



INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
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WORKING GROUP FOR THE PREPARATION OF
PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS

Chapter 8

SET-OFF

(Revised draft prepared by Professor C. Jauffret-Spinosi in the light
of the discussions of the Working Group at its 6th session held in
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ARTICLE 8.1
(Conditions of set-off)

(1) Where two parties owe each other money or other performances of the same kind, either of them ("the first party") may set-off its obligation against that of 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

1. Use of set-off

Under the Principles, when two parties owe each other an obligation arising from 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 (see Article 8.5). Set-off avoids the need for each party to perform its obligation 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 obligation, 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 Marseilles to Athens. A asks B for EUR 5,000 as payment for the transport. B, which had previously become an obligee of A for an amount of EUR 5,000 arising out of an indemnity for damage to other goods transported, may set-off its own obligation to pay EUR 5,000 against the obligation of A to pay it the amount of EUR 5,000. If it does so, neither A nor B remains the other's obligor.

2. A sells a piece of land to B for the price of AUS\$ 25,000. Later, B which is a contractor, builds a house for A. The price of the construction is AUS\$ 50,000. When A asks for the payment of the price of the land, B may set-off the price of the construction. The obligation of B to pay A AUS\$ 25,000 is totally discharged, but A remains obligor to B for AUS\$ 25,000.

To be allowed to set-off its own 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 capacity. 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 the absolute owner of a company.

Illustration

3. Company A sells to Company B machinery for Japanese Yen 600,000. B, which is in business with Company C, a subsidiary of Company A, sells to C products for Japanese Yen 500,000. 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 (see Article 9.1.13)

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 obligations of the same kind is broader than that of "fungible" obligations. 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, may be obligations of the same kind, but not fungible. Cash and securities are not performances of the same kind, in the sense of Article 8.1. Nevertheless, as in the case of different foreign currencies, set off may be exercised if securities are easily convertible and if there is no agreement that only the payment of specified cash or securities is possible. 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 1,500 tonnes of crude oil by pipe-line to Cairo. B, reciprocally, had to transfer each week by road 1,000 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". These are ordinary shares. B is shareholder of the same company. It 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.

Illustrations

6. A had sold ten trucks to B for US\$ 100,000. 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 it cannot make a payment to A before 30 November. B's obligation against A is not performable

7. A owes B EUR 20,000 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 EUR 14,000, 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 un-ascertained when the obligation may be contested 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 China Yuan Renminbi 100,000, for breach of a contract. B is in turn obligor of A, for repayment of a loan of China Yuan Renminbi 120,000, repayment already due. A asks B to pay the China Yuan Renminbi 120,000. B may set-off its obligation against A's obligation arising from the judgement.

10. A sells to B a yacht for EUR 10,000. 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 the 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. However, 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 un-enforceability 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 USD 20,000. A, who is obligee of B for the repayment of a loan of USD 12,000, 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.

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 nonetheless set off that time-barred obligation (see the Chapter on Limitation Periods, Article 10.10).

7. Set-off of obligations arising from the same contract.

Set-off is a convenient means of discharging obligations at once and at the same time. Thus, if the two obligations arise from the same contract, the conditions of set-off are modified. The same contract means a separate specified commercial agreement, (sale contract, franchising contract, leasing contract...) containing all the parties' obligations.

If the obligations of the two parties arise from such a separate contract, the first party is allowed to set-off its own obligation against an obligation of the other party which is not ascertained. An obligation to pay a damage, may be ascertained in its existence. If the

minimum of the amount payable cannot be contested, the first party may set-off its own obligation, up to that minimum amount, even if the total amount of the other party's obligation is unknown.

Though one of the obligations is contested, the right of set-off can be exercised because all of the relevant obligations capable of being set-off arise from the same contract, and may be easily identified. 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. In international commerce, the obligations of the two parties may frequently arise from the same contract.

Illustration

12. A carried turkeys for B from St. Petersburg to Stockholm. The transport charge is Russian Rubles 35,000. 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 Toronto to New York. 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 New York 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 Article 8.1 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 shall be discharged, for example by netting.

