Unilateral setoff and the principles of Undroit
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A. The problems of setoff in international commercial transactions

Setoff is a means of satisfying money debts or debts in kind through the application and reduction of
the debt against an obligation that the creditor owes his debtor. Roman law defined setoff as the
contribution between debts and credits (compensatio est debiti et crediti inter se contributio).
According to the Principles of Unidroit, “where two parties owe each other money or other
performances of the same kind, either of them (“the first party”) may set off its obligations against that
of its obligee (“the other party”) (Unidroit, Article 8.1.1). Setoff is normally used to satisfy obligations
arising out of the same transaction (referred to as “transaction setoff”). Setoff can also be used to
satisfy obligations arising out of different transactions (referred to as “independent
setoff”).

Transaction setoff is relatively simple: B (the second creditor) owes A (the first creditor) the
sum of € 100 as the balance of the purchase price on a contract for sale, and A in turn owes B € 50 as
the return of a security deposit arising out of the same contract for sale. The obligations are set off up
to the concurrence of the smaller of both amounts, that is, up to the amount of € 50. Independent setoff
arises when the counter-obligation (second credit) that is being set off arises from a separate legal
relation: a different contract, an award, a judgment for the enforcement of damages arising out of a
tort, obligations arising out of bills of exchange, reimbursement obligations under letters of credit, or
similar.

Both transaction setoff and independent setoff in civil law countries can be claimed by simple notice
sent by the second creditor to the first creditor or brought up as a defense in a procedure: the debtor
(the second creditor) sends notice to his creditor (the first creditor) advising him that he is setting off
his obligation against a credit that he has against him. If the parties are in a civil law jurisdiction,
setoff occurs automatically once the notice is received by the other party. Under common law, setoff
cannot be claimed by simple notice; it must be presented as a procedural defense that is brought up by
the defendant or respondent. Further, under the common law system, setoff is effective when the final
judgment or award is entered.

There are three types of setoff: unilateral setoff (denominated by some as automatic setoff or legal
setoff), procedural setoff and setoff by agreement (or contractual setoff). Unilateral setoff, which is
available in civil law countries and now under the Unidroit Principles, is a setoff that occurs by the
notice given by one party to the other party; a form of self help, that is, by unilateral desire of one
party without the consent of the other party. Unilateral setoff is at times, in some civil law countries,
called automatic setoff. But this is today a misnomer since most, if not all, civil law countries require
that the party that wishes to have his debt setoff against its credit must express his desire to the other
party; setoff will not occur automatically (see post, section 2.03). Procedural setoff requires that the
parties be in litigation. The procedural setoff can be simple procedural setoff or what is called by some
’substantive setoff’, which is nothing more than a unilateral setoff where the notice of setoff is the
defense of setoff. The other type of procedural setoff is in the form of a counterclaim, also referred to
as judicial setoff, which is the result of a final judgment by a court or an arbitral tribunal. Setoff can
always take place by agreement among the parties. Setoff by agreement (contractual setoff) in most
legal systems is accepted, except on those rare occasions where a party, because of some question of
public policy, cannot freely assign his credit.

Though setoff is a long-standing form of defense to a claim, in an international context it continues to
present certain problems, especially when claimed in an international commercial arbitration
procedure. Setoff can be claimed for debts arising out of the same contract (transactional setoff), in
which case the problems of jurisdiction and applicable law do not normally exist. Setoff, however, is
widely recognized as a means of defense for claims in credits arising out of different contracts
(independent setoff). When setoff is claimed out of a contract different from the contract in which an
arbitration procedure has been commenced, there arises the problem of choice of law and jurisdiction
that has to be resolved by the arbitral tribunal. In international arbitration, if the arbitral tribunal has jurisdiction in the initial claim, does it also have jurisdiction on a claim of setoff brought by the respondent? If it does have jurisdiction, what law should the tribunal apply to determine the conditions of setoff?

In international commercial transactions there also exists the problem of multi-currency setoffs, that is, setoffs of claims in one currency (e.g., U.S. Dollars) against claims in a different currency (Yen, Euro or others). The problem of multi-currency setoffs has been clearly addressed in the Unidroit Principles (see post, section3.15), though most domestic laws do not address this problem.

Setoff in international commercial transactions is further complicated by the fact that there are two different systems in domestic law regarding setoff: the civil law system and the common law system. Setoff in civil law basically is a substantive defense that can be brought before or after a procedure has been commenced. It does not have to be brought up as a defense to a claim. Under common law, setoff normally is brought up as a defense to a claim. Civil law countries recognize that setoff is retroactive to the time when the conditions for independent setoff were available. Under common law, setoff is only effective as of the date in which a judgment or an award is entered. When faced with a claim subject to civil law and a setoff defense for a claim subject to common law, the arbitral tribunal has the task of finding where these systems meet. The 2004 amendment of The Principles of Unidroit incorporated a new section (Article 8) that regulates setoff. These new Unidroit rules are a middle ground between the principles of setoff under civil law and common law countries.

This paper addresses the problems that arise regarding independent unilateral setoff, that is, setoff from claims which are independent of each other because pertaining to different contracts that is claimed as a defense in a procedure (either a judicial or an arbitral procedure). When claims arise from a civil law jurisdiction (including most Asian countries that have adopted modified versions of the French and German codes), independent unilateral setoff, when the conditions of setoff are present at the time that the claim of setoff is made, does not present a problem of jurisdiction for the tribunal. The difficulty comes in the ability of the tribunal to distinguish between a claim of setoff and a counterclaim. This distinction depends on the identification of the conditions under which unilateral setoff may occur.

