because it issues out of the land and carries such unique rights as distraint and forfeiture. Forbes J (at 152) was unpersuaded "that the ancient common law remedies attached to rent should govern in the fourth quarter of the twentieth century one's approach to a tenant's claim to equitable relief".

11. It has been common ground before this court that a lease or tenancy agreement is today to be regarded as a contract like any other. If it has special characteristics, these are a function of construction or statutory interposition, not of principle. The reason is encapsulated in the opening paragraph of the title Landlord and Tenant in 27(1) Halsbury *Laws* (4th ed.):

> "The relationship of landlord and tenant was originally one of contract only, but from early times the contract conferred an estate in the land on the tenant without losing all its contractual characteristics."

12. This does not, of course, answer the question before the court, but it explains how the present problem arises. If this were a simple contract, there would be privity neither as to the debt owed to the previous lessor nor as to damages for the latter's failure to repair. But it is accepted that by virtue of s.141 of the Law of Property Act 1925 the entitlement to recover rent arrears runs with the reversion. It is also accepted that s.142 does not have the same effect in relation to breaches of the lessor's repairing covenant: the covenant runs with the land, making the new lessor liable from the moment of assignment for all extant disrepair but not for breaches occurring prior to the assignment. The sections (so far as material) provide:

Rent and benefit of lessee's covenants to run with the reversion

> 141(1) Rent reserved by a lease … shall be annexed and incident to and shall go with the reversionary estate in the land … without prejudice to any liability affecting a covenantor or his estate.
>
> (2) Any such rent … shall be capable of being recovered … by the person from time to time entitled, subject to the term, to the income … of the land leased.

Obligation of lessor's covenants to run with the reversion

> 142(1) The obligation under a condition or of a covenant entered into by a lessor with reference to the subject-matter of the lease shall … be annexed and incident to and shall go with [the] reversionary estate … and may be taken advantage of and enforced by the person in whom the term is from time to time vested …

13. Mr Nicol accepts for the purposes of his argument the decision of Garland J in *Duncliffe v Caerfelin Properties Ltd* [1989] 2 EGLR 38. The defendants were assignees of the reversion of a flat held on a long lease, the assignors having gone into liquidation when in prolonged breach of the lessor's repairing covenant. The plaintiff lessee contended that the effect of s.142 on an assignment was to transfer the burden of past as well as future breaches of the lessor's covenants. Garland J said:

> "I have formed the conclusion, albeit with some reluctance because of the unhappy state that the plaintiff finds herself in, that what s.142 is talking about is the obligation arising under the lease to observe and perform the repairing covenant as a repairing covenant running with the land and binding the assignee of the reversion. I would find it very hard indeed to construe "obligation" as it is used in this section as meaning the consequences of a past breach prior to the assignee becoming entitled to the reversion…. This is of course a matter of first impression on the construction of the statute."

14. Mr Nicol submits that *Duncliffe* decides only that no action can be maintained at common law for damages for disrepair accruing under a previous lessor. He might also have relied on the fact that the material point in *Duncliffe* was argued and decided solely in terms of s.142. It does not deal with set-off, which is of a different character - a character, Mr Nicol submits, analogous to the abatement of rent which is created by the expenditure of money on repairs which the lessor has failed to carry out. The only difference is that the latter will be (or should be) an ascertained sum while the former has to be quantified.

15. Mr Johnson argues that set-off is the creature either of statute (which has no application here) or of equity. He submits that equity recognises no set-off against anyone except the claimant; so that in the absence of a viable cross-claim for damages or debt against the claimant – and there is conceded to be none here in relation to the earlier arrears – no set-off can arise.

16. If the entitlement to recover arrears of rent passes from assignor to assignee, and if the amount of that entitlement is reduced or extinguished at common law by money which the tenant has expended in remedying the assignor's breaches of covenant (in other words, the abatement of rent passes too), it is not easy to see what principle of law or justice denies similar relief to a lessee who may not have had enough money to do the repairs but was entitled to be compensated from day to day for the conditions he has consequently had to

live in. To the extent that the disrepair was the assignor's fault, and subject always to the terms of the assignment, it will then be for him to indemnify the assignee.

