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WORKING GROUP FOR THE PREPARATION OF  
PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS

Chapter [...]

SET-OFF

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

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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 of them, called the first party, may set off its obligation against its obligee, called the other party, if at the time of set-off,**

**(a) it is entitled to perform its obligation**

**(b) the other party's obligation is ascertained as to its existence and amount and performance is due.**

COMMENT

**1. Use of set-off**

Under the Principles, when two parties owe each other an obligation, arising out of a contract or any cause of action, each party may set off its own obligation against the obligation of the other party. By mutual deduction, both obligations are discharged up to the amount of the lesser.

Set-off avoids the obligations for each party to execute separately.

Under the Principles the obligor to whom payment is asked, and who sets off its own obligation is called the first party.

The obligee who first asks the payment to its obligor, and to whom is opposed the set-off is called the other party.

Illustration

1. A, a ship carrier, had carried goods belonging to B from Marseille to Genoa. A asks B 5000 euros as payment for the transport. B, who had previously become an obligee of A for an amount of 5000 euros, arising out of an indemnity for damages occurred to other goods transported, may set off its own obligation to pay 5000 euros with the obligation of A to pay him the amount of 5000 euros

The two obligations are discharged. A is no longer obligor of B and B is no more obligor to A.

Illustration

2. A sells a piece of land to B for the price of 25000 euros. Later B, who is a contractor, builds a house for A. The price of the construction is 15000 euros. When B asks for the payment of his work, A may set off the price of the piece of land, still unpaid by B, against the price of the construction. The obligation of A to pay 15000 euros is totally discharged, but B remains obligor to A for 10000 euros.

To be allowed to set off one's obligation against the obligation of the other party some conditions are required.

## **2. Obligation owed to each other**

The first party and the other party must be obligor and obligee of each other.

It is only because the first party is obligee of the other party that it may try to discharge its own obligation by set-off.

Each party must be obligor and obligee in the same quality. Set-off is not possible if the first party has an obligation to the other party in its own name and if it is obligee of the other party as a trustee.

An individual member of a partnership cannot set off its obligation to a party who in turn is an obligor of the partnership.

### Illustration

3. Company A, member of a group of companies, sells to B some machinery for 10000 euros. B, which is in business with C, subsidiary of Company A, sells to C products for 15000 euros. A asks B to pay the price for the sale of the machinery. B cannot set off its obligation for the sale of the products to C, even if the capital of C is totally subscribed by A; C is an independent entity. A and B are not obligor and obligee of each other.

The condition that the obligations must be owed to each other may pose a problem where an obligee had transferred by assignment the obligation it has against a third party (obligor) to an assignee. The third party may set off its obligation against the assignee's obligation only if the right of set-off existed against the assignor's obligation before the assignment had been notified to the assignee (cf. Chapter on Assignment of Rights, Article 13 )

## **3. Obligations of the same kind**

Both obligations must be of the same kind.

A money obligation may be set off only against a money obligation.

A delivery of grain may be set off only against a delivery of similar grain.

Set-off cannot be exercised between an obligation in money and an obligation to deliver grain.

The value of food products or grain like corn is known every day, through market prices. So set-off of obligations to deliver this kind of item creates no problem of evaluation.

Whether obligations are of the same kind may depend on commercial practices or special trade rules.

### Illustrations

4. A, a crude oil producer had taken the engagement to deliver to B every month 1500 tons of crude oil by pipe line to Cairo; B reciprocally

had to transfer each week by road 1000 tons of crude oil. The crude oil procured by A and the crude oil delivered by B are not coming from the same origin and are not totally similar, but as their use could be identical, the two obligations relating to the crude oil may be qualified of the same kind, and if A and B are, one day, obligor and obligee for the delivery of some quantity of crude oil, set-off will be available.

5. A holds 100 shares of the Company «South. ». There are ordinary shares. B is shareholder of the same company; he holds 120 redeemable preferred shares. They are obligee and obligor of each other, and by contract it had been provided that payment will be available through shares of par value. But since the shares held by A and the shares held by B are not of the same kind, set-off cannot be exercised.

