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SET-OFF

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Set-Off

The development of international commercial trade has created an assortment of contractual interrelationships. It is no longer unusual for a party to find himself being at the same time both the creditor and the debtor to another party. The question arises whether the debt owed and the debt owing should be considered independent of each other, with each debtor obligated to perform without taking in account the existence of the debt owed to him, or whether one may consider the two debts linked because of their reciprocal nature

Different legal systems recognize the doctrine of “set-off”(or compensation) which links the reciprocal debts of two parties, thereby avoiding the need to make two overlapping payments. But the concept of the “set-off”, as well as the scope of its applicability, differs radically in different legal systems.

There appear to be three principal justifications for permitting debts to be set-off against each other, each of which corresponds to the notion of the set-off in different legal systems.

First, one may view a set-off as serving the merely practical, concrete concern of simplifying the relationship between a debtor and a creditor. In this view, a set-off avoids the necessity of the two parties transferring funds to each other. Under this view, a set-off is created “ipso jure”, automatically, by operation of law, when there are two reciprocal debts fulfilling certain strict prerequisites.

Second, one might view the set-off as a means to avoid the injustice that might result if a debtor could refuse to pay a debt (whether or not the debtor accepts responsibility for the debt) while at the same time demanding that the creditor pay a reciprocal debt owing to the defaulting party. One party would pay and the other would not. In this case, it would be up to the courts to decide whether forcing the second party to pay would be unfair in a given case.

Finally, the recognition of a linkage between two reciprocal debts – permitting a creditor to deduct from an obligation owed to him the reciprocal debt owed by him to the other party – creates a situation where the creditor is in a better position vis-a-vis the debtor’s other creditors. The creditor is better off because he can be paid via the set-off which also extinguishes his debt to the debtor. In this view, the set-off is a form of security for the benefit of a party who is at the same time both creditor and debtor. It is up to the party seeking to benefit from the set-off to inform the other party of his choice to satisfy the debt owed to him by applying the set-off.

One might categorize the three different conceptions of the set-off held by different legal systems respectively as: “set-off by operation of law,” “judicial set-off” and “set-off by election.”

One can look to history and comparative law to find examples of how these different views have been adopted by different legal systems. The notion in Roman law of the “judicial set-off,” which one finds today in Common law countries, is based upon a notion of fairness. “Set-off by operation of law” which one finds in French law (and which has served as the model for Italian, Spanish and Latin American law) emphasizes the desire to avoid the necessity of two separate payments and to simplify the performance of obligations. Finally, “set-off by election,” found in German law (and followed in Swiss and Dutch law), is viewed as a form of security available to the party who elects to take advantage of it.

I. The Different Conceptions of Set-Off lead to Different Legal Results

Before attempting to find a unifying principle for the application of set-off in international contracts, it seems appropriate to restate more fully the different justifications for the doctrine.

In **Roman Law**, the concept of the set-off developed only gradually. At first, the right to assert a set-off was based upon the contractual intent of the parties. Thus, it was necessary for the parties to provide in a contract that they intended that their respective obligations could satisfy their mutual obligations.

When Rome developed its “procedural formula” it was possible to assert a set-off as an affirmative defense, which permitted a judge to cancel out reciprocal obligations of the two parties to a lawsuit. This was not a general notion of set-off – the exception existed only in specific cases, although it was not applied consistently. Sometimes it was necessary to have two obligations created from the same contractual relationship. Other times, this was not required. The concept of the set-off was, above all, a defense recognized as serving the interests of justice, with the judge having the discretion to decide whether or not to apply the set-off.

The evolution of Roman law, with the creation of “the procedure extraordinaire” led to the development of set-off as an independent doctrine, in which a set-off could be applied to debts which did not arise from the same contract, if they were not “ex eadem causa”.

Under Justinian, it was said that set-off applied “ipso jure” which appears to mean that a plaintiff could demand payment of a debt for the amount which rests after his reciprocal debt was deducted as a set-off. It does not appear that Justinian meant that the set-off would take effect automatically at the creation of the second debt.

