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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 5<sup>th</sup> session held in Rome, 3-7 June 2002)

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Article 1  
*(Conditions of set-off)*

**(1) Where two parties owe each other obligations to pay money or to render other performance of the same kind, either of them (“the first party”) may set off its obligation against its obligee (“the other party”) if at the time of set-off**

**(a) the first party is entitled to perform its obligation,**

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

**(2) If the obligations of both parties arise from the same contract, the first party may also set off its obligation against an obligation of the other party which is not ascertained as to its existence or to its amount.**

COMMENT

The word obligation may have a passive or an active meaning. An obligation may be performed and an obligation may be claimed. In some legal systems of law, the passive obligation is called a debt and an active obligation is called a credit or a claim.

The Principles do not govern situations where, by agreement, more than two parties may discharge their obligations, as in a contract of netting. These agreements are ruled by autonomy of the parties.

**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 be performed separately.

Under the Principles the obligor from which payment is asked, and which sets off its own obligation is called “the first party”.

The obligee which first asks for the payment of its obligor, and against which the set-off is raised is called “the other party”.

Illustrations

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 damage to other goods transported, may set-off its own obligation to pay 5000 euros against the obligation of A to pay him the amount of 5000 euros. Neither A nor B remains the other’s obligor.

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 its one's obligation against the obligation of the other party some conditions are required to be satisfied.

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

Each party must be the obligor and the obligee of the other and in the same quality. Set-off is not possible if the first party has an obligation to the other party in its own name but is the obligee of the other party in another capacity, for example as a trustee or as a member of a partnership.

### **Illustration**

3. Company A, a member of a group of companies, sells to B some machinery for 10000 euros. B, which is in business with C, a subsidiary of Company A, sells to C products for 15000 euros. A asks B to pay the sale price 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 the other party has assigned to a third party the obligation owed it by the first party. The first party may nonetheless set-off its obligation against the other party's obligation, 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. In some systems of law, obligations had to be "fungible". A money obligation could be set-off only against a money obligation. A delivery of grains could be set-off only against a delivery of similar grains.

The concept of obligation of the same kind is broader than obligations "fungible". Performances of non monetary obligations may be of the same kind but may be not fungible. Two obligations to deliver wine of the same vineyard but not from the same year, are obligations of the same kind, but not fungible. Whether obligations are of the same kind may depend of commercial practices or special trade rules.

A personal obligation cannot be of the same kind as another obligation. Set-off is not available if one of the obligations has a personal character.

## Illustrations

4. A, a crude oil producer contracted to deliver to B every month 1500 tonnes of crude oil by pipe line to Cairo. B, reciprocally, had to transfer each week by road 1000 tonnes of crude oil. The crude oil produced by A and the crude oil delivered by B do not have the same origin and are not totally similar, but as their use could be identical, the two obligations relating to the crude oil can be said to be 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 a previous contract it had been provided that payment will be available through shares of par value. 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**

The first party must have the right to perform its obligation and therefore to pay by way of set-off. It cannot impose on the other party a performance which is not yet due and ascertained. As set-off imposes payment, the other party must not be allowed to refuse payment and to oppose a defence.

## Illustrations

6. A had sold ten trucks to B for 100.000 euros. B is obliged to pay the price of the trucks before 30 September. B wishes to set-off an obligation it has against A arising from a loan to A, repayment of which had to be made on 30 November. B, before this date, may not set-off its obligation against A, as he cannot make a payment to A before 30 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 30 January. B is obliged to pay A for a claim of damages of 14000 dollars, under a judgment given on 25 January. A asks for payment by B on 9 February. B, whose obligation is performable, is allowed on 10 February to set-off its obligation against A's obligation.

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

### **5. Other party's obligation ascertained**

Set-off may be exercised only when the other party's obligation is ascertained both in its existence and its amount.

The existence of an obligation is ascertained when the obligation itself cannot be contested, as when it is based on a valid and executed contract, or a final sentence or judgement not subject to review.

Conversely, an obligation to pay damages is unascertained when obligation may be contested, with sufficiently proof, by the other party.