#### **4. First party obligation performable**

First party obligation may be performable at present. As set-off imposes payment to other party, the other party must not be allowed to refuse payment and to oppose a defence. The first party must have the right to pay its obligation and therefore to pay by set-off. He cannot impose to the other party a payment which is not yet due.

Being performable, and payment being imposed to the other party, the first party obligation may be due and ascertained. But there is an exception (Article 2).

#### **Illustration**

6. A had sold ten trucks to B for 100.000 euros. B must pay the price of the trucks before the 30 of September. B wants to set off an obligation he had against A arising from a loan, whom repayment had to be made on the 30 of November. B, before the 30 of November may not set off its obligation against A as he cannot impose a payment to A before the 30 of November. B's obligation against A is not performable.

7. A owes B 20000 dollars for the repayment of a loan. The repayment must take place on the 30 of January. B is obligor of A for a claim of damages of 14000 dollars, ascertained by a judgment given on 25 of January. A asks for payment to B on the 9 of February. B whose obligation is performable, is allowed to set off, the 10 of February, its obligation against A's obligation.

8. A had sold 1000 bottles of wines of Bordeaux to B, payment of the price must be made at the latest, on the 30 of October. B is obligee of A and A's obligation is already due. B may set off its own obligation against A's obligation, on the 10 of October, even if the last date to pay the price to A is on the 30 of October, because A is bound to accept a payment before this date.

## 5. Other party's obligation ascertained

Set off may be exercised only if the other party's obligation cannot be contested, the first party may oppose its own obligation only because the obligation of the other party is ascertained.

The other party's obligation must be ascertained in its existence and in amount.

An obligation is ascertained when its existence cannot be contested. It is this case, when the obligation is based on a valid and executed contract. An obligation is also ascertained if it arises from a final sentence or judgement not subject to review.

Conversely, an obligation to pay damages is unascertained when the damages are contested with sufficient proof.

Even if the other party's obligation is not contested in its existence, set-off will not be exercised if the obligation is not ascertained in its amount. If the existence of damages is undisputed but if the amount of the indemnity is not fixed, set-off will not be available.

To pay by set-off imposed that the other party's obligation is totally undiscussed, in its existence and in its amount.

### Illustration

9. A judgement condemned A to pay B 10000 euros, for breach of a contract. B is in turn obligor of A, for repayment of a loan of 12000 euros, repayment already due. A asks B to pay the 12000 euros. B may set off its obligation against A's obligation arising from the judgement.

10. A sells B a yacht for 10000 euros. A is liable to B for tort, the damages not being contested, but the amount not yet being fixed. A will be not allowed to set off its own obligation, as B's obligation is not ascertained.

Other party's obligation may be ascertained, but if the other party is involved in an insolvency procedure, set-off cannot be normally exercised, as set-off does not respect the principle of the equality of the obligees in an insolvency procedure; if set-off were admitted, the first party would be paid in full, unlike the other obligees. But the Principles do not deal with insolvency.

## 6. Other party's obligation due

An obligation is due where the obligee has the right to enforce the payment by its obligor, who cannot express a defence. And the obligee cannot refuse to be paid, he cannot oppose a defence to the payment. Defence, for example, will be available if the time of payment is not yet reached.

The first party may oppose set-off only if the other party's obligation is due. The condition that the other party's obligation is due is dependent of the condition of the certainty of the obligation. To exercise set-off without requirement that the other party's obligation is due, will give the first party a better position than if he had received a normal payment.

As by set-off both obligations will be discharged, the other party's obligation must be ascertained and due. The first party has the right to set off its obligation only if the other party's obligation is not disputed.

#### Illustration

11. By a definitive judgment of 10 of April, A had been convinced to pay to B the price of a sale of pieces of cotton of 20000 dollars. B asks the 20 of April the execution of the judgement. A, who is obligee of B for the repayment of a loan of 12000 dollars, enforceable since the 10 of January, may set off its own obligation against B's obligation. B, whose obligation is ascertained and due cannot not contest the set-off exercised the 2 of May, by A.

An exception may exist for a time-barred obligation.

If the expiration of time prevents the enforcement but does not extinguish the right itself, the first party who is not allowed to enforce the time-barred obligation, may set it off against a claim of the other party. (See Chapter on Limitation Periods, Article 10).