Roman Law, thus, created the notion of “judicial set-off”. It was a defense that a defendant could assert against the plaintiff. It was in the province of the judge to decide if the two reciprocal obligations fulfilled the conditions necessary for the application of the doctrine of set-off. Thus, it was for the judge to decide whether or not a set-off was appropriate in a particular case.

This notion of the “judicial set-off” is recognized today in Common Law countries. It is not surprising that England adopted this view of the set-off since, in Ancient Rome, as in England, legal doctrines arose and developed by means of civil procedure. According to the most reliable authorities, the set-off in England arose as a purely procedural instrument. It was up to the courts to decide whether two reciprocal debts could be set-off against each other. It is notable that the doctrine of set-off was developed in England within the Courts of Equity. At the beginning of the 18th century, two laws were passed related to bankruptcy (the Insolvent Debtor’s Act of 1729 and the Debtors Relief Amendment Act of 1735) each of which envisaged that “one debt must be set against the other.” Applying these two laws, the Chancellor and the courts of equity developed a body of rights comprising “equitable set-off” which would be applied in a variety of different situations.

Under the Common Law, set-off is best viewed as “judicial” even if judges may, and almost always do, search for an implied agreement by the parties demonstrating their intention that their reciprocal debts be set-off against each other. Theoretically, set-off is a procedural defense, granted by the court if the required conditions for applying the set-off are satisfied. It is up to the judge to decide if it is just and fair for a defendant to deduct the debt owed to him by the plaintiff as a set-off against the plaintiff’s claim. One consequence of this is that, since it is the judge who decides whether set-off is appropriate, the set-off takes effect only when the court’s judgment is issued. The set-off is not normally applied retroactively.

Modern scholars suggest that English Law is gradually moving away from the notion of the set-off as procedural defense toward the notion of the set-off as a substantive right.

German law has elaborated its own theory of set-off independent of Roman Law. In Germany, the set-off is basically a voluntary act invoked at the discretion of a party who seeks to take advantage of it. It is, in effect, a means of securing a debt that may or may not be exercised by one against whom demand for payment is made.

All the rules of the BGB relating to set-off confirm this view of the set-off as a form of securitization of debt.

The distinctive feature of German law is that when the required conditions are met, the party who demands payment – or of whom payment is demanded – is able to unilaterally declare that his debt is extinguished by a set-off. This declaration is extra-judicial and no particular formality is required. Neither party is obligated to make the declaration and each may do so or not do so according to his individual interest. A party may choose to wait to make the declaration, to assert the set-off against a different debt or to not assert the set-off at all for whatever reason. There are, however, several exceptions where the law forbids a party to declare a set-off, for example, if a debt arises from a damage award for an intentional tort, or if one of the debts is not subject to attachment.

The law does permit the parties to declare in writing that a set-off will be created automatically when the second, reciprocal obligation is created. This declaration will be without effect if one of the parties is placed in bankruptcy.

That set-off may be created by unilateral declaration bears upon the nature of the set-off and upon its effects. The unilateral declaration, on the one hand, is very useful because it informs one party of the other's intent to call upon the set-off. In practice, however, it may give rise to some difficulties.

First, since a declaration is necessary, it can not be created an automatic set-off, when dealing with the estate of a minor. The minor's guardian must make the declaration in the name of the minor, in accordance with the rules of the guardianship. Further, since a declaration is a unilateral act, it may neither be limited nor conditional. The timing of the declaration is left to he who decides to assert it, for example, before a lawsuit has been commenced, or in the pleadings, or in later motion practice, or even during the trial itself. The debtor might not want to assert the set-off at first, wishing instead to challenge the underlying debt asserted against him, while waiting to see how the lawsuit progresses. The declaration of a set-off might also specify the particular debt that one wishes to extinguish if the creditor is owed several debts by a particular debtor.