In the past there has been a fair amount of discussion on the difference between the German and the French systems of setoff. This difference does not exist any longer (see post, section 2.03). However, there continues to be a difference between setoff in a common law jurisdiction and setoff in a civil law jurisdiction. When the first credit against which a claim for setoff is presented is subject to common law, the conclusions on involuntary independent setoff are somewhat harder than when both claims arise from civil law jurisdictions.

B. Setoff in comparative law

1. Setoff in Civil Law (German and French systems)

In the comparative law of obligations, the rules for setoff under the French Civil Code (Articles 1289 to 1293) have been distinguished from the so-called German system adopted initially under the German Civil Code (BGB, Articles 387 to 396). Under the classical interpretation of the French Civil Code adopted initially in 1804, setoff (compensation) is supposed to occur automatically (ipso iure) at the moment conditions for setoff exist, independently of whether a party has requested setoff or not. The French system of automatic compensation appears in a number of European codes (Belgium, Luxemburg and Spain) as well as the Civil Code of Quebec and a large number of Latin American codes, including Venezuela (Ven.CC. Art. 1332), Colombia (CC.Col, Art. 1715) and Panama (CC.Pann, Art. 1088), among others. Also, in Africa, the Code of Commercial and Civil Obligations of Senegal (Art. 216). Some codes, such as the Italian Civil Code of 1942 (Art. 1242) the Peruvian Civil Code of 1989 (Art. 1288) and more recently the Brazilian Civil Code of 2002 (Art.
leave the question of automatic setoff open, apparently insinuating that they are adopting a system similar to the German system of notice.

Under the German Civil Code, setoff only occurs if a party has expressly claimed setoff by notice to the other party of its intention to apply setoff (BGB, Article 388). The German system has been adopted by many European countries, including Switzerland, in the new 1966 version of the Portuguese Civil Code (Art. 840.1), the Dutch Code of 1992 (Book 6 Art.127), as well as the Civil Code of the Russian Federation (Article 410). It is also adopted in the Japanese Civil Code (Article 506) and in several Arab civil codes, including the Civil Code of Bahrain (Article 356a). According to the Contract Law of the People’s Republic of China, “if a party maintains that the debts be offset, it shall inform the other party. The notice shall go into effect at the time it reaches the other party” (China, Contract Law, Article 99, 2nd paragraph).

Under the German system setoff does not occur automatically, a notice must be sent indicating the intention of setoff. Under the classical interpretation of the French system, the setoff would occur independently of any notice. Under both systems, setoff has retroactive effect back to the time when the conditions of setoff were present.

Despite the apparent difference between the French and the German systems, contemporary doctrine in France as well as in most countries influenced by the French Civil Code recognizes that setoff does not in fact occur automatically. The concept of *ipso iuri* setoff is considered an erroneous interpretation of Roman law. A party must request (claim) setoff either by notice to his counterparty or by bringing setoff as defense in action against the party requesting setoff. If setoff is brought up as a defense in a procedure, the defense is a form of a claim for setoff. If setoff is not brought up as a defense, the party must give some form of notice or expression of intention to the other party of its wish to have setoff applied. The conclusion is that in Civil Code countries (both of French and German influence) setoff operates under the same rules: unilateral setoff can be claimed by simple notice or by bringing up a defense of setoff in a procedure; and, in most countries, setoff will take effect retroactively.

### 2. Setoff in the common law system

In English common law, setoff can only be brought up as a defense in a legal action. There is no automatic setoff by simple notice as exists in civil law countries and, further, setoff is not retroactive (see above sections 2.01 and 2.02). The legal right to claim setoff originates from the statutes of setoff adopted in 1729 and 1735. The purpose of the statute of 1729 was to help debtors that otherwise would face prison for failure to pay debts. In English law it is held that “the right of setoff derived from the statutes operates as a defense to an action at law for payment of a debt, it is commonly described as a procedural defense”. The consequence of treating setoff as a defense is that there is no automatic setoff as exists in civil law. Furthermore, the defense of setoff has no substantive effect on the debt until a final judgment is entered. In effect, “the debt remains in existence until there is judgment for setoff”, setoff is never retroactive as it is in most civil law countries. However, the defense of setoff is said to have, in English law, some substantive effects, since the effect of having brought up the defense of setoff is not totally postponed until the time that final judgment is entered.

In English law setoff is also a defense in equity. To have a right to setoff, the party claiming setoff must show that he has equitable grounds and that, therefore, “it would be manifestly unjust to allow one claim to be enforced without regards to the other”. Further, the cross-claim must arise from the same contract or from a related contract. Equitable setoff can also take place “following and inseparably connected with the dealings and transactions which also give rise to the claim”. Equitable setoff is referred to as a substantive defense and not a procedural defense. A procedural defense of setoff is one brought under common law. This does not mean that when a defense of setoff is brought in equity, the debt is extinguished automatically as occurs in civil law countries (see above, section 2.01), but once the defense has been raised and prior to judgment, it limits the rights of the creditor against whom setoff is being applied. In this sense, “it operates as a complete or partial
defeasance (abrogation) of plaintiff’s claim”. However, the claimant’s claim “is not extinguished prior to judgment”. 

There is no equivalent of equitable setoff in civil law, nor is there in civil law any valid distinction between procedural and substantive setoff as one finds in English law. In effect, under civil law, if the requirements of setoff are available at the time and a debtor claiming setoff has given notice to his creditor or presented a defense for setoff, setoff takes effect concurrently and with a retroactive effect (see ante, section 2.03). In fact, the technicalities of equitable setoff and the difficulty of framing it in comparative law has led to the conclusion that the concept of equitable setoff should not be brought up in an international commercial setting, since it is both unnecessary and confusing.

