COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (PICC)

Edited by
Stefan Vogenauer and
Jan Kleinheisterkamp

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Introduction to Chapter 8 of the PICC

The subject matter of Chapter 8 of the PICC is set-off. The drafters of the PICC chose 'set-off' as the English term to describe the institution called in various other languages compensatio, compensation, Aufrechnung, Verrechnung, compensazione, compensación, verrekking, kvittning. The use of 'set-off' is common in English, but 'compensation' is also used in Scotland. The term set-off is employed mainly to avoid misunderstanding with the use of compensation in the context of tort law.

Set-off is generally defined as a mode of discharging the obligations of the obligor (debtor) and the obligee (creditor) towards each other, as far as they are coextensive, if the requirements fixed by the applicable law are fulfilled. As a means of simplifying performance, set-off has become central to international commerce. It is sometimes provided for by the contract (conventional set-off) in regard to specific requirements, and at other times it is derived directly from a national system (statutory or legal set-off). Chapter 8 of the PICC deals with the latter kind of set-off. Conventional set-off is, however, not excluded, but considered as part of the general doctrine of freedom of contract.

Chapter 8 of the PICC deals with the issue of set-off in five provisions. For some specific situations, set-off is dealt with in other parts of the PICC. Thus, Art 9.1.13(2) deals with set-off in case of assignment of rights and Art 9.1.15(e) specifies some points about the undertaking of the assignor, Art 9.2.7(2) addresses set-off in case of transfer of obligations, Art 9.3.6(1) deals with set-off in the case of assignment of a contract, and Art 10.10 concerns set-off when the obligation is affected by the limitation period.

By way of comparison with Chapter 13 of the PECL, an obvious formal difference is that set-off is governed by seven provisions in the PECL. However, the systems adopted by both international instruments are to a large extent similar; the more or less simultaneous drafting may explain the great similarity between the PECL and the PICC. The main difference is that the PICC do not mention two of the instances for which set-off is excluded under the PECL.

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1 For the discussion on the initially disputed choice of 'set-off' as the generic English term to be used in the PECL, see R Zimmermann, *Comparative Foundations of a European Law of Set-Off and Prescription* (2002) 21.
4 For an analysis of Chapter 13 of the PECL, see A Parra Lucan, 'La compensación en derecho español y en los principios de derecho contractual europeo, una comparación' in A Vaquer (ed), *La tercera parte de los Principios de Derecho Contractual Europeo: the Principles of European Contract Law, Part III* (2005) 301; Pichonnaz (n 3 above).

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First, the PICC, in line with their focus on international commercial contracts, do not envisage a ban on set-off in relation to a party's obligation for wages or maintenance, as is provided for by Art 13:107(b) PECL. However, a national system may exclude set-off in such a situation as a matter of national public policy. Second, contrary to a long tradition going back to Roman law, the PICC do not recognize an exclusion of set-off against claims arising from wrongful acts (as opposed to Art 13:107(c) PECL). This could arise in international commerce where, for example, an obligee which has not been paid, but which has an object in deposit, sells it in order to be able to set off this new obligation with the obligation of the other party. Also, on the substantive requirements for set-off, the issue of ascertainment under Art 8.1 differs slightly from the one under Art 13:102 PECL.

The primary function of set-off is to enable an effective and simplified way to discharge a party's obligation (facilitation of performance), thus avoiding overlapping payments ('circuity of payment') or performances. Set-off therefore has mainly a payment function, or in a broader sense aims only at the performance of the obligation. Since set-off is economically effective (for example, by reducing banking fees), the use of this mechanism should be encouraged and Chapter 8 of the PICC should be interpreted in a way facilitating it. At the same time, though, set-off enables the obligee to get its performance from the other party even if the other had not planned to perform at that stage.

In some legal systems, the ability to set off gives the obligee a (hidden) security, especially in case of bankruptcy. This security function is related to the idea of the retroactivity of the effect of set-off, which has not been followed by the PICC. It is also linked to the idea of a valid notice of set-off after a decree of insolvency against the other party. In this case, the first party, as obligor of the insolvent party, is entitled to set off with what it owes to this insolvent party. The first party is then better off than all other obligees, since by means of set-off it gets the performance of its claim up to the amount of the other obligation, instead of getting merely a percentage of it through the insolvency proceedings. Such a function is however not an intrinsic aim of the institution of set-off, but rather a remnant of its historical evolution. Moreover, the PICC may not be applicable in bankruptcy or insolvency cases.

There is no direct influence from a specific legal system on Chapter 8 of the PICC. It was at first disputed whether or not set-off should be part of the PICC, because of the fundamental differences between civil law and common law jurisdictions on this issue. Chapter 8 was thus introduced into the PICC only in the 2004 edition. Despite the fact...
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that Professor Jauffret-Spinosi from France acted as the rapporteur, the PICC do not follow the French perspective (automatic set-off), nor one of the various common law ways to set off claims (legal set-off, transaction set-off).

The system chosen by the PICC can only be explained by the difficulty the drafters faced in reaching a common solution for both common law and civil law systems, since these traditions largely differ on how to treat set-off. However, the drafters also had to examine the variations within the civil law world. Indeed, despite their common origins, continental codifications have adopted very different approaches to set-off. Thus, whilst the availability of set-off reflects a general principle of law, it was not possible to draw such a broad conclusion about its requirements when setting up a new system. However, the solution developed in the PICC is quite satisfactory, as it provides for a modern system, albeit based on a historical and comparative understanding of the institution.

15 For a historical analysis of the evolution of set-off, see Pichonnaz (n 3 above); Pichonnaz (n 12 above) paras 2000–2107; R Zimmermann, "Die Aufrechnung. Eine rechtsvergleichende Skizze zum Europäischen Vertragsrecht" in V Beuthien et al (eds), Festschrift für Dieter Medicus zum 70. Geburtstag (1999) 707; Zimmermann (n 1 above) 18–60.
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.

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I. Introduction

1. Article 8.1 contains the requirements ('conditions') for set-off. There are five basic requirements: first, mutuality of obligations (see paras 11–15 below); second, obligations of the same kind (see paras 16–23 below); third, the right of the 'first party' to perform its obligation (see paras 25–31 below); fourth, the right to enforce obligations of the 'other party' (see paras 32–35 below); fifth, the ascertainment of the obligation of the 'other party' (see paras 36–48 below). Finally, set-off is triggered by a sixth requirement, which is to give notice, dealt with in Art 8.3. However, since set-off by agreement (contractual set-off) is admitted with no specific limitations, the requirements set by the PICC are of a dispositive nature (ie parties may derogate from them by agreement in one way or another).

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16 See below, Art 8.3 paras 20–21.
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Art 8.1

Set-off may also be excluded; the PICC do not deal with the question, as opposed to Art 13:107 PECL, but exclusion by agreement is possible as a matter of party autonomy.\(^\text{17}\)

These requirements differ partly from those applicable to counterclaims, called in various national systems *Widerklage, action reconventionnelle, reconvenzione*, and *reconvencion*. Although doctrinal works deal with set-off and counterclaims in the same way, the two institutions differ substantially in nature. A counterclaim is a purely procedural device, by which a party, the respondent in proceedings, may bring forward in the same proceedings a cross-action, which the court has to consider under certain requirements. Contrary to set-off, which only allows a party to reduce the amount of the main claim and is invoked within proceedings 'as a shield', a counterclaim allows the judge to require the claimant to perform the part of the counterclaim that may exceed the amount of the main claim; in that sense, a counterclaim works 'as a sword'.\(^\text{18}\) Linked to procedural rules, the requirements for counterclaims are set up by national or arbitral procedural laws. The judge may sometimes grant a stay to the main action until he has decided upon the cross-action.