French Law, although strongly influenced by Roman Law did not adopt the principle of the judicially imposed set-off. Instead the Civil Code has opted for a concept of the set-off by which it takes effect automatically, by operation of law. In essence, under French law, the set-off is merely a method of payment. The applicability of the set-off depends solely upon the law which created it (Articles 1289 through 1299 of the Civil Code) and is automatic and obligatory. This is not to say, however, that French law does not also provide for judicially imposed set-off, as well as set-off that may be created by contract.

In France, a set-off is a means to extinguish a debt (similar, but not identical, to payment of the debt) and, in principle is a mechanism that takes effect automatically. From the moment when the second of two reciprocal obligations is entered into – assuming certain prerequisites are met – the two debts are reduced in an amount equal to the smaller of the two debts. The extinction of the debts is, in theory, automatic, taking effect by operation of law, without any intervention by the parties or by a judge.

The classification of set-off in French law as “automatic” must be refined since the set-off is not a matter of public policy (*ordre public*). If a creditor does not want to assert the set-off, it cannot be invoked *sua sponte* (*d'office*) by a court. This defense is the equivalent of an offer to pay. The debtor thereby acknowledges the debt and cannot thereafter retract. One must therefore distinguish between the desire to assert a set-off which is the voluntary act of the debtor, and the effects of the set-off,

which are automatic. This distinction has no practical consequences for the defendant/debtor but may have consequences for third party creditors, who cannot normally avoid the effects of the set-off, but might be able to invoke in court the set-off in the name of their debtor, in justice.

Certain authors (for example, Mendegris), have said that the a set-off in French law is an act of individual choice, since the party seeking to assert it must manifest an intent to do so. This characterization is neither totally true nor false since there remains in French law the notion that the set-off is automatic. As stated above, the set-off comes into existence automatically (at the time of the creation of the second debt) even if it is given effect only upon the request of one of the parties. Nevertheless, the set-off may be ignored if the debtor does not seek to take advantage of it or if he acts in a manner inconsistent with the set-off, for instance, if the debtor pays the debt without asserting the set-off. Note, however, that the intention to take advantage of the set-off unlike in German Law, does not need to be explicit.

Because the set-off comes into existence automatically, strict conditions must be satisfied before a debt will be subject to set-off. Yet, as noted above, even if these conditions are not met – so that an automatic set-off is not created – the parties may agree by contract that their debts may be set-off against each other. And, again as noted above, the courts may impose a set-off for the benefit of a debtor even if the strict conditions imposed by law are not satisfied. For example, the courts will apply a set-off where one of the parties is bankrupt if the reciprocal debts arose from the same contract or transaction (dettes connexes). The judge, by applying a set-off, gives one creditor a preference over the remaining creditors. The set-off, thus, is a form of securitization of the debt.

The different conceptions of set-off in the different legal systems discussed herein demonstrate the richness of this doctrine, but also its complexity.

In the framework of this report, which is intended to offer a set of rules governing setoff to be adopted for international contracts, it would seem necessary to select among the three theoretical conceptions of the set-off. But, upon further scrutiny one may say that no country has adopted any of the three concepts in its purest form. In practice, the three concepts are not all that different, and certain rules found in each system seem to derive from the others. For example, one can argue that the common law concept of the set-off as a judicially-imposed remedy is not far from the French concept of the set-off as created by operation of law, in that under French law, judicial intervention is necessary to determine that the necessary legal prerequisites have been satisfied. Similarly, one might maintain that the German concept of set-off as a form of securitization is not far from the French view. Certainly, set-off in French law serves as a means of securing a debt. Moreover, the requirement in French law that a party affirmatively assert the set-off makes the “set-off” appear less “automatic” than French legal theory would maintain, and more like the result of a declaration.

Bearing this in mind, one must consider the most appropriate legal basis upon which to establish a uniform set of rules for application of set-off in international contracts.