Under American law, following English law, setoff is brought up as a defense in a procedure. Setoff outside of a legal procedure before court or an arbitral tribunal is only possible by agreement among the parties. In the United States, simple setoff, known as recoupment, is only available for debts arising from the same contract. In Fred Ackerman vs. National Property Analysts (New York, 1992) (887FEDSupp 494), it was held that the defense of setoff or recoupment could only be claimed against debts that arise out of the same transaction that is used to prove the claimant’s or plaintiff’s suit. However, under the American Uniform Commercial Code (UCC), there is a form of setoff by notice that can, and must in fact, be completed outside of a legal procedure. According to the UCC, “the buyer, on notifying the seller of the intention to do so, may deduct all or any part of the damages resulting from any breach of the contract from any part of the price still due under the same contract” (UCC, section 2-717). According to the official comment of the UCC this section “permits the buyer to deduct from the price damages resulting from any breach by the seller and does not limit the relief to cases of breach of warranty, as did the prior uniform statutory provisions” (UCC, section 2-717, official comments, subsection 1). To be able to have the right of deduction (that is, setoff for damages) the buyer must give notice to the seller of its intention “to withheld all or part of the price if he wishes to avoid a default within the meaning of the section” (UCC, section 2-717, official comment N° 2). The notice, under Article 2-717 does not require any formality and it suffices that it uses any language which “reasonably indicates the buyer’s reason for holding up his payment” (UCC, section 2-717, official comment N° 2).

3. Setoff in Unidroit (the middle way)

With the amendment of the Principles of Unidroit in 2004, special rules were adopted to regulate setoff (Articles 8.1 through 8.5). These rules are a middle road between the civil law system and the common law system of setoff, in the sense that setoff can, under the Principles of Unidroit, be claimed in a procedure or outside of a procedure. However, for setoff to occur it is necessary that the party that is claiming setoff (the first party) send notice of its intention to set off to the other party. If at the time the notice is sent the requirements for setoff are present, then setoff will take effect as of the date on which the notice is received by the other party (Principles of Unidroit, Article 8.5.3). This means that, under Unidroit, setoff does not have retroactive effects. However, under Unidroit, setoff, unlike what occurs in common law, does not occur at the time a judgment or an award is entered but rather at the time that notice is received. In an arbitration procedure this would be at the time that the defense of setoff is claimed if notice was not received prior to the commencement of the arbitration. It is possible that, in an arbitration, the first party (the respondent in the arbitration procedure) has already received a notice of setoff from the other party prior to the other party (claimant) having commenced the arbitration. Notices under the rules of Unidroit do not require special formality and they merely must be an expression of consent on the part of the first party of its intention to have setoff operate. It is clear under the Principles of Unidroit, since a notice is necessary, that there is no such a thing as ipso iure setoff (automatic setoff), which used to be the system applied under French law and in countries of French influence (see ante, section 2.01). Notice must be received by the other party, which implies that the other party has actual knowledge of the intention to setoff. For example, the fact that a party may have accounted in its own books for a setoff does not mean that setoff has in fact occurred.
Under the Principles of Unidroit, notices may be given by any means appropriate to the circumstances (Unidroit, Article 1.10) and are effective when notice is received by the person to whom it is given (Unidroit, Article 8.3, third paragraph). Notice of setoff cannot be sent until after the conditions for setoff are present (Unidroit Principles, Article 8.3). For example, if the first party sends a notice of setoff but his or her obligation is not yet due and payable, setoff cannot be claimed (Unidroit Principles, Article 8.1). A notice of setoff sent before the date on which the conditions for setoff were effective has no legal effect.

C. SETOFF AS A DEFENSE (procedural and substantive setoff)

1. Setoff as a defense or a counterclaim

In an international commercial context, the difference between setoff as a simple defense or setoff as a counterclaim is very important. Setoff occurs as a simple defense in an arbitration procedure when the requirements of setoff are met when the respondent (second creditor) claims setoff.

Setoff as a defense requires that there be mutuality; it only operates “where two parties owe each other money or other performance of the same kind” (Unidroit, Article 8.1.1). Both obligations must be in money or of the same kind so that the obligations can substitute one against the other (Dollars against Dollars, Euros against Euros, coffee against coffee). Obligations to pay money are those that most frequently are used in claiming setoff. Setoff between obligations to deliver commodities is not used very frequently. The debts must be liquid (for a certain sum) and be due and payable at the time that setoff is claimed. The obligation must be certain (Unidroit, Article 8.1.1.b), that is, not contested. Certainty means that there is no doubt as to the existence of the obligation of the first creditor in favor of the second creditor. The obligation must also be ascertained as to its amount, and performance of both obligations must be due. The requirements for simple setoff are relatively uniform in all civil law countries.

These requirements find parallels in common law and in the Principles of Unidroit (see post, section 3.05 et seq). The difference between setoff as a defense and setoff as a counterclaim is important. When setoff is brought as a defense in a procedure, the party that claims setoff is affirming that the requirements for setoff are present at the time that he brings up the defense. In civil law countries, this is tantamount to stating that setoff has already occurred since setoff (both in the French system as well as the German system) is retroactive.

When the requirements for setoff are not present at the time that setoff is claimed, setoff is no longer a simple defense but appears as a counterclaim, where the arbitrator may have to decide on the liability of the other party. In an arbitration to collect the balance of the price in a service contract, if the defendant claims that the plaintiff did not properly perform the contract and thus is liable for damages, the arbitrator will have to decide if the plaintiff is liable and for how much. In this case the debt of the second party is not satisfied when he brings the setoff defense, but rather at the time when an award is rendered.