In arbitration, the main requirement for a counterclaim is to raise the issue in the terms of reference and to determine whether the counterclaim is covered by the arbitral clause or, at least, allowed by the rules governing the arbitration.\(^\text{19}\) For example, Art 19(3) of the UNCITRAL Arbitration Rules differentiates between set-off and counterclaims, but both are regulated in the same way. Art 5(5) of the ICC Rules asks for the respondent to put its counterclaim forward in answer to the request; Art 19 of the ICC Rules provides that after the signing of the terms of reference no further (counter-)claim is possible. The ICC Rules are however silent on the requirements for set-off (see para 9 below). Art 19(3) of the Swiss Rules states that the counterclaim and the set-off plea must be put forward in the same way as the main claim.\(^\text{20}\)

A terminological aspect is important. Since in each case, each party may give notice of set-off, Art 8.1 defines the parties and their obligations. 'The first party' is the party that gives notice of set-off. Under Chapter 8 of the PICC, it is irrelevant whether that party is the obligor of the larger obligation or not and whether it has already filed a lawsuit or not. The PICC have avoided using expressions which may give the appearance that the obligations are of different importance, as sometimes occurs in national systems that use the term 'main obligation' (*Hauptforderung, créance principale*). 'The other party' designates the party to which notice of set-off is given. This neutral designation is better than expressions such as 'cross-claim' (*Gegenforderung, contre-créance*). However, the use of 'obligation' as a generic term in Chapter 8 of the PICC has led to contradictions in drafting, since the drafters were more familiar with the binomial 'claim/debt'.\(^\text{21}\)

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\(^{17}\) See Art 1.1 and also below, Art 8.3 para 21.
\(^{18}\) For English law see *Stooke v Taylor* [1880] 5 QBD 569, 575, CA: set-off operates 'as a shield, not as a sword'.
\(^{19}\) For English law see *Econet Satellite Services Ltd v Vee Networks Ltd* [2006] 2 Lloyd's Rep 423, QB.
\(^{21}\) See below, Art. 8.2 paras 14–17.
II. Set-off and jurisdiction (arbitration)

5 Considered as a substantive device, set-off should be independent from any procedural aspects. This is, however, not completely true. As a matter of fact, in arbitration proceedings, the ambit of the arbitral tribunal’s jurisdiction may affect the ability to set-off an obligation with another, especially if the obligation of the other party arises from a different contract. The jurisdictional problem may be due to the fact that the tribunal is not competent to rule on the validity of the obligation of the other party, either because its scope of competence is limited to the obligations arising out of a specific contract only or because of the specific subject matter and the specific jurisdiction over it, such as in the case of labour law or contracts of lease.

6 The most important issue for the PICC is the question of arbitrability over the other party’s obligation. This requires consideration of the variety of situations linked to the specificity of the applicable procedural rules.22

7 The UNCITRAL Arbitration Rules allow both set-off and a counterclaim merely if they arise ‘out of the same contract’.23 The model arbitration clause that accompanies the UNCITRAL Arbitration Rules refers to claims ‘arising out of or relating to’ the same contract. A UNCITRAL report states that ‘the Rules do not state expressly that the set-off claim must be covered by the same arbitration agreement’,24 but goes on to underline that the use of the model clause would mean that ‘both the principal claim and the claim invoked for the purpose of a set-off would be covered by the same arbitration agreement’.25 However, no explanation is given for the variation between Art 19(3) of the UNCITRAL Arbitration Rules and the Model Law.

8 Nevertheless, the addition ‘or relating to’ may cover claims other than those strictly arising out of the same contract;26 the arbitral tribunal might therefore consider claims arising out of the ‘same legal relation’, for instance, in the case of complex contracts (economically joined, but legally distinct). Where the parties have chosen to include in their arbitral agreement the narrow wording of Art 19(3) of the UNCITRAL Arbitration Rules, the English Queen’s Bench Division has decided that ‘transactional set-off’ is not possible with an obligation arising from a different contract.27 The wording of the arbitral clause was

22 For a good analysis of these, see C Kee, ‘Set-Off in International Arbitration: What Can the Asian Region Learn?’ [2005] A Int’l Arb J 141, 147.
23 Art 19(3) of the UNCITRAL Arbitration Rules; Berger (n 20 above) Art 21 para 31.
24 UN Doc A/CN.9/460, Possible future work in the area of international commercial arbitration: note by the Secretariat (1999) para 76.
25 ibid.
26 For a good overview of the present analysis of Art 19(3) of the UNCITRAL Arbitration Rules from an Australian perspective, see Incitec Ltd v Alkimos Shipping Corp (2004) 206 ALR 558, Federal Court of Australia, especially 563–564 (Allsop J): “[t]he clear tide of judicial opinion as to arbitration clauses, where the fair reading of them is not confined, is to give width, flexibility and amplitude to them”; Kee (n 22 above) 148. Art 22 of the Rules of Arbitration of the Australian Centre for International Commercial Arbitration (‘ACICA Arbitration Rules’) of 12 July 2005 (www.acica.org.au/arbitration_rules.html) also takes this broader perspective.
27 Eones Satellite Services Ltd v Vee Networks Ltd [2006] 2 Lloyd’s Rep 423, QB.
considered to be of prime importance, despite the fact that English law governed the
contract; as a matter of fact, this may bar the availability of transaction set-off in any given
case, regardless of the scope of the arbitration agreement, even if transaction set-off is
defined as being of substantive nature.\footnote{ibid 426–427: 'the observations of the Court of Appeal in Aectra are not to be taken to be as conferring
jurisdiction on an arbitral tribunal to determine transaction set-offs based on a separate contract regardless of
the scope of the arbitration agreement'; the case redefined Axel Johnson Petroleum AB v MG Mineral Group
AG [1992] 1 WLR 270, CA.}

The ICC Rules do not specifically address the issue of the set-off defence. If the procedural
requirements are fulfilled, the question of the validity of the set-off plea has to be determined
by the applicable law. If this is the PICC, then the question is answered by Art 8.1. If this is
not the case, the question is disputed. The dominant view is that the validity of a set-off plea
is governed by the law of the claim against which set-off is sought.\footnote{K2 Berger, 'Set-Off in International Economic Arbitration' (1999) 15 Arb Int'l 53; Berger (n 20 above)
Art 19 para 12; Pichonnaz (n 12 above) paras 2023–2035.}

Art 21(5) of the Swiss Rules provides explicitly that 'the arbitral tribunal shall have
jurisdiction to hear a set-off defence even when the relationship out of which this defence is
said to arise is not within the scope of the arbitration clause or is the object of another
arbitration agreement or forum-selection clause'. Thus, even if the obligation is subject to
no arbitration agreement or forum-selection clause, the first party may give notice of set-off
and the arbitral tribunal may decide upon this defence. This more liberal view is in accord-
ance with the present tendency in doctrinal works.\footnote{Berger (n 20 above) Art 21 para 32; JF
Poudret and S Besson, Comparative Law of International Arbitration (2nd edn, 2007) para 324; JF Poudret, 'Compensation et arbitrage' in JM Rapp and M Jaccard (eds), Le droit en
action: recueil de travaux publié par la Faculté de droit de l'Université de Lausanne à l'occasion du Congrès commun
de la Fédération suisse des avocats et de la Société suisse des juristes des 7 et 8 juin 1996 (1996) 379; Berger (n 29
above) 74–78.}

Thus, according to the principle le juge de l'action est le juge de l'exception (ie the judge seized with the main action is also
competent to decide upon the defences), set-off is possible as soon as the requirements of
the PICC are fulfilled. The parties may agree on different requirements, and waive (expressly
or implicitly) Art 21(5) of the Swiss Rules.\footnote{Berger (n 20 above) Art 21 para 33.} This is then a matter of interpretation of their
agreement.

