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Chapter [...]

SET-OFF

(Revised draft prepared by Professor C. Jauffret-Spinosi in the light of the discussions of the Working Group at its 4th session held in Rome, 4-7 June 2001)

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SET-OFF

Article 1 *(Conditions of Set-off)*

Where two parties owe each other obligations to pay money or to render performance of the same kind, either or them may set off its obligation against the other party's obligation if, at the time of set-off,

- a) he is entitled to perform its obligation**
- b) the other party's performance is due and ascertained**

Comments :

Set-off is a substantive right and not a procedural device. It is a beneficial right for an obligor. When an obligee sue his obligor to perform its obligation, the obligor had the right, outside a court, to oppose its own obligation against the obligee. The party opposing set-off- will be called the first party and the obligee, asking for the payment to the first party, is called the other party. If the conditions for set off are met, the two obligations are discharged.

In the Principles, set-off is made by declaration, outside of a jurisdiction. To be effective, set-off- does not need of the intervention of a judge.

There exists other kinds of set-off. Set-off may be decided by a judge (judiciary set-off) and in this case the conditions will be alleged, set-off will depend on the circumstances of the facts and of the appreciation made by the judge. Set-off may also be expressed by contract. The parties will prescribe the provisions regulating set-off , they may also prohibit payment by set-off . Set-off may be reduced or extended by convention.

- Conditions for set-off

1)Mutuality – Reciprocity

Mutuality is in the nature of set-off. The first party is obligor of the other party and also his obligee, and the other party is also obligor and obligee of the first party. A party has to be debtor and creditor in the same quality. A set off cannot be asserted between an obligation, due by a party, in his own right and one due to him as trustee or as administrator. A parent corporation should not be allowed to claim a set-off for the debts that a creditor owes to subsidiaries.

Reciprocity may cause problem in case of assignment of right :

May a debtor assert a set-off upon an obligation he has purchased after the existence of the other party obligation? In this case, the reciprocity exists only at the time of the declaration of set-off, but not before. This problem is dealt in the chapter concerning assignment of rights.

2) Obligations of the same kind

Two things are of the same kind if they can replace each other without harm.

In the more current cases, set-off will concern monetary obligation. A money obligation may be set-off only against a money obligation.

But as set-off is a way of extinction of obligations, it is possible to assert set-off for obligations of the same kind, as for example the transfer of grain of the same quality, or the assignment of securities if they are identical. The necessity that obligations are of the same kind must be verified when the set-off is opposed.

Set off concerning foreign currency which is not exactly obligations of the same kind, is dealt in article 3

3) Obligations due.

An obligation is due, means that the obligee has the right to demand present payment, the obligor is not allowed to raise a defence. This is contrasted with a debt which become due on a specific date in the future or an obligation raised from a “ natural obligation ”. A obligation is due when it is enforceable.

A distinction is made between the obligation of the party asserting set off and the obligation of the other party.

Party declaring set-off may perform.

The obligation of the party declaring set off does not need to be due (enforceable), it is sufficient that he may perform. His obligation may become due in the future, but it is his choice : he may accept to pay before the contractual date for the payment. His obligation is not yet enforceable but he accepts to pay, by set-off. He may refuse the legal protection granted to him. Declaring set-off, he waves his right not to pay before the time.

Performance of the obligation of the other party is due

A debtor can refuse to pay a debt which is not yet enforceable, he is not obliged to pay before the date agreed upon for payment. In commercial transactions only delays which have been agreed are likely to render an obligation non enforceable. In another way, an illegal or a natural obligation might also be unenforceable.

So set-off cannot be opposed if the obligation of the other party is not due. As set-off is an imposed payment, it is not possible to obtain by set-off, the payment of an obligation which is not yet due. It is the right of the other party to pay only when he is legally obliged to pay and not before.

A problem may arise in case of a time barred debt. Is it possible for a debtor to claim set-off, opposing a time barred debt? If the limitation does not extinguish the right, but the claim arising from that right, it seems possible, in defence, to oppose the expired obligation. The possibility to oppose a time barred obligation is dealt in the chapter on limitation.

The requirement of a debt enforceable, (or due) raises also the problem of the possibility to assert set-off when a procedure of insolvency has begun. In case of insolvency most often set off will be a judicial set-off. The judge will appreciate the opportunity of set-off during the procedure.

The other party performance must be ascertained

The certainty of the other party obligation, as in its existence and its amount, is a necessary condition, since the declaration of set off will extinguish the obligations without the intervention of the judge. The discharge of the obligations could not occur if it is impossible to know if really the obligation exists and if it exists, its amount is unknown. Normally the obligation of the first party and the obligation of the other party must be ascertained in their existence and their amount. But however an exception may exist (article 2).

Article 2 :
(Unascertained Claims)

However an obligor may set off an obligation which is not ascertained as to its existence or to its amount, provided obligations of both parties arise from the same legal relationship.

The first party obligation may be unascertained.

It seems at first glance that, if the condition of certainty is not required, it would be possible, for the defence, to delay proceedings, claiming set-off for an obligation which need to be proved, in its existence or in its amount. It would be an easy defence, to gain time and to postpone the payment

But we must make a distinction between an obligation unascertained and a contested obligation. The contestation by one of the parties of an obligation cannot change the quality of

the obligation. A contested obligation can be an ascertained obligation. It is a question of evidence.

The requirement on certainty for the two obligations will reduce the possibilities to assert a set-off.

