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WORKING GROUP FOR THE PREPARATION OF  
PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS

Meeting of the Drafting Group in Freiburg, 17-20 January 2001

Chapter [...]

SET-OFF

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Rome, December 2000

## SET-OFF

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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 ?

Various 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 appears to be three principal justifications for permitting debts to be set-off against each other, each of which corresponds to a different notion of set-off.

One may view a set-off as merely serving the 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.

One might also view the set-off as a means to avoid the injustice that might result if a debtor could refuse to pay a debt, while at the same time he could force his own debtor to pay his debt. 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 link between two reciprocal debts, permitting a debtor to reduce his debt to his creditor by the debt which is due to him by this same creditor, 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. 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. In this case, the debtor is free to claim the set-off , merely, he has to inform the other party of his choice to satisfy the debt owed to him by applying the set-off.

One might categorize these three different notions of set-off held by different legal systems as respectively: “set-off ipso jure”, “procedural set-off” and “set-off by declaration ».

Looking to history and comparative law we find examples of how these different views have been adopted by different legal systems:

In Roman Law, the notion 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. 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 Notions of Set-Off.

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

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, already relating, to provide in a contract that they intended to extinguish by set-off 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. This was not a general notion of set-off -- the defense of set-off, existed only in specific cases and it was not applied always in the same way. Sometimes it was thought 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 device of defence in justice, with the judge having the discretion to decide whether or not to apply set-off.

Roman law evolved with the creation of “the procedure extraordinaire” which led to the development of set-off as an unitary concept. This set-off could be applied to debts which did not arise from the same contract, which were not “ex eadem causa”.

Under Justinian, set-off applied “ipso jure”, apparently meaning 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 « ipso jure » meant that the set-off would exist par operation of law, automatically, at the creation of the second debt. Moreover, set-off was also a matter of contract between the parties.

Thus, Roman Law, created the notion of “procedural 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 its application. Thus, the judge decided whether or not a set-off was appropriate in a particular case.

This notion of the “procedural 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 concepts arose and developed by means of civil procedure. According to the most reliable authorities, the set-off in England arose as a purely procedural device. It was up to the courts to decide whether two reciprocal debts could be set-off against each other. It is notable that the concept of set-off was developed in England in the Court of Equity. At the beginning of the 18th century, two laws which were passed related to bankruptcy (the Insolvent Debtor’s Act of 1729 and the Debtors Relief Amendment Act of 1735), envisaged the possibility that “one debt must be set against the other.”

Applying these two laws, the Chancellor developed in the Chancery Court a body of rules, “equitable set-off”, which would later be applied in a variety of different situations.

Under the Common Law, set-off is best viewed as “procedural” even if judges may, and almost always do, search for an implied agreement by the parties demonstrating their intention was to set off their reciprocal debts. 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 a procedural device toward a notion of set-off of a substantive nature.

German law has elaborated its own theory of set-off, independent of Roman Law. In Germany, the set-off is basically a voluntary act, an election by a party who seeks to take advantage of it. It is, in effect, a means of securing a debt and it 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 obliged to make the declaration. 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, some 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 enters in bankruptcy ), and the parties are always free to exclude by contract the right of set-off.

That set-off may be created by unilateral declaration has consequences for the nature of the set-off and its effects. The unilateral declaration, is 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 automatic 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 during the trial itself. The debtor might not want to assert the set-off at first, wishing perhaps, before; to prove the inexistence of his debt , then 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 the debtor.

French Law, although strongly influenced by Roman Law, did not adopt the principle of a procedural set-off. The Civil Code has opted for a concept of the set-off by which it takes effect automatically, by operation of law. ( Article 1290 du code civil : « La compensation s'opère de plein droit, par la seule force de la loi ») In essence, the set-off is merely a method of payment. The set-off is automatic and obligatory. It depends solely upon the law which created it. Thus, is not to say, that French law does not also provide for procedural set-off (compensation judiciaire, as well as set-off created by contract ( compensation volontaire).

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 parties enter into the second of the two reciprocal obligations, assuming certain prerequisites are met, the two debts are reduced in an amount equal to their difference. The extinction of the debts is, automatic, taking effect by operation of law, without any intervention by the parties. The French conception strive to avoid the discretion of a juge intervening.