### III. Mutuality of obligations

#### 1. Mutuality of obligations and capacity

The first requirement for set-off common to all legal systems is that, as a matter of principle,
each party should be the obligor and obligee of the other in the same capacity or in the same
right.\footnote{Pichonnaz 935} This requirement stems partially from the original procedural nature of set-off; since
in that context the court is not able to involve third parties in its judgment implementing
the set-off defence. 32 The PICC subscribe to the substantive nature of set-off, 33 so set-off with third parties may be possible in specific situations (see paras 14–15 below). However, as a matter of principle, there can be no set-off between an obligation owed by the first party as an individual and an obligation owed to it as a representative of another party that is the real obligor of this obligation.

12 Since a person may act in his own capacity or as a trustee, the Official Comment specifies that mutuality of obligations is only given, if a person is obligee and obligor in the same capacity. 34 Thus, a trustee cannot give notice of set-off to pay a personal obligation by using an obligation in favour of the beneficiary or the trust. 35 Despite the fact that it is the same person acting, the assets are part of separate patrimonies. Australian law has however accepted set-off in such situations by way of equitable set-off in specific cases. 36

13 Mutuality is also absent if a party acts as an obligor in its own capacity and as an obligee for a company it owns, as long as the company has no independent legal personality but is part of a separate patrimony. One of the Illustrations provided by the Official Comment deals with a case of set-off taking place between a first party (the obligor of an obligation owed by the other party) and the obligation of an independent company (owned by the first party) that is the obligee of the other party; 37 as such, the Illustration deals with a case of third party set-off, since the company is legally a 'different entity' with separate legal personality. It is not an example of the issue of 'same capacity'. What is meant by the 'same capacity' requirement is that if the same person is obligor and obligee, both obligations should not be part of separate patrimonies of this same person. 38

2. Third party set-off

14 It has been held that set-off where third parties are involved with the reciprocal obligations is 'a creature unknown to the law'; 39 however, there are some situations where the rule requiring mutuality of obligations is not strictly followed. This is sometimes due to the historical development of the institution of set-off, 40 or else to avoid the deterioration of a party's position due to lack of notice. This is especially the case for an assignment of rights, where set-off is possible by the obligor against the assignee when the right of set-off was available to the obligor before the notice of the assignment was given. 41 It also applies to a transfer of obligations: where set-off was possible by the old obligor against the obligee, set-off is not available to the new obligor although the obligation has been transferred

32 Pichonnaz (n 12 above) paras 886–890.
33 See below, Art 8.3 para 2.
34 Off Cmt 2 to Art 8.1, p 255.
36 Murphy v Zamonex Property Ltd [1993] 31 NSWLR 439, 464, Supreme Court of New South Wales; Doherty v Murphy [1996] 2 VR 553, Supreme Court of Victoria; for explanations, see Derham (n 35 above) para 17.91.
37 Illustration 3 to Art 8.1.
38 For a clear statement to this effect see, eg, Art 6:127(3) Douch Cc.
40 Pichonnaz (n 12 above) paras 797–800.
41 See below, Art 9.1.13 paras 17–18.
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A similar situation arises for a transfer of contract: if it implies an assignment of rights, Art 9.1.13 applies according to Art 9.3.7(1); if it implies a transfer of obligations, Art 9.2.7 applies according to Art 9.3.6(2).

However, as a way to simplify performance, it is possible to turn a third party situation into a regular mutuality situation: the obligor may declare set-off by using the obligation owed by the obligee to a third party, either on the basis of agency (Section 2.2 of the PICC) or as an intervention by paying to the third party the obligation of its obligee towards it.

Thus, the obligor will be able to set off its obligation with its newly acquired right against the other party. The interest of the obligor to use the other party's obligation owed to a third party may vary; the most obvious one is that the obligee may be subject to a decree of bankruptcy. After having performed the obligation owed by its obligee to the third party, the obligor (first party) will have a right to be reimbursed by the (favoured) party, who is its obligee, based either on mandate or negotiorum gestio.

IV. Obligations of the same kind

1. ‘Same kind’ and the nature of the obligations

By definition, to be able to subtract two elements one from another, they must be of the same nature (ie of the same kind). It is therefore not surprising to find this second requirement in the PICC, since it exists in all legal systems in one way or another.

However, the question is to define what is of the same kind and what is not. Art 1291 French Cc indicates that obligations for grains or commodity are considered to be of the same kind. As the Official Comment states, some systems require ‘fungibility’ of obligations, which is a more restrictive approach, since fungibility cannot be said to exist as soon as the obligations deal with objects which are not completely identical.

The aim of the PICC is to encourage the use of set-off, especially in international trade, so that the requirement of obligations being of the same kind must be interpreted broadly. Thus, to decide whether obligations are of the same kind, the object of the obligation is the relevant consideration, not its legal origin (contractual, extra-contractual, public law, etc).

Usually, both obligations are expressed in money. However, if the monetary obligations are expressed in different currencies, the issue of the requirement of the ‘same kind’ may arise. The PICC deal specifically with this problem in Art 8.2. The Official Comment refers to reciprocal obligations to deliver cash and securities as not being of the same kind under Art 8.1. However, set-off of different currencies and even of some securities is expressly allowed, because obligations can always be considered as being ‘of the same kind’ when it is

42 See below, Art. 9.2.7 paras 13–15.
43 See above, Introduction to Chapter 8 para 6.
44 For a comparative survey, see PECL Art 13:101 Notes; Zimmermann (n 15 above) 707–739.
45 Off Cmt 3 to Art 8.1, p 236.
46 eg for German law, see Falands/Gröneberg § 387 para 8.
47 Off Cmt 3 to Art 8.1, p 236.
possible to transform easily two obligations of different kinds into obligations of the same kind. This would not be the case under English law, which only allows set-off between monetary obligations.

19 This indicates that the requirement of obligations being of the same kind need not be fulfilled from the outset, but ultimately at the moment of set-off, i.e., when the first party gives notice of set-off. By doing so, this party may indeed express its view that it does not want to get its right in the kind agreed upon, but (for example) in money, which would enable set-off. Thus, the first limit to this transformation is the common intention of the parties to get specific performance, provided the parties can insist on it in light of Art 7.2.2. The second limit exists for performance of a personal nature (e.g., the performance of an attorney being set off with the performance of a doctor), even if such obligations are not of an exclusively personal character in the sense of Art 7.2.2(d), unless the parties agree to transform the obligation into damages.

20 In civil law systems, a recurrent case where set-off is excluded is the set-off between a monetary obligation and an obligation to return the content of a contract of deposit. The rationale for this ban on set-off can only be explained historically. However, under the PICC, set-off should be possible in such a case, unless there are obligations of different kinds (e.g., an obligation to return a corporeal thing and an obligation to pay a sum of money) that are not transformed by the parties, or when a party insists on specific performance. In the case of a contract of irregular deposit (i.e., a deposit of a sum of money), set-off should be possible in any event under the PICC. This cannot be considered a general principle of law, since a number of legal systems would exclude set-off in this case. However, it is the result of a clear policy decision for the PICC to accept set-off broadly, as it is expressed in Art 8.2 for monetary obligations.