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

### Illustrations

9. A judgement required A to pay B 10000 euros, for breach of a contract. B is in turn obligor of A, for repayment of a loan of 12.000 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 to B a yacht for 10000 euros. A is liable to B for tort, the damage not being contested, but the amount of damages not yet being fixed. A will be not allowed to set-off its own obligation, as B's obligation is not ascertained.

When other party's obligation is ascertained, but that party is involved in an insolvency proceeding, set-off cannot normally be exercised. Set-off does not respect the principle of the equality of the obligees in an insolvency proceeding. 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 when the obligee has the right to enforce performance by its obligor, and the obligor has no available defence to that enforcement. A defence, for example, will be available if the time of payment is not yet reached. As a natural or moral obligation is not enforceable, the first party may not set off its obligations against such an obligation owed by the other party. The enforceability or unenforceability of an obligation may depend of the domestic law rules. Thus, in some cases, the possibility to oppose a set-off may depend of state rules.

### Illustration

11. By a final judgment of 10 April, A had been ordered to pay to B the price of the sale of pieces of cotton of 20000 dollars. A, who is obligee of B for the repayment of a loan of 12000 dollars, enforceable since 10 January, may set-off its own obligation against B's obligation. B, whose obligation is ascertained and due cannot contest the set-off exercised on 2 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 off a time-barred obligation against a claim of the other party. (See chapter on Limitation Periods, Article 10).

### **7. Unascertained claims**

Set-off is a convenient mean of discharging obligations at once and at the same time. Under the Principles if the obligations arise from the same contract, the first party is allowed to set-off its own obligation against a monetary obligation of the other party which is not ascertained. In international commerce, the obligations of the two parties may frequently arise from the same contract.

An obligation, arising from a damage, may be ascertained in its existence and the minimum of the amount cannot be contested. The first party may set-off its own obligation, up to the minimum amount, even if the total amount of the other party's obligation is unknown.

Though one of the obligations is contested, the set-off can be raised because all of the relevant obligations for set-off arise out of the same contract. This can be useful for parties in a business relationship in facilitating quick settlements of claims, even though judicial intervention may be necessary to determine whether the conditions of set-off are in fact satisfied.

#### **Illustration**

12. A, carried turkeys for B from Norwich to Bordeaux. The transport charge is 1000 euros. During the transport one hundred turkeys died through the admitted fault of the carrier. A asks B for the payment of the transport. B may set-off against A's obligation, the obligation to pay for the damage caused by the loss of the turkeys during the transport. Though the amount of the damages is not ascertained, as the two obligations arise from the same contract, it would be easy to estimate the damages and determine if the conditions for set off are satisfied.

13. A, a carrier, accepted to carry, for B, a piano, from Bristol to Bordeaux. A provision of the contract provides expressly that delay penalties would be paid if the piano was not delivered to the concert hall five days before the date of the concert. The piano was delivered in Bordeaux only two days before the date of the concert. A asks for the payment of the charges for the carriage. 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.

### **8. Set-off by agreement**

The parties may achieve by agreement the effects of set-off even if the conditions of Art. 1 are not met. Likewise parties may agree that their mutual obligations are set off automatically either at a specific date or periodically. Also more than two parties may agree that their respective obligations may be discharged for example by netting.

Article 2  
( *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 that the first party shall pay only in a specified currency.**

COMMENT

**1. Convertible currencies**

Obligations to pay in different currencies cannot be qualified as obligations of the same kind, (article 1), Even if they are money, a dollar is not a euro. Nevertheless set-off may be exercised if the two obligations to be paid are in different convertible currencies. However, the relative value of a currency that is not freely convertible cannot be readily ascertained for the purpose of set-off. Set-off cannot be used to impose on the other party a payment in such a currency.

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 “livros” which is the currency of the country where corks are produced and which is not convertible. A asks B for 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 requires to a party to pay exclusively 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 perform its own obligation in a currency different from 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 transport charges. A requires 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 transport charges if they had to be paid in Hochimin-City , in Vietnamese currency.