But in French law, the « automatic » effects of the set-off can be mitigated 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 *ex officio* (d'office) by the judge. This defense is the equivalent of an offer to pay. The debtor thereby acknowledges the debt and cannot retract later. One must therefore distinguish between the will to assert a set-off, which is a 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 a third party, 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,

Certain authors (for example, Mendegris), have said that the set-off in French law is an act of individual choice (compensation volontaire), since the party seeking to assert it must manifest an intent to do so. This opinion is neither totally true nor false since there remains in French law the notion that the set-off is by operation of the law (de plein droit). 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. But the set-off may be ignored if the debtor does not seek to take advantage of it or he acts in a manner inconsistent with the set-off, for example, if the debtor pays voluntarily the debt without asserting the set-off. In fact, the intention to take advantage of the set-off, unlike in German Law, does not need to be explicit, it can be implied. One have to make a distinction between the automatic effect of the set-off and the intention to assert the set-off.

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 apply a set-off for the benefit of a debtor even if the strict conditions imposed by law are not satisfied. For example, a court can 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 security.

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

In the framework of this report, which is intended to offer a set of rules governing set-off 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 so different, and certain rules found in each system seem to derive from the others. For example, one can argue that the procedural set-off is perhaps a kind of an automatic set-off, enforced by the judge who will be able to assure that the necessary legal prerequisites have been satisfied. Similarly, one might maintain that the German concept of set-off as a form of security is not far from the French view, set-off in French law also serves as a means of securing a debt. Moreover, the requirement in French law that a party affirmatively assert in court the set-off, makes the “set-off” appear less

“automatic” than French legal theory would maintain, and brings the French conception nearer to the set-off by declaration.

Bearing all of this in mind, we will 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 as it does not yet exist a uniform law of procedure to be difficult to opt for the procedural set-off, while the two other notions are developed in the substantive law of contract.

To adhere to the judicial set-off would require integrating the notion of set-off in the procedural rules of the various nations. Set-off would not, then, be an appropriate subject for principles 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. The rules of civil procedure are best left to each individual court system.

Thus, it seems that we must look to one of the other notions of set-off where set-off is a substantive device.

Nevertheless, 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 notion chosen.

## II- Set-off ipso jure or by declaration?

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, it is necessary to establish whether set-off will automatically come into existence or be created upon the declaration of one of the parties.

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

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 (de plein droit) 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, that the set-off is effectuated without their participation, and that the two debts are extinguished without the knowledge of the parties (« à l’issue des débiteurs »)

A great many consequences flow from the “automatic” nature of the set-off . 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 mitigate the automatic nature of the set-off 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 time limitation period (peremption d’instance) will not be applied to bar an action unless it is raised by the party. The courts will not apply a limitation ex officio (d’office).

This general rule is applicable to set-off. The courts cannot apply a set-off ex officio. 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 has 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. In Germany it is a rule governing set-off;

It appears that, German law, intending to or not to assert the set-off.

§ 388 of the BGB requires that a party make to the other party a declaration that he wishes to assert a set off. “The set-off is created by the declaration.”

In view of 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 in court.

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

For example, one can make a declaration outside of a judicial proceeding -- and according to the BGB, the set-off exists immediately upon the declaration but after, the set-off may be confirmed 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 the proposed Unidroit principles for set-off, one must consider whether to recommend that parties seeking to assert a set-off must make an express and voluntary declaration out of the court, 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, would be, more official 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 as soon as the date of the declaration, (which could be made by notice)

Even if in theory it exist a great difference between a set-off ipso jure and a set-off by declaration, in practice, the difference is mitigated. 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 easily 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 for the effective date of the set-off.

### III. Retroactivity or « ex nunc Effect » ?

Under a « ipso jure » conception of set-off - automatically taking effect upon the creation of the second debts- it follows that when the debtor invoke 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 informal voluntary declaration might lead one to believe that the set-off would take effect as the date of this informal declaration.