2. 'Same kind' and the terms of the obligations

Obligations subject to different terms or 'modalities' (different periods of limitation, different places of performance, secured or unsecured rights, different rates of interest) may still be set off, since they remain of the same kind. In such cases, the effects may be different for each obligation. Two points should be mentioned.

22 First, when a monetary obligation may be set off with another one which is secured, either by a real or a personal security, they are considered to be of the same kind. This point was probably considered as self-evident by the drafters, since neither the PICC nor the Official Comment mention it. It is important to allow set-off in such a case, or even to favour it, in
order to avoid an unnecessary recourse to the real or personal security. But when one of the obligations is subject to a lien or is under an arrest decree obtained by a third party, the obligee of this obligation has no power to dispose over it, which renders set-off impossible. This is, however, not a consequence of the requirement to have obligations of the 'same kind', but is instead a result of the absence of power to dispose of a right without the consent of a third person.

Second, two obligations of the same kind that must be performed at different places are still of the same kind (see para 21 above). For instance, if a loan is repayable at the lender's place of business—the first party's place of business according to Art 6.1.6(a)—it can be set off against a right to payment of a purchase price that has to be paid at the seller's place of business, which is the other party's place of business according to Art 6.1.6(a). This situation is typical and it would contradict the underlying policy of the PICC to hold that both obligations are not of the same kind. If one party suffers a loss because its obligor resorts to set-off instead of performing the obligation, it should recover damages. The amount of damages corresponds to the difference between the costs necessary for performance at the place required by the contract (or by Art 6.1.6), and the result of the effects of set-off (such as transactional costs and transportation costs).

V. Right to perform and enforceability

Because of the function of set-off, being at the same time a way to facilitate performance for the first party and a way to get performance from the other party, the maturity of the respective obligations may differ. Rightly, Art 8.1(1) requires that the first party should have the right to perform (see paras 25–31 below) and that for the second party the performance should be due (see paras 32–35 below).

1. Right to perform for the party declaring set-off ('performable'), Art 8.1(1)(a)

It is necessary, but also sufficient, that the first party (ie the person declaring set-off) has the right to perform its obligation; it is thus not necessary for the other party to have the right to enforce performance of that obligation at the time of the declaration of set-off. In practice, set-off is often declared when the other party indicates that it wants to get performance from the first party. This requirement is then obviously fulfilled.

Indeed, by declaring set-off, the first party, as the obligor of one obligation, performs. Yet, if its obligation is due at a later stage according to Art 6.1.1, this performance corresponds to an 'earlier performance', which in principle constitutes non-performance of the contract. However, according to Art 6.1.5, earlier performance by the obligor may only be rejected by the obligee if the latter has a legitimate interest in doing so. Yet, when 'the other party' is the obligee of an obligation that the obligor wants to perform before it is due by
means of set-off, the obligor certainly has no legitimate interest in objecting to this earlier performance if it has a reciprocal obligation which is already due.\textsuperscript{58} There should never be additional expenses for earlier performance. Therefore, the first party should be entitled to declare set-off even if its obligation is not yet due according to Art 6.1.1. This is also the position of those domestic legal systems where set-off is achieved by notice of a party.\textsuperscript{59} The Illustration in the Official Comment is misleading because it indicates that a party may not set off its obligation before it is due.\textsuperscript{60} The real question is not whether the obligation is due, but whether the other party is or is not entitled to reject that earlier performance.

27 As a consequence of Art 8.1(1)(a), set-off is still possible if the obligation of the first party is not enforceable, because it is a ‘non-binding obligation’ (also called ‘natural obligation’ in civil law systems), because the obligee has no right to enforce, or because it is an obligation for which the obligor may validly oppose enforcement.

28 When the obligor is not yet entitled to perform (eg because the parties agreed that performance cannot be made before a specific date) set-off is not possible. If the first party’s obligation is affected by a condition precedent that prevents the obligation from becoming binding before the condition is fulfilled, then the first party, by giving notice, might be said to renounce the benefit of the condition precedent.\textsuperscript{61} However, since in some legal systems it is possible for a party to perform earlier without renouncing the benefit of a condition precedent, this would lead to restitution if the condition precedent did not occur.\textsuperscript{62} Indeed, in case of set-off, this would entail intricate problems. Most systems therefore exclude set-off while any conditions precedent remain unfulfilled.\textsuperscript{63} The PICC have not dealt with conditions precedent, but will do so in the next edition.\textsuperscript{64}

29 The Official Comment is misleading about this requirement for set-off. By stating that ‘the first party cannot impose on the other party a performance which either has not yet been ascertained, or is not yet due’,\textsuperscript{65} it gives the impression that earlier performance by means of set-off is not possible. However, by referring to the ‘entitlement’ to performance, rather than to the ‘obligation’ to perform, Art 8.1(1)(a) stresses that earlier performance is possible by means of set-off. Otherwise, Art 8.1(1)(a) would not differ from Art 8.1(1)(b), which stresses that, for the obligation of the other party, ‘performance must be due’ (see paras 32–35 below).

\textsuperscript{58} Pichonnaz (n 12 above) para 2091.
\textsuperscript{59} eg for German law, Palandt/Grüneberg § 387 para 12; for Swiss law, BaslerKomm/Peter Art 120 Swiss CO para 4.
\textsuperscript{60} Illustration 6 to Art 8.1.
\textsuperscript{61} Parra Lucan (n 6 above) 380.
\textsuperscript{62} eg Art 153(2) Swiss CO (restitution based on unjust enrichment); § 161 German Cc.
\textsuperscript{63} For Swiss law see V Aepli, Kommentar zum schweizerischen Zivilrecht, vol 5(1) (3rd edn, 1991) Art 120 Swiss CO para 95.
\textsuperscript{65} Off Cmt 4 to Art 8.1, p 257.
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If the obligor is no longer entitled to perform, set-off is not possible either. This might for instance be the case when the obligation has become subject to an order of attachment.66

Ascertainment of the obligation of the first party is no requirement for set-off. It is rather one of the consequences of set-off because, by declaring set-off, the first party performs and thus necessarily acknowledges the existence and amount of the obligation. The Official Comment is misleading in this respect, as it maintains that the obligation of the first party has to be ascertained.67 This, however, is only true for the obligation of the other party (see paras 36–48 below).