#### Article 2

*(Unascertained obligations)*

**An obligor may also 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 contract.**

#### COMMENT

Set-off of an unascertained obligation may be not just a defence to delay proceeding, claiming set-off for an obligation which needs to be proved in its existence or in its amount.

Set-off is a convenient means of discharging obligations at once and at the same time. Under the Principles it is allowed to the first party to set off its obligation against the other party, even if its obligation is unascertained, but only where the two obligations arise from the same contract. In international commerce, obligations of the two parties may frequently arise from the same contract.

Arising from the same contract, the same facts, the same documents, will be a matter of proof and will permit to examine the principal claim, the cross claims and if the conditions for set-off are fulfilled. So there is no need to require that first party obligation be ascertained.

#### Illustrations

1. A, carried turkeys for B from Norwich to Bordeaux. The price of the transport is 1000 euros. During the transport one hundred turkeys died by

the fault of the carrier who does not respect the rules for carrying poultry. A asks B the payment for the carriage. B may set off against A's obligation, an obligation for the damages occurred to the turkeys during the transport. The death of the turkeys is not contested nor the bad conditions of the transport in violation of the legal rules, just the amount of the damages is not evaluated. But as the two obligations arise from the same contract, it could be easy to evaluate the damages suffered by B and appreciate if the two obligations may be set off and to what amount.

2. A, a carrier, accepted to carry, for B, a piano, from Bristol to Bordeaux. A provision of the contract provides expressly that delay penalties will be paid if the piano is not delivered to the concert hall five days before the date of the concert. The piano is delivered in Bordeaux only two days before the date of the concert. A asks the payment of the charges for the carriage to B. B may set off its obligation for the delay penalties against A's obligation, even if A contests the amount of the indemnity owed for the delay.

This possibility to exercise a set-off is useful between parties in business relationship. It permits to find quickly a settlement

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

**Where the obligations are to pay money in different currencies, the right of set-off may be exercised, provided that both currencies are freely convertible and the parties have not agreed the first party shall pay only in a specified currency.**

#### COMMENT

##### **1. Convertible currencies**

Different currencies cannot be qualified of obligations of the same kind, (Article 1), nevertheless set-off may be exercised if the two obligations had to be paid in different convertible currencies. But set-off is not available if currencies are not freely convertible, as it is difficult to know exactly the amount of the obligation. So, it cannot be imposed to the other party the payment in a currency non convertible.

#### Illustration

1. A wine producer of California sells 500 bottles of wine for 20000 dollars to B, a corks producer. B sells 100000 corks to A for the price of 10000 « livres » which is the currency of the country where corks are produced. And which is not convertible. A asking B payment of the

20000 dollars B may not set off the 10000 «livros » against the 20000 dollars.

## 2. Currency specified by contract

If a contract expressly imposes to a party to pay exclusively in a specific place and in a specified currency, this party will not be able to set off its own obligation against the other party's obligation, if it had to exercise its own obligation in a place and in a currency different of the place and the currency provided in the contract.

### Illustration

2. A sells products to B for 10000 dollars. The sale contract expressly provides that the price will be paid by the buyer, exclusively in New York and in dollars. B, an Asian carrier, is obligee of A for an unpaid invoice for charges of transport. A asks the payment of the 10000 dollars. B, who contractually is obliged to pay the price of the products in New York, in dollars, is not allowed to set off, against A, its obligation for the charges of transport if it had to be paid in Hochimin Ville, in Vietnamese currency.

### Article 4 ( *Set-off by notice* )

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

#### COMMENT

In the Principles the right of set-off is exercised by notice to the other party only. Set-off is not performed automatically nor by declaration of the judge. The first party must express its intention to set off. He must inform the other party that he will discharge its own obligation by set-off.

Article 1.9 of the Principles provides for notice. It may be given by any means appropriate to circumstances and it is effective when it reaches the person to which it is given.

The first party may validly send the notice of set-off by mail, fax, telex or other forms of electronic communication.

To be effective notice must not be sent before the conditions for set-off are fulfilled.