It would seem to be difficult to choose the Common Law notion of the set-off as a judicial remedy because in the common law system, the set-off has developed within the sphere of civil procedure rather than as an aspect of contract law.

To adhere to the “judicial” notion of set-off would require integrating the notion of set-off in the procedural rules of the various nations. Set-off would not, therefore, be an appropriate subject for a uniform series of rules governing international contracts. Each country is, in effect, master of its own courts’ procedures, including, for example, the requirements of a legally sufficient complaint, the availability of certain defenses and the preclusive effect of dismissed claims. I would submit that the rules of civil procedure are best left to each individual court system.

Thus, it seems that we must look to one of the conceptions of the set-off as found in the Civil Law countries. Nevertheless, as in the Common Law countries, the role of the courts will be very

important, whatever substantive rules are chosen, even if these rules are chosen to minimize the disputes that will inevitably be presented to the courts. There will always be a judicial aspect to set-off, but the power of the courts will be more or less extensive depending on the concept chosen.

II. Assuming that one rejects the notion of the set-off as a procedural remedy and focuses instead on the civil law notion of the set-off as a matter of substantive law, one must decide whether to adopt conception of the set-off as automatically coming into existence or as being created upon the declaration of one of the parties.

At first glance, the difference between these two concepts seems considerable.

One can illustrate the automatic nature of set-off under the French view. Article 1290 of the Civil Code provides.

“The set-off operates automatically, by operation of law, with the two parties not necessarily being aware of the fact. The two debts extinguish each other from the moment they both exist, in an amount equal to the smaller of the two debts.”

Reading this text, it would appear that the two parties have no role to play, and that the set-off is effectuated without their participation. One might even say that the two debts are extinguished without the knowledge of the parties.

A great many consequences flow from the “automatic” nature of the set-off in the French law. Many rules, most often relating to third parties, are based upon this automatic nature. Moreover, a minor can take advantage of a set-off because the set-off comes into effect automatically, and not by an act of one of the parties.

But one must immediately qualify the automatic nature of the set-off in French law by stating another, more general, rule (which does not arise from the rules relating to set-off): that a legal right must be raised by a party to be given effect. This rule applies to all the rights that the law recognizes without the participation of the parties. Thus, a two-year limitations period will not be applied to bar an action unless it is raised by the party. The courts will not apply the statute of limitations sua sponte (d’office)

This general rule is applicable to set-off. The courts cannot apply a set-off sua sponte. The debtor who has been sued for payment of a debt must pay if he fails to raise the set-off as a defense. The right to the set-off, if not affirmatively asserted, is waived.

But once the debtor has raised the defense of the set-off, thereby demonstrating to debtor’s intent to refuse to pay the debt other than by set-off, the automatic nature of the set-off comes into play. The court has no power to assess the fairness of the set-off. The court may only consider whether the legal prerequisites have been satisfied and, if so, the court must apply the set-off.

One thus can see the difference between taking advantage of the set-off, which requires that a party asserts it, and the automatic nature of the set-off, once the set-off has been asserted. It would seem that the automatic nature of the set-off has consequences primarily with respect to the rights of third parties.

In German law the set-off is a voluntary act. In contrast with French law, this voluntary aspect does not result from a broader principle of law, that one must affirmatively assert a right created by law.

It appears that, given the nature of the set-off as a form of securitizing a debt, German law envisions that a party must choose expressly whether to assert the set-off.

Article 388 of the BGB requires that a party make declaration that he wishes to assert a set-off, – “the set-off created by declaration.”

Viewing the statutory language, there appears to be a great difference between German law and French law. This is true in principle, but only in principle, because the French debtor must also affirmatively assert the set-off

The voluntary declaration found in German law has the advantage of informing the other party of the intention of the debtor to assert the set-off, but it also causes complications.

For example, since one can make a declaration outside of a judicial proceeding – and according to the BGB, the set-off exists immediately upon the declaration – the set-off may be confirmed after, in court. Thus, one must distinguish between a substantive declaration and a procedural declaration. The requirement for a substantive declaration originally presented problems in German Law, which have now been resolved.