2. Enforceability of the obligation of the other party

Set-off is a form of enforcement of the other party's obligation. Since, by declaring set-off, the first party, as obligee of this obligation, compels the obligor to perform by having its obligation discharged, this should not be possible before the obligation is due according to the principles set forth in Art 6.1.1. This requirement is self-evident in any system based on automatic set-off (ie where set-off operates as a matter of law, without any notice or judicial decision),68 and it is also acknowledged in all continental legal systems.69 As a consequence, set-off is not possible if the obligation of the other party is a natural obligation, ie an obligation that cannot be enforced (see para 27 above).70

If the obligor can oppose a peremptory exception (ie an exception that leads to a permanent bar to the enforcement of the claim) to the performance of an obligation, set-off is no longer possible. A further question is whether the obligor already must have asserted the exception at the time notice of set-off is given or whether it is sufficient that the exception might have been asserted. In favour of the first position, it could be argued that Art 10.10, which allows set-off as long as the obligor has not asserted the expiry of the limitation period, means that set-off is only barred when a peremptory exception has effectively been asserted before the notice of set-off. However, the exception can only be asserted in judicial proceedings, while notice of set-off can be given outside of a courtroom. Thus, the other party, as an obligor, would be in a worse position under this interpretation than if set-off were only barred if the expiry of the limitation period had already been asserted.71

It seems preferable to derive inspiration from the better solution chosen by Art 14:503 PECL, and to give the other party the right to assert the exception of the expiry of the limitation period even after the first party has given notice of set-off. This should be done

66 On set-off in case of bankruptcy, see below, Art 8.3 paras 14–19; Pichonnaz (n 12 above) paras 2012–2017; Pichonnaz (n 10 above) 107; Zimmermann (n 1 above) 43; HR Schüpbach, 'Compensation et execution forcee' in P Angst et al (eds), Schuldbetreibung und Konkurs im Wandel: Festschrift 75 Jahre Konferenz der Betreibungs- und Konkursbeamten der Schweiz (2000) 135.
67 Off Cmt 5 to Art 8.1, p 257.
68 See below, Art 8.3 paras 1–6.
69 For references see PECL Art 13:101 Notes.
70 For the same requirement in the PECL, see Parra Lucan (n 6 above) 380; Zimmermann (n 1 above) 50.
71 For the same rationale see Aepli (n 63 above) Art 120 Swiss CO para 80.
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within a reasonable time after notice (fixed at 2 months by the PECL). Otherwise, the other party may be considered to have renounced the benefit of its exception.\(^{72}\)

Set-off is also barred if the obligation of the other party is an obligation affected by a condition precedent, since the obligation only becomes binding when the condition is fulfilled.

VI. The other party’s obligation must be ascertained, Art 8.1(1)(b) and Art 8.1(2)

Art 8.1(1)(b) and Art 8.1(2) deal with the requirement of ascertainment, sometimes called liquidity (liquidité) (see paras 37–41 below). There is a fundamental distinction between the case where the other party’s obligation arises from the same contract as the obligation of the first party and where the requirement of ascertainment is waived under Art 8.1(2) and the case where the reciprocal obligations arise out of different contracts and ascertainment is required (see paras 42–46 below). On this issue, the PICC differ from Art 13:102 PECL.

1. The notion of ascertainment, Art 8.1(1)(b)

According to Art 8.1(1)(b), the obligation of the other party must be ascertained as to its existence and its amount. Strangely, this requirement is taken from legal systems where set-off is automatic and occurs without any intervention of a judge or the parties.\(^{73}\) In legal systems where set-off is triggered by notice (as is also the case under Art 8.3), substantive ascertainment is usually not required.\(^{74}\)

The obligation is ascertained as to its existence if the obligor acknowledges its existence or if a final judgment or award, no longer subject to review, states its existence. The Official Comment defines the ascertainment as to the existence of the obligation as the status ‘when the obligation itself cannot be contested’.\(^{75}\) This understanding of ascertainment diverges from the more procedural approach of the common law.\(^{76}\) The main difficulty with this

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\(^{72}\) See below, Art 10.10 para 1. For an explanation of the solution in the PECL, see Zimmermann (in 1 above) 161.

\(^{73}\) eg Art 1291 French CC; for the reasons for this requirement in French law, see Pichonnaz (in 12 above) paras 1371–1372; RJ Pothis, ‘Traité des obligations’ in M Dupin (ed), Oeuvres de Pothis, vol 1 (1824) 628. See also Art 1243 Italian CC; § 1439 Austrian CC. For the notion of automatic set-off, see below, Art 8.3 paras 1–6.

\(^{74}\) eg § 388 German CC; Art 124 Swiss CC; or even (for Austrian law) OGH 4 March 1970, JBl 1970, 418, 419; see also OGH 2 March 1977, JBl 1978, 262; OGH 9 September 1987, JBl 1988, 380.

\(^{75}\) Off Cmt 5 to Art 8.1, p 257.

\(^{76}\) Swayne v Taylor (1880) 5 QBD 569, 575, CA: [Set-off] is available only where the claims on both sides are in respect of liquidated debts, or money demands which can be readily and without difficulty ascertained; also Accra Refining and Manufacturing Inc v Essoar NV (1994) 1 WLR 1634, 1648, CA; Stein v Blake [1996] AC 243, 251, HL. For rules on ‘liquidated damages’ see Derham (in 35 above) 15. The English statutory insolvency regime, however, allows set-off not only for any sum ‘payable at present or in the future’ and ‘for certain or contingent’ claims, but also for amounts ‘capable of being ascertained by fixed rules or as a matter of opinion’. see UK Insolvency Rules 1986, rule 2.85 para 4 and rule 4.50 para 4.
solution in the PICC is to decide whether an obligation remains ascertained as to its existence when the obligor contests its existence without any grounds for supporting that claim, despite the fact that the first party has immediate available proof of its existence.\(^77\) If the ascertainment requirement makes sense, which is rather doubtful (see para 40 below), a mere formal dispute without any ground should not be sufficient to deprive an obligation of its ascertained characteristic.

Even if ascertained as to its existence, the other party’s obligation may not necessarily be ascertained as to its amount. Thus, even if the other party does not contest its liability and therefore its obligation to pay damages, the exact amount of damages may be contested, perhaps because it has not been fixed by agreement or by a final judgment or award. That is why the Official Comment states that ‘if the existence of the harm is not disputed, but the amount of the compensation has not been fixed, set-off will not be available’.\(^78\) This is problematic. There have been, for instance, notable controversies in Italian law about the question of whether the obligation is always unascertained when the amount has not been stated from the beginning or whether it is sufficient if the judge can reasonably be expected to determine the amount (eg by mathematical calculation).\(^79\) In order to favour set-off, an obligation should be considered as ascertained even if the amount is not stated, as long as the amount can very easily be determined.

Contracting parties are strongly encouraged to eliminate contractually the requirement for ascertainment of the other party’s obligation.\(^80\) First, the ascertainment requirement significantly restricts the ability to set off obligations arising from different contracts to a significant extent; it is rather unusual for the other party’s obligation to be ascertained where there is doubt. For this practical reason, national systems with this requirement have softened it by introducing a ‘middle course’ through the so-called judicial set-off. This allows set-off to be operated by the judge when ascertainment can be done easily and rapidly.\(^81\) The PECL address this issue in a much better way, since Art 13:102 PECL allows foregoing the requirement of ascertainment when the other party’s interests are not prejudiced. In any case, procedural rules, including those applicable in arbitration proceedings, nowadays prevent dubious claims from being filed at a later (or too late a) stage of proceedings.\(^82\) Second, there is no sound doctrinal justification for the ascertainment requirement, as is obvious from the approach of the legal systems where set-off is triggered by notice.\(^83\)

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\(^78\) Off Cmt 5 to Art 8.1, p 257.

\(^79\) See among others Merlin (n 77 above) 474; Pichonnaz (n 12 above) para 1855.

\(^80\) Pichonnaz (n 12 above) paras 2100–2102; and now als HKK/Zimmermann §§ 387–396 para 56.

\(^81\) eg Italian law; for French law see Zimmermann (n 1 above) 53; F Terré et al, *Droit civil: les obligations* (9th edn, 2005) paras 1299, 1307, 1313; Rép Civ, *Compensation* paras 39–42, 87–94, 135–147. See also below, Art 8.3 para 3.