In fact, the effects of the set-off under German law are retroactive. Thus, the concept of a voluntary set off (by declaration) is not quite “ 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 conception of set-off ipso jure to be found in the German system. Being true to the conception of set-off as created by 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 date of creating the set-off. The effects of the set-off should begin to run from this date.

Logically, if a conception of the set-off ipso jure is adopted, the effects should run from the creation of the second debt. If a conception of the set-off by declaration (voluntary set-off) 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 procedural 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 conception 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 ».

If one adopts the concept of the set-off as a procedural 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 coherence, one might decide in the case of set-off by declaration that the effects of the declaration will 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. 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 par « voie d'huissier » 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, but it could have serious consequences if the effective date is disputed.

If a conception of set-off ipso jure is adopted, 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 the set-off) this date will not, normally, be difficult to determine.

If the conception of set-off by declaration seems more suitable, the effect of the set-off might run from the date of the declaration; the determination of this date should not normally pose any more difficulties than determining the date of the 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. In this case, the notion of set-off adopted would at the same time derive from the doctrine of set-off ipso jure and by declaration.

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.

Whatever theoretical concept of set-off is chosen and whatever effective date 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 to right to set-off.

#### IV. The Range for set-off

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 and discussion and surprise, particularly among the representatives from the Common Law systems.

The situations in which set-offs are available will be determined by the strictness of the prerequisites imposed. The narrower the applicability of set-off, the greater the difficulty in knowing whether a set-off could be created and the most of the time, parties will have to resort to judicial intervention.

Since we are examining only those rules relating to international commercial contracts, one might limit set-off to debts created between merchants linked by commercial relationships. Since these parties are regularly debtors and creditors of each other, why impose separate payments ? 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 excluded 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 deriving from the same contract ? This would certainly narrow the number of situations in which a set-off could be asserted.

The idea that set-off can only applied to debts arising from the same contract derives from the view of set-off as a procedural device. The judges must 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 asserts the set-off, it may only do so in the course of settling the dispute.

It seems 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 admitted by the courts (*compensation judiciaire*).

The requirement that debts emanate from the same contract, or that the debts be linked, seems therefore to derive from the procedural notion of the set-off. If one intends to rely upon a Civil Law concept of the set-off, it would seem advisable not to require that the debts arise from the same contract nor to require 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 a contract is integrate to a group of 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 and thus limit set-off to debts arising in the arena of contract law? One might consider impossible to claim set-off of a debt created by the failure to perform a contract by a debt allowed compensating a tort; 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 seek to establish that the debt that one wants to extinguish by set off is not contractual in nature. This would lead to judicial intervention. It would thus seem better not to limit set-off to contractual obligations.

## 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.

There is a choice. On one hand, if one chooses to adopt the conception of set-off *ipso jure*, the courts should not have any discretion 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, depending on the facts of the dispute. Under this latter conception, the judges have a power to evaluate whether set-off will be equitable; in this case we are closer to the notion of set-off as a form of procedural device

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, because 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, for example a corporation or partnership. In principle, legal entities are independent of their members. It should not be permitted to set-off members' personal debts with debts owed to the legal entity. It should be absolutely necessary that the creditor will be debtor of the party who claims the set-off. A parent corporation should not be allowed to claim a set-off for the debt that his creditor owes to subsidiaries, even if the parent corporation guaranteed the debts. The difference between the legal identities will make the set-off inapplicable : the two debts are not reciprocal.

Another difficulty arises from the transfer of rights – where no reciprocal relation existed 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) asserts a set-off based upon a debt he has purchased afterward, through a transfer. This will be valid for set-off, only if the transfer of the original debt is enforceable against the creditor by the debtor.

Some systems of law (as in French law) require that certain formal prerequisites be respected : notice of the transfer must be made to the debtor whose debt is transferred (débiteur cédé). But, because of the automatic effect of the set-off, there is no need for this debtor (le débiteur cédé) to approve or acknowledge . He must merely receive notice. A different result is found in some systems of law (as in German law) where the declaration of set-off is a voluntary act which gives rise to the set-off. There in the case of an transfer of the right, the approval of the three parties, the assignor, the assignee and the debtor, whose debt has been transferred, is necessary.