Thus, in drafting a proposed uniform law of the set-off, one must consider whether to recommend that parties seeking to assert a set-off must make an express declaration, even if this is more of a question of concept and underlying justification than of practical results.

Nevertheless, it seems that perhaps a rule requiring a voluntary declaration of set-off would be preferable in the business world.

If a declaration of set-off is made according to certain flexible formalities, the intent of one party to pay his debt via the set-off is, would be, officially acknowledged vis-a-vis the other party and third parties. This seems to provide some degree of certainty for all of the interested parties, since the intent of the debtor to make payment, in the form of the set-off, has been made known. With respect to third parties, if the set-off is in their interest, the set-off should be binding.

In practice, there is no great difference between a requirement that one declare one’s intent to set-off a debt and the obligation that one affirmatively invoke a set-off that has already been created by operation of law. Moreover, the requirement of a declaration seems to be advantageous because the date of the creation of the set-off is known.

But, the difference in principle, between the declaration of intent and the imposition of the set-off by operation of law, could logically have consequences based upon the effective date of the set-off.

III. Giving Retroactive Effect to Set-Off

Under the French view of set-off – which automatically taking effect upon the creation of the second debt – it follows that when the debtor invokes the set-off in the course of a judicial process, the set-off should be retroactive to the date of creation of the set-off. Invoking (but not declaring) the set-off, the debtor merely takes advantage of a pre-existing legal occurrence.

The requirement (as in Germany) for a voluntary declaration might lead one to believe that the set-off would take effect as of the date of the declaration.

In fact, the effects of the set-off under German law are retroactive. Thus, the concept of the set-off as a creation of the declaration is not quite theoretically “pure”. The effective date of the set-off (for example, in calculating interest) runs from the date of the second debt. Thus, there is a trace of the French concept of set-off to be found in the German system. Being true to the concept of set-off as

created by the declaration, one would have expected that the effective date of the set-off would have been the date of the declaration.

One might think that the choice whether to apply a set-off retroactively would logically flow from the means of creating the set-off. The effects of the set-off should begin to run from the date it is created.

If the French concept of the set-off as automatically created by law is adopted, the effects should run from the creation of the second debt. If the German concept of the set-off as a creation of the declaration is adopted, one would expect the day of the declaration to be the effective date. Similarly, if one adopted the common law system of set-off as a judicial remedy, one would expect the day of the judgment to be the effective date.

But it is possible also to imagine a lag in time between the creation of a set-off and the effective date. The set-off might be given retroactive effect, or it might only be given effect at some future date. Whatever the case, a coherent choice of rules governing the effective date of a set-off is desirable.

If one supposes that a set-off need not be declared and that the assertion of the set-off in court is only a recognition of a pre-existing legal right, the set-off should be given retroactive effect. It should take effect from the birth of the second debt, since that is the date of the creation, by law, of the set-off.

If one adopts the concept of the set-off by declaration, the effects of the set-off should run from the date of the declaration, since that is the date that the set-off is created. But perhaps there would appear to be a risk of confusion if that date is used as the effective date, since the declaration is made outside the court.

If one adopts the concept of the set-off as a judicial remedy, the day of the judgment should govern.

Thus, the effective date of the set-off could pose a problem.

On the one hand, one could link the effects of the set-off to the theoretical conception adopted. With either set-off imposed by operation of law or by the declaration of a party, the relevant date would be, respectively, the date of the creation of the second debt or the date of the declaration.

Or, on the other hand, one can decouple the date of the creation of the set-off from the date of its effects, at least in the case of set-off by declaration. At the risk of sacrificing a degree of theoretical purity, one might decide in the case of set-off by declaration that the effects of the declaration would be retroactive to the date of the second debt.

It could be useful as well, in determining the effective date of the set-off, to consider how difficult it would be to establish as a matter of proof the effective date as an evidentiary matter.