\(^82\) Parra Lucan (n 6 above) 391.

\(^83\) eg for German law see Zimmermann (n 1 above) 54; HH Jakobs and W Schubert (eds), *Die Beratung des Bürgerlichen Gesetzbuchs in systematischer Zusammenstellung der unveröffentlichten Quellen. Rechts der Schuldverhältnisse I*: §§ 241 bis 432 (1978) § 387 n 6; FP von Kübèl, *Recht der Schuldverhältnisse, allgemeiner*
The difficulties cannot be resolved by interpreting Art 8.1(1)(b) and Art 8.2 by reference to Art 13:102 PECL. The main concern of Art 13:102 PECL is to avoid the respondent delaying legal proceedings by invoking set-off on account of a dubious cross-claim. It thus only allows the debtor to set off an unascertained claim where 'set-off will not prejudice the interests of the other party' and presumes that such prejudice does not occur where the claims of both parties arise from the same legal relationship. The ascertainment requirement is a kind of middle course, mainly inspired by Dutch law, between keeping the ascertainment requirement and discarding it. This solution is, however, unfortunate, since it requires judicial intervention to know whether or not the notice of set-off has produced any effect, as the judge has to decide whether the interests of the claimant are prejudiced or not. Yet, as long as set-off is declared outside of legal proceedings, it is not clear why the claim should be ascertained as to its existence or amount at that time.

2. The notion of 'the same contract' under Art 8.1(2)

If the ascertainment requirement has not been contractually renounced by the parties, Art 8.1(2) requires the determination of whether the obligations 'arise from the same contract' or not. If the obligations arise from the same contract, Art 8.1(2) waives the requirement for ascertainment of the other party's obligation.

The notion of 'the same contract' is not defined by the PICC, nor by the Official Comment. The main question is to determine whether or not obligations arising out of complex contracts are covered by this phrase.

A complex contract exists when two or more contracts concluded separately are linked by the intention of the parties in such a way that they should be considered to be unified, both economically and in law. Should reciprocal obligations arising from one part or another of a complex contract be considered as arising from different contracts? Neither the PICC nor the Official Comment address this question. The travaux préparatoires are also silent.

If the notion of 'the same contract' is construed very narrowly, the possibility of set-off is considerably reduced, because of the requirement of ascertainment (see para 40 above). Moreover, the rationale of the distinction between the same and different contracts with regard to the ascertainment requirement is far from clear. The Official Comment merely states that 'set-off is a convenient means of discharging obligations at once and at the
same time. Therefore, if the two obligations arise from the same contract, the conditions of set-off are modified.\(^8\) Evidently, the convenience of set-off exists also for parties involved in a more complex relationship, especially if the obligations arise in relation to the same complex contract.

For these reasons, obligations arising from a complex contract should be considered as arising from the same contract.\(^8\) This interpretation favours the PICC's general aim of allowing set-off and addresses the difficulty of requiring ascertainment when set-off operates by mere notice.\(^9\) It is also consistent with a similar enlargement of the requirement of 'connectivity' found for instance in French law, which also has a substantive ascertainment requirement.\(^9\)

3. Obligation easily ascertained

Unlike Italian or French law, the PICC do not soften the requirement of ascertainment to allow a court to operate set-off between two or more obligations when the other party's obligation is easily ascertainable (è di facile e pronta liquidazione).\(^9\) In that scenario, set-off is achieved by the judgment, after the court has ascertained the easily ascertainable obligation. This type of set-off is therefore totally different from set-off by notice as foreseen by Art 8.3 PICC.

The need for reasonable solutions in practice might militate in favour of the development of a softened requirement of ascertainment. However, it would be wiser to abandon this requirement completely. Introducing into the PICC, by means of gap-filling, the possibility of judicial set-off in the case of easily ascertainable obligations would be less effective.

VII. Burden of proof

Since set-off is triggered by notice from one party, this party invokes its right not to pay in cash but to setoff its obligation instead. Therefore, the general principle, that the party invoking a right has to prove the requirements justifying it, applies (onus probandi incumbit qui dicit).\(^9\) This means that the 'first party' (i.e. the party giving notice) has to prove the following five basic requirements:\(^9\) (1) mutuality of obligations; (2) obligations of the same kind; (3) the right of the first party to perform its obligation; (4) the right to enforce obligations of the other party; (5) the ascertainment of the obligation of the other party.

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\(^8\) ibid (emphasis added).

\(^9\) Zimmermann (n 84 above) 21 does not address the issue. He speaks of the 'same legal relationship', though, which might lead to an extensive or broad interpretation of the notion of 'same contract'.

\(^9\) See below, Art 8.3 paras 1-6.


\(^9\) Art 1243(2) Italian CC; for developments see Pichonnaz (n 12 above) para 1853; Merlin (n 77 above) 503; Nappi (n 77 above) 44.

\(^9\) Principle 21.1 of the 2004 Principles of Transnational Civil Procedure, edited by the ALI and UNIDROIT.

\(^9\) See above, Art 8.1 para 1.
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(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.

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I. Overview

1 The requirement in Art 8.1 for two or more obligations of the same kind has created issues mainly in relation with monetary obligations expressed in different currencies. Some national systems, such as German law, have adopted the view that obligations in foreign and domestic currencies are not 'of the same kind', which therefore bars set-off unless the parties agree to it (conventional set-off). Others, such as French law, Austrian law, and Italian law, accept that the obligations are of the same kind if they are freely convertible—the same view applies to some extent under Swiss law and Dutch law. In English law, the House of Lords has held that an English court may give judgment for a sum of money expressed in a foreign currency and, if the defendant fails to tender payment in that currency, the court may issue execution for the sterling equivalent. Because of these varieties of solutions and the uncertainty of the answers, it is to be welcomed that the PICC should deal

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with the issue in a specific provision. According to Art 8.2, there are two different situations: set-off in case of freely convertible currencies (see paras 2-11 below) and restrictions to set-off between foreign currencies (see paras 12-17 below).

II. Set-off for freely convertible currencies

1. The principle

The aim of seeing the PICC applied globally has motivated the drafters to adopt the view that set-off should always be possible when the obligations are expressed in 'different' (a term which makes more sense than 'foreign' in an international context) currencies and these are freely convertible. As a matter of fact, in international transactions obligations are often expressed in different currencies, especially if the obligations arise from different contracts. If the PICC had not considered these monetary obligations to be of the same kind, they would frequently bar set-off.

Moreover, being designed to be applied in international commercial transactions, the PICC can disregard the rationale of some domestic codes which, in line with nationalist ideologies of the nineteenth century, favour national currencies either by forcing the parties to pay in that currency or by barring set-off with foreign currencies. Finally, the approach of the PICC consistent with the modern approach increasingly followed in national legal systems and with European law which, in Art 8(6) of the Regulation on the introduction of the euro, obliges the Member States to accept set-off in case of monetary obligations in different currencies if they are in euros or the currency of one of the Member States.

However, by stating that set-off should be possible, the PICC have not yet answered the difficult question as to which is the currency in which the subtraction between both monetary obligations should take place. According to the Official Comment, the principles of Art 6.1.9 apply. This means that the obligor may choose to pay in either the currency expressed by the monetary obligations or the currency in the place of payment. However, in case of two reciprocal obligations, with different currencies expressed in the obligations and maybe different places of payment, the choice of each mutual obligor might lead to a desire for payment in different currencies for each obligation. For instance, there may be a contract under which A's obligation is expressed in US dollars (with place of payment in Paris) while B's obligation is expressed in euros (with place of payment in Geneva). Applying the principle underlying Art 6.1.9, both obligors may choose whether they want to perform in the currency expressed in the contract or in the one of the place of payment. They may therefore end up with one obligation having to be paid

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102 Zimmermann (n 1 above) 49.
104 Off Cmt 1 to Art 8.2, p 260.
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in US dollars (currency of the contract) and the other one in Swiss francs (currency of the place of payment).