### b. 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 of 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, if set-off is a way of extinguishing obligations.

Thus, reciprocity and 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. It is almost always the case in practice. It seems that in common law countries, set-off is limited to monetary debts.

If one limits the applicability of set-off to monetary debts the only difficulty presented is the problem of foreign currency debts. 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 must be paid in different places and in different currencies. However 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 or securities.

#### c. A Requirement that the Two Debts be Liquid.

A debt is “liquid” when it is certain and the sum owed has been determined.

The idea that the existence and amount of the debt be “certain” is fundamental. It is essential that the amount and existence of the debt not be subject to dispute. In practice, the most likely situations where a party will seek recourse in the courts is where she claims that she 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 greatly 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 formality that would presume the existence of a debt and its amount. Clearly, if a debt has been recognised in a judgment, its existence can not 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 easily. Nevertheless, one might require that the debts be evidenced in writing.



Apart from the certainty of the existence of the reciprocal debt, is it also necessary that the amount of the debts be certain as well?

Thus, legal systems, which have embraced the notion of set-off as imposed by operation of law, (like the French system), 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 a procedural set-off, if the debts arise from the same legal relationship, (*dettes connexes*), the judge had the power to declare the set-off even if all the prerequisites are not established as, for example, if one of the debts is not liquid.

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.

So there is a choice between the conception of set-off *ipso jure* and the conception of procedural set-off; if one chooses this latter conception it will be in the province of the judges to evaluate the certainty of the existence of the debts and their amount; under the notion of set-off *ipso jure* the certainty and the liquidity of the two debts seems necessary.

We find differences between the legal systems. French law, applying the conception of set-off *ipso jure* considers liquidity of the two debts as a substantive requirement, German law does not impose as a requirement for set-off the liquidity of the cross claim. Dutch law had adopted a kind of compromise position, the judge may adjudicate upon the claim without taking account of the set-off declared by the defendant, if it cannot easily be determined whether that defense is justified.

Of course, each time the judge must evaluate, we are (more or less) operating under a notion of procedural set-off.

But even French law may apply procedural set-off (*compensation judiciaire*) if the two debts arise from the same relationship. In this case the judge may assert the set-off even if the legal prerequisites are not established.

#### d. The Debt must be immediately enforceable (*exigible*)

A debt is enforceable (“*exigible*”) when the creditor has the right to demand present payment. This is contrasted with debts which come due on a specific date in the future. The 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, it seems that only delays which have been accorded are likely to render a debt not payable. In another way, an illegal debt, such as a gambling debt, might also not be enforceable.

Some legal systems require that a debt be enforceable, before it can be the basis for a claim and also before it can be asserted as a set-off. But some other legal systems do not require the principal claim to be enforceable. A party may claim the set-off even if the debt owed by him is not enforceable, it is his choice to accept to pay before the contractual date for the payment. In a conception of voluntary set-off, the debtor who is able to assert the declaration of set-off may or may not decide to pay by set-off, even if his debts is not yet enforceable. It depends on the choice of this debtor.

Of course, the parties can always agree otherwise and provide that a debt not yet enforceable can be the subject of a set-off.

In a procedural conception of set-off, the courts will appreciate the fairness of applying a set-off (and not simply observing whether the requisite conditions are satisfied). In this conception 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 in the case, to decide whether a set-off should be made. The court would have a much more active role than in a system in which set-off are created automatically, where the conditions for their creation must necessarily be more strict.

## V. Conclusion

If the working group of Unidroit decides to recommend the promulgation of rules relating to set-off, the main following questions must be in discussion :

- 1) Is set-off to be considered a doctrine of substantial, or procedural law ?
- 2) Does the party who seeks to benefit from the set-off have to inform the other party of his or her intention (to make a declaration of the set off) ?
  - an informal declaration ?
  - a declaration in the court ?
- 3) What will be the effective date of the set-off ( retroactive effect, date of the declaration, date of the judgement) ?
- 4) What prerequisites must be imposed for set-off ,
  - mutuality,
  - debts of the same nature-( fungibilité),
  - liquidity
  - enforceability ( exigibilité)