ARTICLE 8.2 *(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**

Payments in different currencies are not performances of the same kind according to Article 8.1. Nevertheless set-off may be exercised if the two obligations to be paid are in different convertible currencies. According to Article 6.1.9 if there is no agreement to the contrary, payment may be made by the obligor in the currency of the place for payment, if this currency is convertible. 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. Only convertible currencies may be set-off.

Illustration

1. A, a wine producer of California, sells 500 bottles of wine for US\$ 20,000 to B, a cork producer. B sells 100,000 corks to A for the price of 10,000 "livros", which is the currency of the country where corks are produced and which is not convertible. A asks B for payment of the US\$ 20,000. B may not set-off the 10,000 "livros" against the US\$ 20,000.

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 USD 10,000. 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 USD 10,000. 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 Ho Chi Min City, in Vietnamese currency.

ARTICLE 8.3

(Set-off by notice)

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

Notice may be given by any means appropriate to the circumstances and is effective when it reaches the person to which it is given (see Article 1.9 of the Principles).

Under 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 court. The first party must inform the other party that it will discharge its own obligation by set-off. Notice must not be conditional. To be effective, notice must be sent after the conditions for set-off are fulfilled.

ARTICLE 8.4
(*Content of Notice*)

(1) The notice must specify the obligations to which it relates

(2) If the notice does not specify the obligation against which set-off is exercised, the other party may, within a reasonable time, declare to the first party the obligation to which set-off relates, or, if no such declaration is made, the set-off will relate to all the obligations proportionally.

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. Declaration by the other party

If the first party has two or more obligations against the other party, and if the first party has not specified the obligations it wants to be paid by set-off, the other party may freely choose the first party's obligations it wants to be discharged..

Illustration

1. A and B are in business relationship. B asks A, on 30 December 2001, for payment of USD 5,000 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 USD 4,000, USD 3,500 and USD 4,500, respectively. If A wants to set-off B's obligation, it has to indicate, in the notice, which of the three obligations owed by B it wants to set-off.

If A does not indicate in the notice which obligation owed by B it wants set-off, B may in a reasonable time, indicate to A, that its obligation of USD 4,500 from the contract of 28 October 2001 will be totally discharged by set off and that the obligation of USD 3,500 from the contract of 27 September 2001 will be discharged up to USD 500. B after set-off applied, remains obligor of B for USD 7,000.

2. Absence of declaration

If the notice does not specify the obligations the first party wants to set off and if the other party has not made any declaration in a reasonable time, all the obligations of the other party will be discharged by set-off proportionally, up to the value of the first party obligation

In the illustration above, set-off will discharge the obligation of USD 4,000 arising from the contract of 10 July, up to USD 1,667; the obligation of USD 3,500 arising from the contract of 27 September, up to USD 1,458 and the obligation of USD 4,500 arising from the contract of 28 October, up to USD 1,875.

ARTICLE 8.5
(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 8.1 are satisfied, both parties' obligations are discharged to the extent of the set-off, as if two reciprocal payments had been made.

Illustration

1. A owes USD 100 to B and B owes USD 100 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 USD 100 to A, who in turn owes USD 70 to B. A, asks for the payment of the USD 100, B declares that it wants to set-off A's obligation of USD 70. 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 USD 30, 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 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. Consequently, the party who may and wants to set-off its obligation, must 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 USD 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 USD 100 on 22 December. By a judgement dated 30 November 2000, B is ordered to pay to A USD 80 damages. The obligation to pay USD 80 is due and ascertained at the date of the judgement, on 30 November. Set-off is exercised by A by notice on 10 December. The set-off will take place at the time of notice as all the conditions required are satisfied before this date. The two obligations are discharged up to the amount of the lesser. B will remain obligee of B for USD 20. After the 10 December, interest no longer accrues, except on the amount of USD 20.

At the time when the conditions for set-off are satisfied and notice has been sent, not only the principal obligations are discharged but also related rights, e.g. rights securing an obligation accordingly are discharged.

Illustration

4. A, a banker, had lent B EUR 10,000, and obtained a personal security given by B's wife securing payment. B is obligee of A for EUR 12,000, being money received on account of B. A asks payment of the EUR 10,000 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.