5 Since the last limb of Art 8.2 PICC suggests that set-off is restricted only if the first party's obligation must be made in a specific currency (without reference to the other party's obligation), it is implicitly indicated that for the PICC it is the first party's position that counts. This makes sense, since set-off is primarily a means of execution for the obligation (see paras 14–17 below). The obligation primarily paid by means of set-off is the one of the first party, since by giving notice this party declares its intention to use the other party's obligation to pay its own obligation.

6 As a consequence, the first party must indicate in its notice in which currency of payment the subtraction will take place, according to the alternatives in Art 6.1.9 (in the previous case mentioned in para 4 above, if B gives notice of set-off, it can choose between euros or Swiss francs). In the absence of any indication, subtraction is made according to the currency in which the first party's obligation is expressed (in the previous case, set-off will be in euros if B gives notice of set-off, but in US dollars if A gives notice instead). Under the PICC, there is no room for the view that the currency of the lesser obligation should be converted into the currency of the greater obligation, as is the case in English law. This may well make sense when set-off is operated by the court, which implicitly means that the obligee of the greater obligation has normally filed the law suit. When set-off is triggered by notice, this rationale no longer applies, since the first party may have either a lesser or a greater obligation.

7 Accordingly, the currencies of the monetary obligations might be totally different and never end up to be the same. Thus, the party, which manages to notify the other of set-off first, determines the applicable currency for the subtraction. For instance, there may be a case where A's obligation is expressed in US dollars (with place of payment in Tokyo) and B's obligation is expressed in euros (with place of payment in Geneva). If A is first to notify its intention to set-off, the subtraction will be in US dollars or, if A chooses, in yen. If B is first to notify set-off, subtraction will be in euros or, if B chooses, in Swiss francs. This is the only possible understanding of Art 8.2, since the provision clearly indicates that set-off is possible as soon as both monetary obligations are freely convertible. The question as to which party has notified first has to be answered on the basis of the receipt principle enounced by Art 1.10(2), according to which the party that has first received notification of set-off is the last to have given notification.

2. The conversion and the exchange rate

8 Under Art 6.1.9(3), the exchange rate is the official rate of the place of payment. Again, it might well be that the two reciprocal obligations have different places of payment. Applying the same idea as above, what counts is the place of payment of the first party's obligation, which is either fixed by the contract or is the place of business of the other party (the obligee of the first party's obligation) according to Art 6.1.6(1)(a).

105 *Milangos v George Frank (Textiles) Ltd* [1976] AC 443, HL; Derham (n 35 above) para 5.76. For such a proposal in Swiss law, see *Aepli* (n 63 above) Art 120 Swiss CO para 70.

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Art 6.1.9(3) provides that the exchange rate is the official rate at the time when payment is due; if payment is not made at the time when it is due, then under Art 6.1.9(4) the obligee has the choice to ask for the exchange rate to be set either at the date payment was due or at the time payment is actually made. Applied to set-off, these principles mean that the first party (the obligee of the other party's obligation, which is the only one that has to be converted and is necessarily already due)106 may choose between the time when payment is due and the time when notice of set-off is received (which is the moment when payment becomes effective).107 In the absence of any indication, the time when notice of set-off is received appears the most appropriate, since all the effects of set-off take place at that moment.108 When notice of set-off is made before the first party's obligation is due, the exchange rate can only be the one at the time when notice is received by the other party.109

Finally, for currencies outside the euro-zone, it should be the purchasing rate for the currency of the first party's obligation at the time of conversion chosen by the first party.110 For currencies that have disappeared with the introduction of the euro-zone, the exchange rate is 'the irrevocably fixed conversion rate adopted for the currency of each participating Member State by the Council according to the first sentence of Art 1091(4) of the Treaty [on European Union]."112

By way of illustration, there may be a contract under which A's obligation, due on 1 January 2008, is expressed in US dollars (with place of payment in Tokyo), while B's obligation, due on 1 December 2007, is expressed in euros (with place of payment in Geneva). On 1 March 2008, A gives notice of set-off to B, who receives it on 3 March 2008. A indicates that it chooses the exchange rate on the date of notice. Thus, the buying rate of US dollars on 3 March 2008 applies to convert the monetary obligation expressed in euros into US dollars. If A gives notice of set-off on 15 December 2007 (received by B on 16 December 2007), the exchange rate may only be the buying rate of US dollars on 16 December 2007, since the due date of A's obligation has not yet matured.

III. Restriction to set-off between foreign currencies

Art 8.2 imposes two limits on the general acceptance of set-off between two obligations expressed in different currencies. The first deals with obligations expressed in a not freely convertible currency (see para 13 below); the second concerns any agreement by the parties that the first party shall pay only in a specified currency (see paras 14–17 below).

106 See paras 2–5 above.
107 See however KP Berger, 'Set-Off' [2005] ICC Int'l Ct Arb Bull, Special suppl 17, 21, who only refers to the time of notice without further explanation.
108 See below, Art 8.3 paras 10–12.
109 Berger (n 107 above) 21.
110 See above, Art 6.1.9 para 11 and para 7 above.
112 Art 1 third indent of Council Reg 574/98 (n 103 above).
1. **Set-off in not freely convertible currencies**

When one of the obligations is expressed in a currency that is not freely convertible, it is difficult to determine either how to convert the other party's obligation into this currency or how to convert the other party's obligation expressed in this currency into a freely convertible currency. In both situations, the subtraction which has to be made is not readily ascertainable, which justifies barring set-off. In that case, the monetary obligations are considered as not being of the same kind in the sense of Art 8.1.

2. **Currency imposed by agreement**

Art 6.1.9(1)(b) expressly states that if the parties have agreed that payment should be made only in the currency in which the monetary obligation is expressed, the obligor must pay in that currency. Since set-off is a way of payment and should not put the obligee in a worse situation than effective payment, Art 8.2 applies the same idea to set-off. The underlying principle is that it is the other party's obligation which has to be converted into the currency of the first party's obligation (see paras 4-7 above). Thus, when the first party gives notice of set-off, it has to convert the other party's obligation into the currency of the first party's obligation, and it does not have the choice of converting it into the currency of the place of payment of the first party's obligation. The currency of the first party's obligation imposed by agreement therefore restricts the options of the first party, but not set-off as such.

However, set-off would indeed be barred if the other party's obligation must be paid in a specific currency. Indeed, unless it is accepted that the first party may waive the restriction imposed on the other party to pay in a specific currency (by accepting that this restriction was agreed in the first party's interest), the set-off is prevented by the ban on converting the other party's obligation into the currency of the first party's obligation. This is not clear from the wording of Art 8.2. The provision and its Official Comment focus exclusively on the obligation of the first party. This is not consistent with the principles underlying Art 6.1.9.