In common law, when the claim for setoff is a counterclaim the judge (or the arbitrator) must enter a judgment for each claim since each claim is treated as a separate action. If setoff is brought as a counterclaim, the respondent is not merely claiming setoff, he is bringing a new claim which will have to be proved and on which the tribunal will have to make a substantive determination. Setoff as a counterclaim exists when the conditions or requirements for setoff are not present when the respondent files his response or makes his claim for setoff. For the tribunal to be able to decide setoff as a counterclaim, it will have to determine first that it has jurisdiction on the counterclaim. This will require that the tribunal first define which type of setoff is being claimed by the defendant, be it simple setoff as defense or automatic setoff, or a counterclaim.

In civil law, simple setoff (unilateral setoff) discharges debts up to the concurrence of the lesser of the two credits. For example, in a contract for works, if the contractor requests payment of € 150,000
remaining on the contract and the employer claims setoff for €50,000, the contractor’s claim is reduced to €100,000. If the second creditor’s (respondent’s) defense for setoff is for an amount higher than the claimant’s (first creditor), then setoff is applied to the lesser of the two amounts. In the prior example, if the employer had originally commenced arbitration to recover his deposit of €50,000 and contractor presented a defense for setoff for €150,000, the claim would be satisfied in its entirety (i.e. €50,000), but the award would not cover the excess of €100,000. Setoff would only operate up to the lesser of both amounts, but the respondent, in theory, could not enforce the award for the additional sum of €100,000. The rule of limited setoff is provided for expressly in several civil codes. In Germany, Article 389 of the Civil Code provides that setoff is up to in the measure of the scope of the credits that are being setoff. In Colombia the Civil Code provides that the credits are reciprocally extinguished (paid) up to the meeting of their values (CC.Col, Article 1715). The Italian Civil Code calls for satisfaction up to the corresponding amounts (CC 1241). The Spanish Supreme Court, in a decision of June 2001 held that, when the second credit used for the defense of setoff is for a larger amount than the first credit (plaintiff’s credit) (second credit > first credit), the only way that the second creditor can get a judgment for the excess (denominated by the Spanish Supreme Court as the credit plus or the surplus credit above the amount that has been used for setoff) is by bringing a formal counterclaim that allows the judgment to order the plaintiff to pay the surplus credit (plus crediticio).32

2. The requirements for setoff as a defense

The first requirement for simple setoff is mutuality, also referred to as reciprocity (réciprocité) in civil law. Reciprocity requires that the obligations be shared by both sides, that is, “each party is the obligor and obligee of the other” and “must be in the same capacity” (Unidroit, comment 2, Article 8.1). Reciprocity is required in all legal systems. The French Civil Code provides “where two persons are debtors towards each other there operates between them setoff, which extinguishes both debts” (CC.Fr., Article 1289). Reciprocity is required in the Unidroit Principles (Article 8.1.1). Mutuality is also required in common law. In effect, “mutuality in fact refers to two characteristics, that the demands must be between the same parties, and that they must be held in the same capacity or right of interest”.34 “Cross demands which are not mutual may not be set off except under special circumstances”.35 When one of the debts is held in trust, mutuality requires that setoff occur with the person that has the beneficial interest; the beneficial interest must be clear.36

Mutuality does not by definition require that the debts arise from the same contract. In civil law, the debts can arise from the same contract or different contracts. In Italy, Article 1246 of the Civil Code provides that setoff will occur independently of the origin of the rights of one or the other credit, with a reference to the origin of one or the other obligation.37 In some civil law jurisdictions, such as occurs in Venezuela and Argentina, doubt has arisen as to whether setoff can occur between two obligations that originate from the same contract. This principle, however, is not universal.38 In common law, setoff in equity can only occur for debts that arise out of the same transaction. Statutory setoff, however, is not subject to this requirement. Unidroit recognizes that setoff can arise from the same contract or from different contracts. However, it does provide a more lenient system of setoff when the obligations arise from the same contract. According to the official comment of Unidroit: “if the obligations of two parties arise from the same contract, the first party is allowed to set off its own obligation against an obligation of the other party, even where that other party’s obligation is not ascertained as to its existence or to its amounts” (Unidroit commentary, comment 7 to Article 8.1).39

The second requirement for automatic setoff is that the obligations must be of the same kind (Unidroit, Article 8.1.1) (Unidroit, comment 3 to Article 8.1). Most cases of setoff involve a claim for money debts. If obligations from money debts are denominated in the same currency, there is no doubt that the obligations are totally identical except, of course, for the amount. When the obligations are denominated in different currencies, so that there is a foreign currency obligation for one of the parties, Unidroit has developed special rules (see Unidroit, Article 8.2) (see post, section 3.15).

The debt must be ascertained as to its existence as well as to its amount (Unidroit, comment 5, Article 8.1). “The existence of an obligation is ascertained when the obligation itself cannot be contested”
French doctrine holds that a claim for damages is not ascertained as to its existence. In Quebecois case law it has been held that the reality of the obligations must not be in dispute and that the amount of each obligation has to be fixed with precision or subject to be fixed or easily set in an amount. In England, in the case of *Stooke v Taylor* (1880) it was held that, to be able to claim setoff under the statutes, the claims on both sides must be liquidated debts “or money demands which can be readily and without difficulty ascertained”. However, a debt for liquidated damages is considered ascertained.

The fourth requirement is that the obligations must be due and payable, not subject to any term or condition. Unidroit provides that the first party must have the right to perform its obligation. “It cannot impose on the other party a performance which it either has not yet ascertained or is not yet due” (Unidroit, comment 4, Article 8.1). A typical case developed from the example in the Unidroit Principles is that party A owes B €20,000 for the repayment of a loan, which has to take place on January 30. In turn, B is obliged to pay A a claim for damages of €14,000 under a judgment handed down on January 25. A asks B to pay on February 9. B, is allowed to set off its obligation against the obligation of A. If, on the other hand, A had requested that B pay its obligations on January 25, B could not have claimed setoff against the debt of A (Unidroit, comment 6 to Article 8.1).