A broad conception of set-off- may admit an exception, if it can be said that set-off is a kind of security. But in this case the intervention of a court will be necessary to appraise the existence and the value of the two debts. So the exception, permitting to an obligor to oppose, as set-off, an unascertained obligation, must be limited. Set-off of an unascertained obligation will be possible only if the two obligations arise from the same legal relationship (dettes connexes). The judge, in this case, will appreciate, in the same proceeding, the principal claim and if the conditions for set-off exist. In international commerce often the two parties are in relationship and in the due course of their business, they are, each other, obligor and obligee. In these circumstances, even if one of the obligations is not ascertained, it would be possible to oppose set-off. The judge will adjudicate or not the principal claim taking account or refusing to take account of the set-off declared by the defendant whom cross claim is not ascertained. The effectivity of the set-off will be in the discretion of the judge. He will decide, and this will not be always very easy, if the two obligations arise from the same relationship, from the same contract.

Article 3 :
(*Foreign Currency Set-off*)

Where the obligations are to pay money in different currencies, the right of set-off may be exercised, unless the currency of the other party's obligation is not freely convertible or unless the parties have agreed that the party declaring set-off shall pay only in a specified currency.

(If the obligations are not payable in the same place , the party declaring set off shall bear the expenses of delivery).

or

Where the obligations are to pay money in different currencies, the right of set-off may be exercised, unless the currency of the other party's obligation is not freely convertible *or unless the parties have agreed that payment should be made only in the currency in which the monetary obligation is expressed.*

Comment

Different currencies cannot be qualified of “ obligations of the same kind ” admitted in the article 1 but nevertheless set-off may be exercised if the two obligations had to be paid in different places. However set-off must not prejudice the interests of the party against whom the set-off is opposed.

It may exist a distinction between the currency of the place of payment and the currency of the contract. Article 6.1.9 of the Principles express that an obligor is allowed to pay in the currency of the place of payment except if that currency is not freely convertible or if the parties have agreed that payment should be made only in the currency in which the monetary obligation is expressed.

Normally the contract will precise in what currency the payment had to be made. If the contract allow the first party to pay in an other currency than the currency in which the claim is expressed, set off is possible. Set-off will be prohibited only if the contract impose payment in a specific currency.

Some currencies are not convertible. In this case it is difficult to know exactly the amount of the obligations. So payment by set-off cannot be made.

If the existence of a different place of payment involves expenses for the obligee against whom set-off is declared, the costs arising from the place of payment, shall be borne by the party declaring the set-off.

Article 4 :
(Set-off by notice)

The right of set-off is exercised by notice to the other party.

Comment

The obligor who wants to oppose a set off had to declare it. Set-off is a voluntary act. A declaration or set-off is necessary, but an informal, extrajudicial declaration is sufficient. No intervention by a court is needed. The declaration will provide some degree of certainty for all the interested parties, since the intent of the obligor to make payment in the form of the set-off is known. Whith respect to third parties, if the set-off is in their interest, the set-off should be binding as soon as the date of the declaration..

If, later, parties plead in court, the judgement will have only declaratory effect. Set-off apply at the date of the declaration by notice, even if the effective date is retroactive at the time where the two obligations confronted each other. The declaration cannot be subjected to a condition. The obligor cannot declare set-off for the future.

The declaration has to be made by notice. The Principles specify the notice in article 1.9 and provide for other situations where unilateral declaration of one party is made by notice (3.14-7.3.2).

The notice cannot be sent before the others party's obligation had become due, but it is possible to send the notice declaring set-off, if the obligation of the party declaring set-off is not yet due (article 1).

Article 5

(Plurality of claims and obligations)

- 1) Where a party giving notice of set-off has two or more claims against the other party, he has to identify the obligation to which the notice of set-off relates.**
- 2) Where the party giving notice of set-off has to perform two or more obligations toward the other party, the rule in article 6.1.12 apply with appropriate modifications.**

Comment

If the other party owes to the party declaring set-off more than one obligation, in the notice the first party must indicate expressly the obligation he wanted to be discharged. He has the choice but he must express this choice.

If he does not make a choice, the obligation cannot be identified by the other party, and in consequence it is impossible to verify if the conditions of set off are fulfilled. So in the absence of the indication of the precise obligation, the notice of set-off will be ineffective for insufficient identification.

If the party declaring notice owes more than one obligation to the other party, and if he does not indicate what of his obligation toward the other party is concerned by the set-off, the rules concerning the imputation of payment, specified in article 6.1.12 shall apply (the obligation which is due or the first due, the obligation for which the obligation has least security, the obligation which is the more burdensome for the obligor, the obligation which has arisen first).

Article 6

(Effect of set-off)

Set off discharges the obligations up to the amount of the lesser obligation, from the time that the right of set-off could be exercised.

Comment

Set-off is retroactive. The two obligations will be extinguished, when for the first time, the conditions being fulfilled, they confronted each other, when, the second obligation in time, met the first obligation already existing.

Interests will not run from the moment when the two obligations have been set-off-, when they matched each other.

At the time where the two reciprocal obligations fulfil the conditions required by article 1, they are discharged with all their accessories, as securities. The limitation will be interrupted. Except if the two obligations are on the same amount, the two parties are not totally in the same situation than if two payments had been made. Only the party detaining the obligation with the less value is entirely satisfied. The other obligation is only partly satisfied. Set-off permits this imposed partial payment. One of the parties remains creditor for the part of his obligation unpaid by set-off.