Article 5  
(*Content of Notice*)

**The notice must sufficiently identify the obligations to which it relates.**

COMMENT

**1. Obligations owed by the other party**

If the first party has two or more claims against the other party, the obligation (or the obligations) the first party wants to be paid by set-off, must be identified in the notice.

The other party, reading the notice, must know the ground for set-off and the amount of set-off.

Notice has no effect if not sufficiently precise.

Illustration

A and B are in business relationship. B asks to A, on the 30 of December 2001, payment of 5000 dollars owed by A. A sells regularly cloth to B, who pays the price of the cloth at different dates. On the 30 of December 2001, B is obligor of A in execution of three previous contracts. By a contract of the 10 of July 2000, B owes still 4000 dollars to A. In execution of a contract of the 27 of September, B owes 3500 dollars and he is also obligor for 4500 dollars for an unpaid invoice of the 28 of October 2001. If A wants to set off B's obligation, he had to indicate, in the notice, which of the three obligations owed to him by B he wants to set off.

If A does not indicate in the notice which obligation owed by B he wants set off, the notice will be without effect.

**2. Obligations owed by the first party**

Where the party giving notice of set-off has to perform two or more obligations toward the other party and if the other party had not specified the obligations it wants to be paid, the rule in Article 6.1.12 relative to imputation of payments applies with appropriate modifications.

Article 6  
(*Effect of set-off*)

- (1) **Set-off discharges the obligations.**
- (2) **If obligations differ in amount, set-off discharges the obligations up to the amount of the lesser obligation.**

**(3) Set-off takes effect at the time the right of set-off could have been exercised.**

COMMENT

**1. Discharge by set-off**

If the conditions under Articles 1 and 2 are fulfilled, both parties' obligations are discharged, as if two reciprocal payments had been made. Parties are no more obligor and obligee of each other

Illustration

1. A owes 100 dollars to B and B owes 100 dollars to A. B asks for the payment of its obligation A by notice declares to B that he sets off its own obligation. Nor A nor B, after set-off takes effect, are obligor and obligee of each other. The two obligations are discharged.

If the two obligations differ in their amount, set-off shall discharge the obligations, but only up to the amount of the lesser.

Illustration

2. B owes 100 dollars to A, who himself owes 70 dollars to B. A asks for the payment of the 100 dollars, B declares that it wants to set off A's obligation of 70 dollars. If the conditions for set-off are met, A is no more obligor of B, its obligation is entirely discharged. But A is still obligee of B for 30 dollars the unpaid part of the obligation by set-off.

**2. Retroactive effect**

The obligations are discharged not at the time of the notice, but at the time where all the conditions are fulfilled. As some conditions are required by Articles 1 and 2, set-off has no effect if the conditions are not met.

The two obligations are discharged as soon as, confronted each other, set-off was suitable, all the conditions for set-off being met. As far as one condition is missing, the obligations cannot be discharged.

Illustration

3. A owes B 100 dollars for the price of goods sold by B. A's obligation is ascertained and the price is due on the 20 of November 2000. B asks payment of the 100 dollars on the 22 of December. A opposed set-off, being obligee of B, by a judgement dated of the 30 of November condemning B to pay 80 dollars to A for damages. The obligation of 80 dollars has become due and ascertained at the date of the judgement, on

the 30 of November. Set-off is exercised by notice on the 22 of December, but the effect of set-off will take place, at the time where the two obligations, were confronted each other and fulfilled the conditions required, that is on the 30 of November. The obligations are discharged at this date. Interest no longer accrues.

Retroactive effect allows to set off a time-barred obligation if the limitation period had not yet occurred when set-off could first have been exercised.

At the time where the conditions for set-off are met, not only the principal obligations are discharged but also the related rights, e.g. rights securing an obligation are discharged accordingly.

#### Illustration

4. A, a banker, had lent B 10000 euros, and obtained, to securing the repayment a personal security given by B's wife. B is obligee of A for 12000 euros, arising from unpaid interests. A asks payment of the 10000 euros to B, who exercises set-off. The conditions required for A's obligation and B's obligation have been fulfilled on the 10 of December. At this date, A and B's obligations are discharged, and on the same day, B's wife is no more security for the repayment of the loan.