17. Precisely this would follow from what Lightman J held in the later case of *Lotteryking Ltd v AMEC Properties Ltd* [1995] 2 EGLR 13. The issue arose in relation to an attempt to restrain the sale of a reversion until the lessor's repairing obligations had been met. One of the grounds was that on a sale the tenant's right of set-off would not pass. Lightman J, refusing to make an order, held:

> "A tenant's right to set off (against any liability to make payment to the landlord due under the lease) his claim for damages for breach of a provision in a collateral contract which runs with the reversion is exercisable (equally with his right to set off a claim for damages for breach of such a covenant contained in the lease) not merely against the person entitled to the reversion at the date of the breach, but also against any successor in title. The successor in title acquires the reversion and the benefit of all covenants contained in the lease subject to all equities existing at the date of his acquisition."

18. It would have been of value to have Lightman J's views on the decision of Garland J, but *Duncliffe* was not among the cases drawn to his attention; nor, incidentally, was *British Anzani*. But it is no less valuable to have the instinctive reaction of an experienced equity judge to the present issue.

19. The decision of Forbes J in *British Anzani* has been extensively cited by both counsel in support of their contentions, but the case concerned a pleaded cross-claim for damages and, despite its helpful citations, affords no authority on the present point.

20. S.77 of the Law of Property Act 1925 deems all covenants relating to land, in the absence of an expressed contrary intention, to be made on behalf of the covenantor's successors in title. If the lessor's repairing covenant runs with the land, it seems at least arguable that breaches should do the same. An assignee for value should not be able to plead ignorance of the state of the property he is acquiring (the same may not be true of a donee or heir), but he may genuinely not know the extent of the damage for which – on this view – he is liable to the tenant. He may, however, have a remedy over against his assignor under the Civil Liability (Contribution) Act 1978 and CPR 20.6 once the amount is ascertained, since the latter on any view remains liable. Contrary to Mr Johnson's argument in terrorem, double recovery against the current and previous lessors would not be permitted by any court.

21. Mr Nicol has not relied on s.77 because he fears that the separation of law and equity prevents it. Instead he submits that on assignment the tenancy remains affected by the equities, including the equitable set-off which has been continuously available against any claim for rent. He might have derived support from the parenthetic provision, to which Mr Johnson has drawn our attention, of s.136(1) of the Law of Property Act 1925 (replacing the similar provision in s.25(6) of the Judicature Act 1873) that a legal assignment of a thing in

action is to have effect at law “subject to equities having priority over the right of the assignee”.

22. In the present state of authority, county court judges have decided this question both ways (see *Panton v St Mary’s Estates Ltd,* Legal Action, Aug. 2002, 28; *Kemra (Management) Ltd v Lewis* [1999] CLY 1373), reflecting the balance of the arguments on what at this level is a new point. In this situation it is legitimate to examine their respective consequences.

23. If Mr Nicol is right, an assignee lessor – absent some specific contractual protection – may inherit an undetermined abatement of rent arrears which have passed to him with the reversion. Indeed the set-off may go back to an even earlier reversioner; and there will be no guarantee that the assignee can exercise any remedy over against his predecessors.

24. If Mr Johnson is right, a lessor who has no chance of obtaining vacant possession because the rent arrears owed to him will be abated or extinguished by a cross-claim for damages for disrepair can sell the reversion at something close to a vacant possession value, since the assignee will be able not only to recover the rent arrears in full but (if they are substantial) to obtain a possession order on the strength of them. Equally a lessor in such a situation would need only to assign the reversion to his own nominee or to a relative in order to liberate his claim for arrears from the cross-claim for damages and, with luck, to secure vacant possession. This could quite well have been the background in a case such as *Kemra* (ante).

25. In a written submission Mr Johnson has explored the availability to Mr Muscat (who bought the property at auction) of a remedy over against Mr Walker should Mr Smith be held entitled to a set-off against Mr Muscat’s claim. In Mr Walker’s absence we cannot determine this question, but there may be force in the contention that a sale with full title guarantee, by bringing in the covenant implied by s.3 of the Law of Property (Miscellaneous Provisions) Act 1994, warrants that any rent arrears passing with the title are free of rights exercisable by third parties.

26. One of the seminal cases drawn upon by Forbes J in *British Anzani* (ante) is the decision of this court in *Hanak v Green* [1958] 2 QB 9. As Buxton LJ explains in detail in his judgment, the authoritative judgment of Morris LJ in that case reasserts what Lord Hobhouse said in *Government of Newfoundland v Newfoundland Railway* (1888) 13 App Cas 199, 212, 213:

> “It would be a lamentable thing if it were found to be the law that a party to a contract may assign a portion of it, perhaps a beneficial portion, so that the assignee shall take the benefit, wholly discharged of any counter-claim by the other party in respect of the rest of the contract, which may be burdensome.
>
> ……………
>
> Unliquidated damages may be set off as between the original parties, and also against an assignee if flowing out of and inseparably

> connected with dealings and transactions which also give rise to the subject of the assignment."