The review of the requirements of setoff shows that, with some minor exceptions, these requirements are applicable in all legal systems and this is what is reflected in the Principles of Unidroit. When faced with a claim of setoff, the arbitrator, independently of the law applicable, can easily determine which are the requirements for setoff to proceed as a defense. At times, however, the arbitrators can face certain questions on the requirements for setoff in a particular case. The fact that the claimant objects to a defense of setoff does not mean that the claim for setoff automatically converts itself into a counterclaim. The arbitral tribunal may well have to decide if the simple claim for unilateral setoff in the particular case is possible. The fact that the arbitrators may have to consider additional matters when a setoff defense is presented, is reflected in the ICC Rules of Arbitration (1998). Under the ICC Rules (1998) “set-off shall be taken into account in determining the advance to cover costs … insofar as it may require the Arbitral Tribunal to consider additional matters” (ICC Rules, Art. 30(5)). Additional matters include considerations as to existence of the obligation and the amount.

### 3. Setoff between debts in multiple currencies

In an international setting mutual obligations to pay money are frequently denominated in different currencies (Rupees, Dollars, Yen). Most municipal law systems do not have specific rules for this case. Even though foreign money for one of the parties, is considered as money, obligations denominated in two different currencies are not considered homogeneous. The Principles of Unidroit, following classical civil law doctrine as well as common law authority, when one of the obligations is in foreign money for one of the parties, distinguishes foreign money debts in two classes: foreign money debts where the foreign money is the currency of account and foreign money debts where the foreign money is the currency of payment. Under the Principles of Unidroit, the debtor of an obligation expressed in a currency different to the legal currency in the place of payment can discharge his debt in the legal currency at the place of payment, except when said currency is not freely convertible or the parties have agreed that the payment shall be made only and exclusively in the currency in which the debt is expressed (that is, foreign currency is adopted as the currency of payment) (Unidroit, Article 6.1.9). Unidroit, when it adopted in 2004 the rules for setoff (Unidroit, Article 8), it also adopted special rules that reflected the rules of section 6.1.9 for the purpose of allowing multiple currency setoff to take place. For this purpose, Unidroit adopted a specific rule whereby: “Where the obligations are to pay money in different currencies, the right of setoff may be exercised, provided that both currencies are freely convertible and the parties have not agreed that the first party shall pay only in a specified currency” (Unidroit, Article 8.2).

### D. SETOFF IN INTERNATIONAL ARBITRATION

**Applicable law**
In an international arbitration the tribunal is faced with two tasks if a claim for setoff is presented. It must determine if it has jurisdiction on the claim for setoff; and it must determine the applicable law to claim for setoff. The arbitral tribunal must decide what law it will apply for the purpose of deciding this defense. That is, which is the law that is applied to the determination of the requirements to allow setoff. The law applicable to setoff is different to the law applicable to the dispute. The tribunal has basically two choices: it can apply the conflict rule of the *lex arbitri* or, in the alternative, it can decide to apply general principles of international commercial law.

In ICC Case 3540 (1980) the tribunal, acting as *amiable compositeur*, applied *lex mercatoria* to determine if setoff could proceed. The tribunal decided that it would examine whether the solution contained in its award based on *lex mercatoria* would be fundamentally different from that resulting from the national laws invoked by the parties (in this case the parties had invoked French law and Swiss law). According to the tribunal, *lex mercatoria* holds “that in principle the setoff should be accepted”; according to the general principles of law, setoff is a form of extinction of two obligations of the same kind, existing reciprocally between two persons. The contemporary expression of the rules of setoff in international commercial practice could be said to be the rules of Unidroit regarding setoff.

The second approach that a tribunal can follow is to determine the applicable law by using the conflict rules of the *lex arbitri* or by using its own evaluation of what would be the conflict principle applicable (*vois direct*). The most standard choice of law rule is found in Rome I on the law applicable to contract obligations, which provides that “where the right of setoff is not agreed by the parties, setoff shall be governed by the law applicable to the claim against which the right to setoff is ascertained” (Rome I, Article 17). Under English law, when setoff is substantive as opposed to procedural, the law governing the claim which the defendant ascertains as being discharged is the one that governs the right to setoff. When setoff is a form of a counterclaim the determination of the conditions of setoff and whether the claim can be raised in an action is up to the *lex fori*. In practice, the problem of the applicable law will be important in those cases of independent setoff where the claimant’s claim is subject to common law. If both claims are subject to civil law, the rules of setoff are relatively simple.

**Jurisdiction of the tribunal**

The tribunal on the question of jurisdiction will face one of three different circumstances: (i) the reciprocal claims (both the first claim and the second claim) arise out of the same contract (the typical case of transaction setoff, see ante, section 1.01); (ii) the reciprocal claims arise out of two different unrelated contracts; and, (iii) the reciprocal claims arise out of two or more different contracts but which are in some way related. In the first case, when the claims arise out of the same transaction, there is no problem of jurisdiction or applicable law, since the arbitration, as well as the governing law provisions in the contract will normally apply to all rights and obligations that originate from the contract. In this case the tribunal does not have to define whether or not the defense of setoff is a simple defense of setoff or a counterclaim (see above, section 3.01). An example taken from the comments in Unidroit is that of a transporter that accepts the transport of a piano for B from Toronto to New York. A provision in the contract foresees expressly penalties that should be paid in case the piano is not delivered to the concert hall five days before the date of the concert. The piano is delivered in New York only two days before the concert date. A sues for the payment of the transport. B can setoff A’s claim against A for penalties due to the delay in the delivery of the piano. Setoff would proceed even if A were contesting the amount of the penalty due to the delay.