Would it be easier to prove the date of the creation of the second debt or to determine the date of the declaration of intent to assert the set-off?

It would seem that if the declaration is made according to certain formalities in the presence of an officer of the court or even if the declaration is made by a more informal method such as by registered mail with the proof of receipt, that date would be easier to determine.

But it also seems relatively easy to know the date of the creation of a second debt, being either the date of a purchase order, the date of the invoice, the date of delivery, if this can be determined from the contract.

It is a question only of evidence, perhaps, but it could have serious consequences if the effective date is disputed.

Logically with a concept of set-off imposed by operation of law, one might propose that it be given a retroactive effect. The day of the creation of the second debt would be the effective date of the set-off. If the two debts are certain and liquid (a prerequisite for the creation of a set-off) this date will not, normally, be difficult to determine.

With a concept of set-off by declaration, the set-off might run from the date of the declaration. The determination of this date should not pose any more difficulties than determining the date of second debt, perhaps even less.

But it is also possible, as German law has done, to choose set-off by declaration with a retroactive effect dating from the date of the creation of the second debt.

This would result in a set-off that would be at the same time a set-off by declaration and by operation of law. But it seems that logic would require fixing the effective date of the set-off to the creation of the set-off, whether that would be the creation of the second debt or the declaration.

But whatever theoretical concept of set-off is chosen and whatever effective date the set-off is given, one must also determine in what situations set-off will be applicable, that is, when may two reciprocal debts be applied one against the other. Thus, one must examine in what contexts a party may assert its right to set-off.

IV. The Range of Situations in which Set-off may be Asserted

Rereading the minutes of our meeting in Rome in March 1998, it seems to me that questions relating to the range of situations in which set-off may be applied raised the most surprise and discussion, particularly among the representatives from the Common Law systems.

The breadth of situations in which set-off is available will be determined by the strictness of the legal prerequisites imposed. The narrower the applicability of set-off however, the greater the difficulty in knowing whether a set-off is created and the more often the parties will have to resort to judicial intervention.

Since we are examining only rules relating to international commercial contracts, one might think of limiting set-off to debts created between merchants linked by commercial relationships. Since these parties are regularly debtors and creditors of each other, why not impose a system of prompt payments via the set-off? In fact, set-offs are rarely used between merchants who deal with each other frequently. Other financial and contractual methods, are available to extinguish the debts between parties, such as current account advances (checking accounts) and credit accounts. In these cases, even if they do not expressly so state, the parties have waived their right to set-off their debts, but this waiver is effective only for these particular debts.

Is it necessary to limit set-off – as certain English authors have suggested – to debts created in the same contract? This would certainly narrow the number of situations in which a set-off could be asserted.

The idea to apply the set-off only to debts arising from the same contract arises from the view of the set-off as a procedural device. The court may consider only the arguments raised by the parties and may decide only the matters in dispute between them. It is logical that where the court creates the set-off it may only do so in the course of settling the dispute.

One can observe that in arbitrations, only the set-off of debts arising from the contract submitted to the arbitrators may be the subject of the arbitration award.

The idea of a link between the debts exists also in Civil Law countries which recognize the set-off of related debts (“dettes connexes”), but one finds this most often in the case of set-off created by the courts.

The requirement that debts emanate from the same contract, or that the debts be linked, seems therefore to the “judicial” notion of the set-off. If one intends to rely upon a Civil Law concept of the set-off, it would seem advisable to not require neither that the debts arise from the same contract nor that they be related. The notion of “relatedness” is not a simple one, nor is it always easy to determine when two debts “arise from the same contract.” Where an obligation arises from a group of related contracts, it will not always be easy to draw these distinctions, as one may see from examining English case law.

Is it necessary to limit set-off to debts arising from contracts or limit set-off to debts arising in the arena of contract law ? One might consider applying set-off to debts created by the failure to perform a contract – for instance, the non-payment of the purchase price of a good purchased or the damage award awarded in favor of the seller against the purchaser. Again, it will be difficult to draw a clear line. It is not always simple to know if there is a contract, a quasi-contract or a damage award. The determination of what obligations are “contractual” is not always a simple task.