It also endorses the holding of James LJ in *Roxburghe v Cox* (1881) 17 Ch.D 520, 526 that

> "an assignee of a chose in action …. takes subject to all rights of set-off and other defences which were available against the assignor...."

Conclusions

27. These principles appear to me to be as sound today as they were a century and more ago, and to be dispositive of the problem before the court. Equally if not more important, they seem to me to produce the least unjust outcome.

28. Mr Johnson contends that any such effect is blocked by ss. 141 and 142 as construed by Garland J in *Duncliffe v Caerfelin Properties Ltd.* For my part I accept Mr Nicol's submission – see paragraph 14 above – that *Duncliffe* excludes only a cause of action against the assignee landlord for his assignor's breach of covenant, not a set-off against a rent debt which has passed under s.141. I do not accept Mr Johnson's submission that such an equity robs ss. 141 and 142 of effect. In my view it gives effect to s.141 subject to those equities which, with or without s. 136(1), affect the rights which the section transfers; and it does no violence to s.142. It is not necessary for us to determine whether *Duncliffe* was rightly decided.

29. It follows that the view taken by Lightman J in *Lotteryking* was correct. If the law were as the judge below held it to be, it would be asymmetrical and anomalous. It would distinguish on no just basis between the tenant who, faced with serious breaches of his landlord's repairing covenant, could find the money and obtain the necessary access to do the works and the tenant who, in the same situation, was forced by lack of means or want of access to put up with the consequences of disrepair. To treat rental payments withheld by the tenant as expended in the first case on rent but in the second case as simply retained on account of damages, although seemingly inconsequential, would have radical consequences for the tenant's finances, and frequently too for his security of tenure, if the reversion is assigned.

30. It is far too late to correct the asymmetry by restoring the aura of inviolability with which the law came, during the seventeenth and eighteenth centuries, to invest rent. It would also be wrong in principle to do so: rent today is correctly regarded as consideration not merely for granting possession but for undertaking obligations which go with the reversion. The just answer is that, provided the nexus between the rent and the breach is appropriately close, what the common law recognises as an abatement of rent where the damage has been quantified in expenditure is treated by equity as the potential subject-matter of a set-off where the damage requires quantification.

31. Thus, and adopting with gratitude the fuller account of the law contained in the judgment of Buxton LJ, I would conclude that Mr Smith is entitled to set off against Mr Muscat's claim for assigned rent arrears any damages due to him for the assignor's breach of his repairing obligations because the debt, a chose in action, vests in Mr Muscat as assignee subject to all equities which were available to Mr Smith against the assignor. These, it is accepted, will include Mr Walker's liability to pay unliquidated damages for disrepair.

32. The claim and counterclaim must be remitted for trial in the county court in the light of the judgments in this court.

Lord Justice Buxton :

Introduction

33. I gratefully adopt the account of the history of and issues in the case that is set out by Sedley LJ. I agree with him in drawing attention, for instance in his §§ 16 and 23, to the imbalance, injustice, and possible abuse that can result from the application of section 142 without regard to any wider protection that equity and the law of contract potentially provide to the tenant. As my Lord points out, in his § 14, Garland J was led to his conclusion in *Duncliffe*, and then only with very strong reservations about its rationality or justice, because he was not taken to any authority on set-off. In our case set-off was firmly before the court, not least because of the view of equity's role that was taken by Lightman J in *Lotteryking*. As my Lord has concluded, and I respectfully agree, this is indeed a case in which the rules of equity must prevail. That result can, however, only be reached by a somewhat less direct route than that which was urged on us by the appellant. It will therefore be necessary to go in some detail into the equitable basis of the relief available to the tenant, if only to demonstrate the comparatively narrow ground upon which, in my view, the present decision has to proceed.

Set-off and assignment

34. The appeal was argued before us on the basis that Mr Smith was entitled to set off his claim against Mr Walker in defence of the claim made on him by Mr Muscat by the operation of the general rules of equitable set-off, quite simply because Mr Smith's claim against Mr Walker can be said to be

> "so closely connected with [Mr Muscat]'s demands that it would be manifestly unjust to allow [Mr Muscat] to enforce payment without taking into account the cross-claim":

a formulation that adapts to the present facts the observations of Lord Denning MR in *Federal Commerce v Molena Alpha* [1978] 1 QB 927 at p 975A. However, that argument must fail because, for reasons that I develop in more detail below, it is not and never has been the law that A when sued by B can set-off as against B a debt or liability owed to A by C, however much the relationship between the three parties falls within the verbal terms quoted above.