According to Unidroit, in those cases where the reciprocal claims arise out of the same contract, setoff can take place even if the debt of one of the parties is not certain as to its existence or its amount (Unidroit, Article 8.1.2). This provision in fact allows setoff to take place even though the conditions of certainty as to the existence and amount are not present at the time that the claim for setoff is made,
as long as the claims for setoff arise out of the same contract. This would allow a claim for setoff based on damages owed because of defective performance of a contract.

The second case is when the reciprocal claims originate from two different contracts between the same parties, which may bring up the question both of jurisdiction and of applicable law. Because mutuality is essential for a setoff defense (see ante, sections 3.04 and 3.05), the two different contracts are assumed to be between the same parties. For example, party A, a wine producer in Italy, brings a claim against party B for the sum of €10,000 arising from the sale of 1,000 bottles of wine. In turn, party B, a cork producer in Portugal, brings up a defense of setoff for the sum of €5,000 that corresponds to the unpaid purchase price for a 100,000 corks. In this example, where both the wine and the corks have been delivered and the prices are payable in both contracts upon delivery, there is a simple claim of setoff. In fact, once the defense for setoff is presented, setoff takes effect automatically. If both contracts have an ICC arbitration clause and both contracts are subject to Portuguese law despite the fact that the claims arise from different contracts, there is no problem of jurisdiction since both have exactly the same jurisdiction and are subject to exactly the same law.

If, on the contrary, in the example immediately above, the first contract has an ICC arbitration clause and is subject to Italian law, and the second contract is subject to ordinary jurisdiction of the courts of Lisbon and to Portuguese law, the tribunal must determine both the applicable law and its own jurisdiction. In this case, by application of Article 17 of Rome I Convention, the applicable law would be Italian law. In effect, if setoff is not agreed by the parties setoff shall be governed by the law applicable to the claim against which the right to setoff is asserted” (Rome I, Art. 17) (see ante, section 4.02). In any case, the conditions for setoff are universal and, therefore, the choice of Italian law or Portuguese law or even the application of the Unidroit Principles call for the use of the same standards to define if the conditions for a setoff defense are available.

The difficult question in this case is that of jurisdiction, that is, can the arbitral tribunal accept the defense of setoff even though the second claim does not have an arbitration clause. In the above example, if setoff is brought up as a defense, the party that is claiming setoff is accepting, by definition, the jurisdiction of the arbitral tribunal to declare setoff up to the amount that the tribunal finds the claimant owed the respondent at the time that his defense was brought up. All the tribunal has to do is to verify if the conditions of setoff are present. On the other hand, if setoff is claimed as a simple defense, the claimant who made the choice of the tribunal when he commenced the arbitration cannot claim that the tribunal has no jurisdiction to decide on the defense brought up by the respondent. The claimant, when he files his request for arbitration, does so under the understanding that the respondent will have a right to bring before the tribunal all the defenses that he deems pertinent, including payment or satisfaction of the debt by whatever means, including by setoff. Further, the setoff defense is a statement by the Respondent that his obligation to the Claimant has been satisfied. In Civil Law countries this means that the claim was paid (in whole or in part) at the time that the conditions for setoff were present and notice sent. In substantive law (as opposed to procedural law) the right to setoff on the debt is not “subordinated to the condition” that the tribunal have jurisdiction.

Related contracts is a reference to a group of different contracts among the same parties and which are all directed to one single commercial activity. If the related contracts have the same arbitration clause, then a claim for setoff from one contract can be brought in a procedure to collect a claim under the other contract (see ante, section 4.04). Also, because the contracts are connected, even if one of the contracts does not have an arbitration clause, a claim for setoff from one contract to the other will operate as a transaction setoff and should be allowed. ICC Case N° 5971 (1994), involved a joint venture contract subject to ICC arbitration in Paris and a know-how and a sales contract with ICC arbitration in Zurich. In an arbitration under the joint venture agreement, the respondent claimed setoff for credits owed to respondent under the other two contracts. The tribunal held that the “three agreements were an economic unit” and, therefore, “the defense of setoff was acceptable unless you could show the parties’ intention to keep all three contracts separate.” The extension of jurisdiction
to the defense of setoff, does not extend the jurisdiction to other matters arising out of the related contracts.
From the Institutes of Justinian taken from Pedro Bonfante, Institutions de derecho romano, translation to Spanish by Luis Bacci and Andrés LaRosa, reviewed by Fernando Campuzano H., Madrid (1959), § 136, p. 432.

Under the definition in Unidroit, if setoff is being claimed as a defense in arbitration by the respondent, the respondent is referred to as the first party and the claimant in the arbitration is referred to as the other party. This terminology used in Unidroit has been criticized as a terminology that is conceptualized from the debtor’s perspective. Michael Schöll, Setoff defenses in international arbitration, criteria for best practice – a comparative perspective, in SAS Special Series N° 26 (2006), p. 97 et seq. at p. 121. Schöll considers that the term ‘the other party’ refers to the cross-claim. In fact, my reading of the terminology in Unidroit is that that first party is the party that presented the defense of setoff. In any case, for simplicity I use in this paper the following terminology: “first creditor” will be the party against whom setoff is claimed and the “first claim” is the term given to his credit; this usually will be the party in an arbitration that acts as the plaintiff or claimant. The “second creditor” I use to identify the party that is offering setoff as a defense and “second claim” as the credit that belongs to this party. There is no magic in the terminology; both parties are reciprocal creditors and debtors.

The terminology “transaction setoff” and “independent setoff” taken from Philip Wood, English and international setoff, London (1989). According to P. Wood, transaction setoff “arises when reciprocal claims arise out of the same or closely related transactions”, P. Wood, idem, § 4-2, p. 106. Independent setoff “is the setoff of reciprocal claims which are unconnected and independent of each other”, P. Wood, idem, § 2.01, p. 32.