Thus, if one limits set-off to contractual obligations, a party may always maintain that the debt that one wants to extinguish by set off is not contractual by nature. This would lead to judicial intervention. It would thus seem better to not limit set-off to contractual obligations.

But of course in an arbitration, the application of a set-off will depend of the scope of the arbitration.

V. Prerequisites for the Creation of a Set-Off

One is tempted to adopt simple and clear criteria for determining which debts should be subject to set-off.

This preference follows logically if one chooses to adopt the model of set-off as a matter of law; the courts should not have any discretion in deciding whether to apply the set-off. The courts should only consider whether the necessary prerequisites have been satisfied. The alternative is that the courts would decide whether a set-off should be applied based upon a balancing of the equities in a dispute. Under this latter conception, the court's decision would be discretionary, rather than a strict consideration of the necessary elements, and thus, one would, in fact, be closer to the notion of set-off as a form of judicial remedy.

Nevertheless, all legal systems impose some legal conditions for applying set-off.

a. Reciprocity

The two parties involved in the set-off must each be a debtor of the other. Difficulties arise when a third-party is permitted to intervene in a business transaction that originally involved two debts. Thus, for a set-off to take effect, there must be a debtor who is also the creditor of the other party and only of that other party. Difficulties also may arise when one of the debtors is a legal entity, such as a corporation or partnership. In keeping with the principal that legal entities are independent of their owners, members, or shareholders should not be permitted to set-off their personal debts with debts owed to the legal entity. It should be absolutely necessary that the creditor and the debtor of each

of the two debts to be set-off be identical. A parent corporation should not be allowed set-off a debt owed to it with the debt owed by one of its subsidiaries, even if the parent corporation guarantees the debts of its subsidiary. The different legal identities make the set-off inapplicable – the two debts are not reciprocal.

Another difficulty arises from the transfer of rights – where no reciprocal relation at the time of the creation of the second debt.

There are different solutions to this problem in the different legal systems.

Imagine that a creditor demands payment from one of his debtors and the debtor (who was not, originally, also a creditor of the creditor) asserts a set-off based upon a debt of the creditor that he has purchased afterward through a transfer. This will be valid only if the transfer of the original creditor's debt is assertable, "opposable" against the creditor.

French law requires that certain formal prerequisites be respected, such as notice of the transfer to the debtor. But, because of the automatic effect of the set-off, there is no need for the debtor to approve the transfer, he must merely be notified of it. A different result is found in German law where the declaration of set-off is a voluntary act which gives rise to the set-off. It is necessary there, in the case of an transfer of the right, to have the approval of the three parties, including the assignor, the assignee and the debtor whose debt has been transferred.

b. The fungibility of the Debts

Two things are fungible if they can each replace each other without harm. A requirement that the two obligations to be subject to the set-off be fungible seems desirable. Since a goal of the set-off is to simplify the making two separate payments, the result of the set-off should be the same as if two payments had been made. The fungibility of the debts seems to incorporate an essential element of set-off, to the extent that set-off embodies the notion of extinguishing obligations.

Thus, fungibility should be prerequisite for the application of a set-off.

It also seems preferable that set-off be applicable only in situations involving monetary debts. This is far from the case in practice. Yet, in common law countries, set-offs are limited to monetary debts. This seems to be the preferable approach.

If one limits the applicability of set-off to monetary debts the only difficulty presented is the problem of exchange rates. Most legal systems are reluctant to apply set-off when one of the debts is stated in a non-convertible currency, but there is even a reluctance to apply set-off when the currencies are convertible. Obviously, when dealing with international commercial transactions, debts are going to be stated in different currencies. Yet, the applicability of set-off seems desirable and should not pose great difficulty if the currencies are convertible.