35. However, in the present case Mr Muscat's right against Mr Smith comes to him by assignment by Mr Walker of the rights under the reversion that were originally held by Mr Walker, and which were the basis and context of Mr Smith's claim. It is that assignment, and the rules of equity that are applied to it, rather than the more general law of set-off, that supports Mr Smith's defence against a claim made by Mr Muscat as assignee.

36. The point is therefore a short one. It will, however, be necessary to preface it by some account of the general law of equitable set-off in order to address the argument presented to us; and then to turn to the effect on this case of the assignment.

The nature of equitable set-off

37. In *Mellham v Burton* [2003] EWCA Civ 173 I noted, with the agreement of the other members of that constitution of this court, that the expression "equitable set-off" is used in legal discourse in a number of cases, some of which are far distant from what I ventured there to characterise as equitable set-off properly so called. The latter is what we are concerned with in this case. As the masterly (per Lord Diplock in *Gilbert Ash v Modern Engineering* [1974] AC 717) account of Morris LJ in *Hanak v Green* [1958] 2 QB 9 makes clear, this category of set-off is restricted to the introduction of a defence to legal proceedings after action brought. That was fully accepted by both parties to this appeal to be the nature of this case.

38. The history of this form of equitable set-off is well known, and is fully described by Morris LJ in *Hanak v Green*. However, it is relevant to the issues debated in this appeal to remind ourselves that the contribution of equity was to provide relief against an action at law where there was an equity that went to impeach the title to the legal demand: see per Lord Cottenham LC in *Rawson v Samuel* (1841) Cr & Ph 161 at pp 178-179. The most normal case of such "equity", as before the Judicature Acts it had to be called, was where the defendant had an unliquidated cross-claim that was recognised in equity but not in law, and in support of which the court of equity would enjoin the legal proceedings: see per Morris LJ in *Hanak v Green* [1958] 2 QB at p24. In addition to an unliquidated cross-claim account had also to be taken of specific defences available in a court of equity but not in a court of law that could be deployed to inhibit the action at law. With the fusion of law and equity under the Judicature Acts, the latter category of defence is available as a defence or claim in the principal action, and does not have to be and is not addressed as a separate defence of set-off or counterclaim. However, cross-claims that previously had been recognised in equity but not in law as impeaching the claim can now be asserted in the principal action, but by way of the distinct defence of equitable set-off.

39. The effect, put shortly, was therefore that whilst common law set-off under the Statutes of Set-Off was limited to liquidated claims, equity permitted, and actions at law now permit, a defence by way of set-off of an unliquidated claim that impeached the title to the claim; or, in the more modern terminology adopted by this court in *National WestminsterBank v Skelton* [1993] 1 WLR 72 at p76G and in the *Federal Commerce* case cited in §34 above, of whether the cross-claim is sufficiently connected with the claim as to make it unfair that the defendant should be obliged to pay the claim without deduction.

40. This institution is called "equitable" set-off because, but only because, it permits the setting-off in an action at law of unliquidated claims that, before 1873, could only be pursued at law by a separate action, and could only affect the proceedings at law by way of an equitable injunction. The institution does not otherwise appeal to any specifically equitable doctrine, and in particular does not permit of any deduction from or reduction of the claim other than by the assertion of a counter-claim that is sufficiently connected with or related to the original claim.

41. In the present case, the appellant wishes to assert that the value of his claim against Mr Walker can be set-off against the claim brought against him by Mr Muscat. These two claims are, no doubt, connected with each other, not least because they arise under the same lease; and it may appear inequitable, in the general sense of that word, for Mr Muscat to be able to claim in respect of arrears that arose while Mr Walker was landlord, but for Mr Smith not to be able to assert, as against Mr Muscat, breaches of covenant on Mr Walker's part. That anomaly, if it is one, is caused by the fact that, as Garland J pointed out in *Duncliffe*, section 141 (2) and (3) of the 1925 Act makes specific provision to enable the assignee of the reversion to sue for accrued arrears of rent, whilst there is no statutory provision enabling the tenant to complain as against the assignee in respect of accrued breaches of covenant committed by the latter's predecessor in title. But that is all that the 1925 Act does. It says nothing as to set-off.