Some civil codes expressly forbid setoff against certain types of credit as a matter of public policy. These limitations extend to unilateral setoff. For example, in Vietnam, you cannot claim setoff, nor agree to setoff against obligations for child support or support of a spouse (CC.Vietnam, Art. 381). In Venezuela you cannot set off against debts owed to the State (Ven.CC, Art. 1335).

Initially, setoff was known under Roman law as a procedural defense. It was incorporated into common law initially as a defense in equity. Setoff was incorporated into the French Civil Code in 1804 and later, in its more modern form, into the German Code of 1868.

If one distinguishes the French system of setoff with the German system, one could identify four systems of setoff: the French system, the German system, the common law system and the middle way adopted recently by Unidroit and which I discuss in this paper. In German doctrine, Reinhard Zimmerman claims that in fact there are five systems, the French system, the German system, the common law system, the system adopted in Scotland and the system adopted in Sweden. The Swedish system of setoff does not operate retroactively but merely has effects into the future (ex nunc). Reinhard Zimmerman, Comparative foundations of a European law of setoff and perspective, Cambridge (2002), p. 33. The Swedish system, as described by Zimmerman, where setoff only has effects into the future, is also the system adopted by Unidroit. In my opinion, today the French system and the German system are the same (see post, text section 2.03). The system adopted in Scotland is similar to the German and French in that it operates retrospectively, but it must be pleaded in court, Zimmerman, idem. This system is apparently only used in Scotland.

Article 1290 of the French Civil Code provides that “Setoff is brought about as a right by the sole operation of the law, even without the knowledge of the debtors; the two debts are reciprocally extinguished from the moment when they happen to exist at the same time, to the extent of their respective amounts”. The text in French reads “La compensation s'opère de plein droit par la seule force de la loi, même à l'insu des débiteurs; les deux dettes s'éteignent réciproquement, à l'instant où elles se trouvent exister à la fois, jusqu'à concurrence de leurs quotités respectives”.

Belgian Civil Code, Art. 1920; Spanish Civil Code, Art. 1202.
Civil Code of Quebec, Art. 1673.
Swiss Code of Obligations, Art.120

Some countries do not adopt retroactivity.


According to Louis Josserand, “the drafters of the Civil Code, when they adopted the principles of automatic setoff, thought that they were following Roman law; under Justinian, setoff operated *ipso iure* and the drafters of the Code translated these two words as ‘legally or by operation of the law’. It seems that they made an error since the words *ipso iure* was simply a way of contrasting it with *ope exceptionis* that said that the defendant was not obliged, like did happen in the classic times, to claim setoff through an exception in *limine litis*, Cours de

15 Derham The law of setoff, 3rd Ed., Oxford (2003), § 2.04
16 Derham § 2.33 at p. 23.
17 Derham, idem. Also on the non-availability of independent setoff as self-help, see Philip Wood § 2-39-2-48, 42-46, 43-44.
19 Derham § 2.36. One of the effects is to limit the right to assign the debt that is being used to claim set off.
21 Derham, idem, at § 4.13, p. 82.
23 Derham, idem, § 4.30, pp. 94 – 95. According to Philip Wood, transaction setoff is also a form of self-help remedy, Philip Wood, idem, § 4.25, p. 112, also quoted in Derham, idem, § 4.32. This does not mean that setoff occurs automatically upon notice, but that it is a self-help remedy by which a defendant exercises its rights in the case of a claim against them, Derham, idem.
24 Equity as a body of rules only exists in common law. This should not be confused with equity in the sense of fairness, which is used in civil law for the interpretation of contracts and, at times, for the interpretation of the proper performance of contracts. Contrary to this, at times it has been stated that an equitable component exists in setoff, Ole Lando and Hugh Beale, Editors, Principles of European Contract Law, The Hague, (Kluwer International) 2000 to 2003, comment to article 13:102 quoted in Michael Scholl (2006) idem, in p. 115.
25 Philip Wood, idem, § 1-12, p. 7. Philip Wood adds that, in fact, the understanding of setoff is not advanced by bringing in technical terms that are not understood by attorneys in other jurisdictions and which are totally unnecessary, Philip Wood, § 1-13, p. 8.
26 There are cases of setoff in barter contracts with alternate delivery. The most common setoff in kind arises in the case of traded securities. However, most of these refer to cases of voluntary setoff.
27 Obligations that arise from the same contract, under Unidroit, do not have to be “ascertained as to its existence or its amount (Unidroit, Article 8.1.2). This rule is now in Unidroit and is not universally accepted in civil law countries. When the obligations arise from the same contract there normally is no problem of jurisdiction nor applicable law, but it is difficult to state that setoff occurs by simple notice, Unidroit Comment N° 5 to Article 8.1).
28 They are the same in both countries of French influence as well as German influence.
29 The requirements (conditions) for setoff in Unidroit are included in Article 8.1.
30 Derham, § 1.04. “The usual practice is to enter separate judgments on both the claim and the counterclaim but with execution issuing only for the balance”, Derham, idem. Derham quotes Stumore vs. Campbell & Co., 1QB314, 317. The practice does not apply when the beneficial ownership of the counterclaim is in separate hands, John Dee Group Ltd vs. Von H(21) Ltd. (1988).BCC, 972, 976 CA.
31 Supreme Court of Spain, decision of June 9, 2001, decision 5543, reported in Repertorio Judicial Aranzadi, quotation taken from Código Civil anotado, Francisco Javier Fernández Urruzainqui, Madrid 2006, comments to Article 1195 of the Spanish Civil Code.
32 Contemporary French doctrine states that reciprocity, more than a condition - a requirement for setoff is of the essence to setoff. “If setoff can be considered as a form of payment (satisfaction) of a debt, it does not operate as a payment except among reciprocal debts”, Jacques Ghestin, Marc Billiau and Gregori Loiseau, idem (2005), § 982. Reciprocity is a requirement under the German Civil Code (BGB, Art. 387), the Japanese Civil Code (Art. 501(1)), the Vietnam Civil Code (Art. 380(1)), the Swiss Code of Obligations (Art. 120), the Spanish Civil Code (Art. 1195), the Portuguese Civil Code (Art. 847), the Italian Civil Code (Art. 1242), as well as all Latin American codes, including: Colombia (Art. 714), Perú (Art. 1288), Argentina (Art. 818), Panama (Art. 1081), Venezuela (Art. 1331) and Brazil (Art. 368). Mutuality brings forth the problem of setoff and company groups, which I am not covering in this paper. The general rule, however, is to apply mutuality strictly, i.e. it does not extend the right of setoff to obligations owed by companies that belong to the same group.
34 Freeman vs. Lomas, 1851 8HAIR109, citation taken from Derham, idem, § 11.03, p. 443.
Lex mercatoria is a general reference to general principles of international commercial law, applied universally without reference to a particular country. In general, see Harold Berman and Colin Kaufman, The law of international commercial transactions, XIX.ILJ221.