One can also imagine a system where the right to set-off is more expansive, including obligations to delivery commodities where the price is fixed by a market price list.

But it would seem preferable that set-off be limited to monetary debts.

c. The Requirement that the two debts be liquid

A debt is "liquid" when it is certain and the sum owing has been determined.

The idea that the amount of the debt be “certain” is key. It is essential that the amount or existence of the debt not be subject to dispute. In practice, the most likely situation where a party will seek recourse in the courts is when one of the parties claims that he does not, in fact, owe any money to the other, or that the debt is not for the amount claimed.

If one can insure that there can be no dispute as to the existence or amount of the debt, the method for implementing set-off will be much simplified.

Should we propose specific evidentiary rules to assure the certainty of the two debts.

It would seem better to leave the question of whether a debt is sufficiently certain to the ordinary rules of evidence applicable in each legal system.

But one can imagine proposing a certain formality that would be presumptive proof of the existence of a debt and its amount. Clearly, if a debt has been recognized in a judgment, its existence cannot be challenged. This can also be said of debts evidenced by deeds. But in the commercial sphere, the imposition of strict, formal requirements will not be accepted. Nevertheless, one might require that the debts be contained in writing.

Thus, it seems that the debts subject to set-off should be evidenced by a writing.

Apart from the certainty of the existence of the reciprocal debts, one might consider whether it is also necessary that the amount of the debts be certain as well.

Thus, legal systems, like the French system, which have embraced the notion of set-off as imposed by operation of law, require that the amount of the two debts be certain. The set-off is created from the moment that the second of the two debts comes into existence, but only if one can determine the amount of each debt. There is no option of determining the amount of either of the debts by appraisal. Thus, set-off can only arise where two sums of money are owed, except in the rare case of the set-off two fungible commodities, where one can perform a simple calculation to determine the amount of the set-off.

In other legal systems, the liquidity of the two debts is not required. In these systems, one may seek the intervention of a court to appraise the value of the two debts. However, it seems that this role for the court leads back to a concept of set-off as a judicially-imposed remedy.

d. The debt must be enforceable (exigible)

A debt is “exigible” when the creditor has the right to demand immediate payment. This may be contrasted with debts which come due on a specific date in the future. The debtor can refuse to pay a debt which is not due for payment because the debtor is not obligated to pay before the date agreed upon for payment. In commercial transactions, it seems that only delays which have been accorded to a purchaser are likely to render a debt not payable. Also, an illegal debt, such as a gambling debt, might also not be enforceable.

The majority of legal systems require that a debt be enforceable, before it can be sued upon, but also before it can be asserted as a set-off. Of course, the parties can always agree otherwise and provide that a debt not yet enforceable can be the subject of a set-off.

It should thus be anticipated that set-off will only apply to debts enforceable.

If a conception of the set off as being created by operation of law is adopted, the debts must be certain, liquid, fungible and “exigible”. Only by means of strict conditions, which limit the scope of applicability of set-off, can one hope to avoid the need for constant judicial intervention.

If, on the other hand, one adopts a system under which the courts are assessing the fairness of applying a set-off (and not simply observing whether the requisite conditions are satisfied), the range of conditions in which set-off might be applied could be more flexible. It would be within the discretion of the courts, based upon the facts of a given dispute, to decide whether a set-off should be effected. The court would have a much more active role than in a system in which set-offs are created automatically, where the conditions for their creation must necessarily be more strict.

V. Conclusion

If Unidroit decides to recommend the promulgation of rules relating to set-off, the following might form the basis of such a recommendation:

That the set-off be considered as a doctrine of substantial, rather than procedural law.

That the party which seeks to benefit from the set-off either has to declare it in court, or to declare the set-off in an extra-judicial manner, informing the other party of his or her intention.

That the effective date of the set-off run from either the date of the creation of the second debt or the date of the declaration.

That a requirement of creating an automatic set-off is that the debts involved be certain, liquid, fungible and payable.