42. Mr Smith therefore has to assert his set-off by appealing to general principle, reaching well outside the law of landlord and tenant. There is no case supporting, or coming anywhere near to supporting, a general principle making set off available where the defendant has a claim against someone other than the plaintiff; and such a rule would be contrary to elementary principles of the law of contract; contrary to the essential nature of set-off; and contrary to assumptions made in cases of high authority, including many that bind this court.

43. First, the law of contract. The breaches of which Mr Smith complains, and which he wishes to set-off in this action, were committed by Mr Walker, not by Mr Muscat. For that reason, it is necessarily and properly accepted in Mr Smith's pleadings and in his argument that he could not bring an action for damages against Mr Muscat. That is because there is no privity of contract between Mr Smith and Mr Muscat in respect of those breaches. To permit Mr Smith's claim nonetheless to be effective against Mr Muscat by way of set-off would undermine that basic rule.

44. Second, the set-off with which we are concerned is and is only one that operates as an incident of litigation. Such a set-off is merely a sub-species of counterclaim: see the analysis of Slade LJ in the *National Westminster Bank* case, [1993] 1 WLR at p 76 E-G. It is a special and privileged type of cross-claim because it operates in the litigation to extinguish the claim and prevent its original establishment, rather than to provide a sum to be balanced off against the claim once established: see the account given by Lord Denning MR in the *Federal Commerce* case, [1978] 1 QB at pp 973G-974G. That distinction is of course of crucial importance to Mr Smith in defending the possession action in the present case. But a counterclaim plainly cannot be asserted against someone other than the claimant: so by the same token neither can the sub-species that is set-off be so asserted.

45. Third, authority. The dearth of specific statements supporting the proposition that a cross-claim must be a claim against the original claimant is attributable to the fact that that proposition has always been taken for granted. All of the recent cases discussing whether the cross-claim was sufficiently closely connected with the claim to be set off against it in the same litigation presuppose that the claims, whatever they are, lie between the same parties. That stands out from, for instance, the various discussions cited in the judgment of Forbes J in *British Anzani v International Marine* [1980] 1 QB 137 at p 154D-H. Counsel for Mr Smith sought to suggest that a wider rule could be found in the dictum of Lord Denning MR in the *Federal Commerce* case [1978] QB 927 at p 974:

> "We no longer have to ask ourselves: what would the courts of common law or courts of equity have done before theJudicature Act? We have to ask ourselves: what should we do now so as to ensure fair dealing between the parties?"

But that observation went only to a more liberal attitude to the question of whether a cross-claim sufficiently impeached the claim to create a set-off: the issue discussed in the passage with which this dictum culminates, and to which reference has already been made in §44 above. It certainly cannot be relied on a convert the rule of set-off into some more general equitable doctrine, and much less into a form of palm-tree justice.

46. The general principles of set-off therefore do not assist Mr Smith. However, the unfairness that appears from Mr Muscat being able to sue for rent arrears dating back to the time of Mr Walker, without being liable for the breaches of covenant committed by Mr Walker, is underlined by Mr Muscat's title to sue being itself derived from Mr Walker by assignment. It is the particular rules that apply after assignment that determine this appeal.

The effect of an equitable assignment

47. Three cases decided very shortly after the Judicature Acts held that the rule that an assignee takes subject to existing equities, as confirmed by section 25 of the Judicature Act 1873, extended to the "equity" created by the former power of the courts of equity to intervene by injunction in a case of equitable set-off. Accordingly, in an action at law after 1873 the assignee was bound by a set-off that could have been asserted against his assignor.

48. That conclusion was first enunciated in *Young v Kitchin* (1878) 3 Ex D 127 by Cleasby B at p 129 (the argument of Bompas QC at p 128 is also illuminating). The same view was taken by James LJ in *Roxburghe v Cox* (1881) 17 Ch D 520 at p 526; and by the Privy Council, per Lord Hobhouse, in *Government of Newfoundland v Newfoundland Ry* (1888) 13 App Cas 199 at p 213. James LJ said:

> "the assignee of a chose in action…..takes subject to all rights of set-off and other defences which were available against the assignor…."

Lord Hobhouse said:

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

49. *Young v Kitchin* and *Newfoundland* were cited with approval by Morris LJ in *Hanak v Green* [1958] 2 QB at p 26. *Newfoundland* was subjected to very close scrutiny by the House of Lords, speaking by Lord Brandon of Oakbrook, in *Bank of Boston Connecticut v European Grain and Shipping* [1989] AC 1056 at pp 1109-1110, but only in connexion with the argument advanced in that case that *Newfoundland* could be relied on to secure a set-off against an assignee that would not have been available against his assignor: a proposition that was rejected without, however, casting doubt on the basic *Newfoundland* doctrine.