For comments on the new rules in Unidroit see Klaus Peter Berger, Set-off in Unidroit Principles, ICC (2005), International Court of Arbitration Special Supplement (2005), p. 17


Lex mercatoria is a general reference to general principles of international commercial law, applied universally without reference to a particular country. In general, see Harold Berman and Colin Kaufman, The law of international commercial transactions, XIX.ILJ221.

ICC Case 3540 (1980), idem, at p. 110.

ICC 3450 at p. 112.

According to Redfern and Hunter, *vois direct or direct choice* method of choosing the substantive law in reality gives “arbitrators the freedom to choose as they please”, Alan Redfern, Martin Hunter, Nigel Blackaby and Constantine Partasides, Redfern and Hunter on international arbitration, Oxford (2009), § 3.218 at p. 234.

Regulation EC No 593-2008 of the European Parliament and Council of June 17, 2008 on the law applicable to contractual obligations, referred to as Rome I, effective as of December 17, 2009, referred to as Rome I.

The text of Rome I taken from Richard Plender and Michael Wilderspin, The European private international law of obligations, London (2009), Appendix I.

Sir Lawrence Collins, Dicey, Morris and Collins on The conflicts of law, London (2006), § 7-032, p. 190.

Example taken from Principles of Unidroit, Example N° 13 in comments to Article 8.1, illustrations in § 7 of the comments.

This example is taken with modifications, from the illustration in comment N° 1 to Unidroit Article 8.2. The illustration, however, in Unidroit refers to contracts where the amounts are owed in two different currencies, which the example that I built above does not.

In reference to the conditions for setoff under Unidroit, see above, § 3.06 to 3.10. We concluded there that the conditions or requirements of setoff as a defense are, with minor variations, universal. Further, it has been correctly held that "set-off has a similar purpose in almost all systems of law"; Alexis Mourre, The set-off paradox in international arbitration, in Arbitration International, Vol. 24, N° 3 LCIA, p. 393. The conditions for setoff under the Portuguese Civil Code are established in Article 847 which requires that the second credit must refer to a debt that is payable against which an exception for delay cannot be brought and referred to tangible things of the same kind and quality. If the amount undetermined this does not, however, under the Portuguese law, stop the defense of setoff (CC.Port., Article 847, subsection 3). The conditions for setoff under the Italian Civil Code are provided for under Article 1243, which requires that both debts refer to money or tangible things of the same kind and are both liquid and payable. If the debts are not liquid, however, but they can be easily determined, the judge can declare setoff for the part of the debt that it recognizes as existent and suspend final judgment until the undetermined sum is defined.

Walter Bühler, Verrechnung und Schiedsvertrag, RJS 1940/1941, p.209, quote taken from J.F. Poudret, Compensation et Arbitrage, Les Droit en action, Lausssane (1996), p. 365. Poudret also considers the difference when the first claim has an arbitration clause but the second claim does not; and the inverse where the first claim does not have an arbitration clause and the second claim does.

The Italian Cassation (Chamber of the Supreme Court for civil matters) held in 1995 that a group of related contracts exists when all are directed at a single economic result or business, Cas. N° 4645 Dec. 1995, quote taken from Gilda Fernando, I contratti collegati, in Guido Alpa and Mario Bessone, I contratti – aggiornamento, T. 1999, p. 1913. The French Cassation in a decision in the case of Gaz de France (2006) (Cassation First Chamber April 4, 2006, file G02/18277) held that the contract for the supply of heating services to a hospital was connected as one indivisible whole to a separate contract for the supply of gas which was necessary to produce the heat. Taken from Denis Mazeaud, L’indivisibilité du contrat, Revue des Contrats (July 2006), p. 700.


ICC 5971, from French version F-X.Train (2003), idem. M. Schöll (2006), idem, states that 5971 “stands for the proposition that setoff is fundamentally a question of jurisdiction of the arbitral tribunal” … since “the extinction of the arbitration clause on a theory of the uniform business transaction – is typically jurisdictional”, Schöll, p. 114. Schöll quotes Marc Blessing, Introduction to arbitration, Basel (1999), pp. 190-192. I disagree with this comment. Indivisibility of the business contained in related contracts, which is used by the tribunal, is substantive, see James Otis Rodner, Los contratos enlazados, Caracas (2008), pp. 40-46.

F-X Train, idem (2003), § 209 – 214 and 728.Also, J.O. Rodner, idem (2008), § 4.100 to 4.114, pp. 113 to 199.