Article 3  
(*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. It does not operate automatically or by declaration of the judge. The first party must inform the other party that it will discharge its own obligation by set-off. Notice must not be conditional.

Notice may be given by any means appropriate to the circumstances and it is effective when it reaches the person to which it is given. ( Article I. 9 of the Principles) The first party may send the notice of set-off by mail, fax, telex or other forms of electronic communication.

To be effective, notice must ordinarily be sent after the conditions for set-off are fulfilled. In some circumstances, it will be possible to send the notice some days before all the conditions will be satisfied, if there is no doubt that the missing condition will be fulfilled : for example if the other party's obligation will become due only few days after the day when the notice is sent.

Article 4  
(*Content of Notice*)

**(1) The notice must sufficiently specify the obligation to which it relates.**

**(2) If the notice does not specify the obligation of the other party which must be set off, the notice is ineffective.**

**(3) If the notice does not specify the obligation the first party wants to set off, the rules in article 6.1.12 will apply with appropriate modifications.**

COMMENT

The notice must specify the obligations of both parties that are to be set off. The other party, reading the notice, must know the ground for set-off and the amount of set-off.



## **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 specified in the notice. The first party may freely choose the other party's obligation he wants to be discharged, but it must specify its choice.

If notice is not sufficiently precise, it would be impossible to verify if the conditions required are satisfied. Being not sufficiently precise, notice has no effect

### Illustration

A and B are in business relationship. B asks A, on 30 December 2001, for payment of 5000 dollars owed by A. A, regularly sells cloths to B. On 30 December 2001, B is obligor of A in respect of three previous contracts. By contracts of 10 July 2000, 27 September 2000, and 28 October 2001, B owed A 4000 dollars, 3500 dollars and 4500 dollars, respectively. If A wants to set-off B's obligation, he has to indicate, in the notice, which of the three obligations owed 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 and none of B's obligations will be discharged.

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

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

### Article 5 ( *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 as from the time of notice.**

### COMMENT

#### **1. Discharge by set-off**

If the conditions of set-off specified in Article 1 are satisfied, both parties's obligations are discharged to the extent of the set-off, as if two reciprocal payments had been made.

### 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 it sets off its own obligation. After set-off takes effect, the two obligations are discharged.

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

### Illustration

2. B owes 100 dollars to A, who in turn 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 longer obligor of B, as 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. Set-off effective at the time of notice.**

The obligations are discharged at the time of the notice if, at that time, the conditions required for set-off are fulfilled.

Set-off does not operate retroactively. It has prospective effect only.

The date of effectiveness of set-off is consistent with the necessity to declare set-off by notice, and in practice, the date when set-off is effective will be easy to know.

The situation has to be evaluated as if at the time of notice both obligations had been paid. Some consequences arise from this rule:

Interest on the obligations runs until the time of the notice, so the party who may and wants to set-off its obligation, has to declare set-off as soon as possible if it wishes to stop the accrual of interest.

If an undue payment had been made after set-off had been declared, restitution will take place, as the payment has no legal ground. If the payment had been made before the notice, it is an effective payment and restitution cannot be required.

### 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 20 November 2000. B asks for payment of the 100 dollars on 22 December. By a judgement dated 30 November 2000, B is ordered to pay to A 80 dollars damages. The obligation to pay 80 dollars is due and ascertained at the date of the judgement, on the 30 November. Set-off is exercised by A by notice on 10 December. The effect of set-off will take place at the time of notice as all the conditions required being satisfied before this date. The two obligations are discharged up to the amount of the lesser. B will remain obligee of A for 20 dollars. After the 10 December, interest no longer accrues, except on the amount of 20 dollars.

At the time where the conditions for set-off are satisfied and notice has been sent, 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 a personal security given by B's wife securing payment. B is obligee of A for 12000 euros, being money received on account of B. A asks payment of the 10000 euros to B, who declares set-off by notice on 12 December. The conditions required for A's obligation and B's obligation were fulfilled on 10 December. At the date of the notice on 12 December, A and B's obligations are discharged, as is the personal security given by B's wife.