50. I conclude, therefore, that those cases remain good law. The inseparable connexion between the two dealings that is required by *Newfoundland* is plainly provided by the fact that both arise under the same lease. The rule of privity referred to in §43 above is not offended, because the outcome of a valid assignment is recognised as an exception to the general doctrine of privity: see e.g. *Halsbury's Laws* (4th edition, reissue), vol 9(1) §754. This jurisprudence compells the recognition of a set-off against Mr Muscat's claim of the unliquidated damages owed to Mr Smith by Mr Muscat's assignor, Mr Walker.

51. In *Lotteryking* Lightman J held that the set-off operated because the assignee had succeeded to the reversion and to its annexed covenants. The reversion itself is not, however, a chose in action, and Mr Muscat's claim for past rent is not asserted simply under a covenant that he succeeded to when he succeeded to the reversion. Rather, the claim for *previously accrued* arrears that he asserts against Mr Smith is specifically transferred to him by his assignor by the operation of section 141 of the 1925 Act, as described in §41 above.

52. The jurisprudence relating to set-off discussed above was not put before us during argument. We therefore invited further written submissions upon it. In a powerful argument Mr Johnson, for the landlord, while not challenging the general effect of the authorities, submitted that the equitable rules of set-off were excluded from cases of landlord and tenant by the provisions of section 142. As held by Garland J in *Duncliffe*, the tenant could not directly bring proceedings in respect of prior breaches of covenant; so by the same token he should not be permitted to rely on a set-off when himself sued. Otherwise, it was submitted, the statutory scheme of sections 141 and 142 would be robbed of all effect. And Mr Johnson pointed out that those provisions contained no wording comparable to section 25(6) of the Judicature Act 1873, which had guided the decision in, for instance, *Young v Kitchin*.

53. I would acknowledge the force of these submissions, but I am not persuaded by them. First, I think that it may put matters too high to speak of the "scheme" of sections 141 and 142. As Sedley LJ points out in his judgment, if the effects of those provisions are not moderated by equity, surprising and unsatisfactory outcomes result, as indeed Garland J thought in *Duncliffe*. Indeed, the form of section 141 may be attributable not to any conscious policy to favour the landlord over the tenant, but simply because of the history of its predecessor legislation in reversing the previous law that prevented an assignee of a reversion from suing on the covenants that it contained: see for instance Megarry & Wade, *Real Property* (6th

edition), §§ 15-011 and 15-051. Second, even if sections 141 and 142 could be regarded as a scheme, it would need more than that fact to exclude general rules of equity from the scheme. That is particularly so because the 1925 Act does contain specific legislation making the right to assign subject to the right of set-off: section 136, the successor provision to section 25(6) of the Judicature Act 1873.

54. I therefore see no reason for thinking that section 141 was intended to exclude that rule of equity, confirmed by statute, from a case where the landlord asserts a claim as an assigned chose in action. I would therefore hold that Mr Muscat, if he asserts a claim for rent against Mr Smith to which he has title only because he has succeeded Mr Walker in the claim, is by the same token bound by the setting-off by Mr Smith of his claim under the lease against Mr Walker.

The "fallback" grounds

55. I entirely agree with what is said by Sedley LJ in §7 of his judgment, and there is nothing that I would wish to add.

Lord Justice Ward :

56. Buxton L.J.'s illuminating judgment on the nature of equitable set-off explains why the rules relating to assignment determine the outcome of this appeal. That rule is stated in *Snell's Equity*, 30th Edition, paragraph 5-22 to be this:-

> "The assignee of a chose in action cannot acquire a better right than the assignor had, and the assignee takes the chose in action subject to all the equities affecting it in the hands of the assignor which are in existence before notice is received by the debtor."

The authority for that proposition is *Roxburghe v Cox* (1881) 17 Ch.D 520 and my Lords have cited the relevant passage from the judgment of James L.J.

57. I therefore agree with my Lords that for the reasons they give this appeal must be allowed and the claim and counterclaim remitted to the County Court.

Order: Appeal allowed and claim and counterclaim remitted to the County Council; question of costs to be dealt with in writing and parties notified accordingly.
(Order does not form part of the approved judgment)