A draft of Chapter 8 of the PICC from January 2002 stated clearly that set-off is possible 'unless the currency of the other party's obligation is not freely convertible'. The Comment to this draft also focused on the other party's obligation. However, the following draft of April 2002 was modified to read 'the first party's obligation'. The draft Official Comment gave no reason for this change, but stated quite clearly that 'if a contract expressly imposes to a party to pay exclusively in a specific place and in a specified currency, this party will not be able to set off its own obligation against the other party's obligation, if it had to exercise its own obligation in a place and in a currency different of the place and the currency provided in the contract'.

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113 Off Cmt 1 to Art 8.2, p 260.
115 See above, Introduction to Chapter 8 para 6.
117 ibid 5.
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The rationale is therefore that the currency of the first party’s obligation should not be changed because of set-off. That would not be the case anyway, since the first party’s obligation is always paid either in the currency of the contract or of the place of payment. A draft Illustration to Art 8.2 of April 2002 may explain the change of direction in the 2002 draft and in the final version. This draft Illustration says that the first party’s obligation has to be paid in US dollars (which is an exclusive clause), but then when the other party claims for payment, the first party is not allowed to use set-off to discharge its obligation of paying in US dollars, if it had to be paid in Ho Chi Min City, in Vietnamese currency.\(^{119}\) Thus, in this Illustration, set-off is barred not because the first party’s obligation is said to be exclusively paid in US dollars, but because the other party’s obligation is said to be paid exclusively in a non-US dollars currency. By using an example where both obligations had to be paid in the agreed currency, the drafters lost sight of the reason for restricting set-off. In the final version of this Illustration to Art 8.2, the drafters dropped the reference to the exclusive payment in Vietnamese currency without noticing the problem that arose from this deletion.\(^{120}\)

According to this analysis, what may bar set-off is that the other party’s obligation has to be paid exclusively in the agreed currency. Even in this case, however, if this restriction has been set up in the first party’s interest, this party may validly waive the restriction by exerting set-off. Parties may however be advised to adapt Art 8.2 in order to reflect its real purpose by modifying the wording as follows: ‘... provided ... the parties have not agreed that the other party shall pay only in a specified currency’.

IV. Burden of proof

The question of obligations in different currencies is linked to the issue of obligations of the same kind, which has to be proven by the first party. In the case of obligations in different currencies, the first party can prove that they are of the same kind by reference to Art 8.2. The other party would have to prove that one currency is not freely convertible, since there is a presumption in favour of freedom of conversion of currencies. Furthermore, if the other party considers that the first party has to pay in a specified currency according to the contract, the burden of proving that lies with the other party.

\(^{119}\) ibid.

\(^{120}\) Illustration 2 to Art 8.2.
Article 8.3

(Set-off by notice)
The right of set-off is exercised by notice to the other party.

I. The requirement of notice

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I. The requirement of notice

1. The principle of set-off by notice

Art 8.3 is drafted in almost the same way as Art 13:104 PECL. Set-off is exercised by mere notice to the other party of the first party’s intention to discharge its obligation by using the other party’s obligation(s). Thus, set-off operates neither automatically nor by a court decision or an award of an arbitral tribunal.

2. Art 8.3 makes clear that set-off under the PICC (like under the PECL) has a substantive nature, which means that it can operate outside of a courtroom and has a discharging effect on the obligation of the first party without the intervention of a judge or an arbitrator. This substantive nature is now widespread in the civil law systems influenced by medieval Roman law. This choice is welcome, since it allows set-off to be largely freed from national or arbitral procedural rules. Thus, the PICC apply even if the procedural law is one of a common law system.

3. The procedural nature of set-off as assumed in some jurisdictions means that set-off can only be invoked within legal proceedings; a party that wants to invoke a counterclaim must either wait until the other party asks for performance in front of a judge or claim set-off in front of a judge itself. Thus, if set-off is of a procedural nature, no set-off is possible outside of a courtroom and the obligations are discharged by the judgment itself. The English law

121 Art 13:104 PECL: ‘[Notice of Set-Off] The right of set-off is exercised by notice to the other party.’
122 Pichonnaz (n 12 above) paras 979–1057; P Pichonnaz, ‘Da Roma a Bologna: l’evoluzione della nozione di “compensatio ipso iure”’ (2002) 2 Rivista di diritto romano 1; Pichonnaz (n 3 above) 283; Zimmermann (n 1 above) 22.
123 It does not alter the fact that in arbitration proceedings the procedural rules have to fix the ambit of jurisdiction; see above, Art 8.1 paras 5–10; Econet Satellite Services Ltd v Vee Networks Ltd [2006] 2 Lloyd’s Rep 423, QB.
of set-off is mainly of a procedural nature, 124 this is the case for legal (or statutory) set-off and common law abatement, which were initially made possible by statutes adopted to protect insolvent obligors. 125 Insolvency set-off however operates as a substantive device, and there is also a tendency towards a substantive approach with regard to equitable set-off. 126 Finally, in some civil law systems there is also judicial set-off, a type of set-off of a procedural nature where the judge himself discharges both reciprocal obligations up to the smaller amount if the other party's obligation is not ascertained but can be 'easily and rapidly ascertained' by the judge. 127

Despite the substantive nature of set-off under the PICC, recourse to the judge remains possible if the parties do not agree on the principle of set-off, on its requirements, or on the amount of the obligations that have been discharged by means of set-off. The arbitral award or the decision of the judge has, however, merely a declarative effect. A decision does not produce the discharging effect, but merely confirms that it has been produced by the notice given by the first party. 128

The solution chosen by the PICC cannot be considered to be a general principle of law, since set-off in English law and other common law systems still has a procedural nature. 129

Set-off by notice is not a general principle of law either. The choice made by the drafters of the PICC is based on the convergence of many systems towards set-off by notice, such as German law, 130 Swiss law, 131 Austrian law (in its present interpretation), 132 Greek law, Portuguese law, Dutch law, and the Nordic legal systems. 133 Even in legal systems where

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124 Zimmermann (n 1 above) 26; Derham (n 35 above) paras 6–7; Wood (n 3 above) paras 113–117; Pichonnaz (n 12 above) paras 1906–1990.
125 Derham (n 35 above) para 1.11.
127 For the dominant opinion in French law, see F Chabas, 'Réflexions sur la compensation judiciaire' [1966] JCP 2026; R Mendegris, La nature juridique de la compensation (1969) para 143; Rep Civ, Compensation para 149; Malaria and Ayres (n 97 above) para 1073; Pichonnaz (n 12 above) paras 1819–1827. However, some authors consider the retroactive effect of this judicial set-off to give it a substantive nature: H Mazeaud and F Chabas, Leçons de droit civil: obligations, théorie générale, vol 2 (9th edn, 1999) 1188; Starck et al (n 97 above) para 332. For Italian law see Art 1243(2) Italian CC; Pichonnaz (n 12 above) paras 1849–1877; Merlin (n 77 above) 8.
128 On this issue see also PECL Art 13:104 Notes.
129 Derham (n 35 above) para 2.33, at least for common law set-off.
130 § 388 German CC; Pichonnaz (n 12 above) para 1653; von Kübel, (n 83 above) para 1087; Jakobs and Schubert (n 83 above) §§ 388, pp 699–704.
131 Art 124 Swiss CO; Pichonnaz (n 12 above) para 1588; PF von Wyss, Motive zu der auf Grund der Kommissionsbeschlüsse vom September 1877 bearbeiteten neuen Redaktion des allgemeinen Teiles des Entwurfs zu einem schweizerischen Obligationenreiche (1877) 32.
133 Art 441 Greek CC; Art 848 Portuguese CC; Art 6:127 Dutch CC; for the Nordic legal systems see PECL Art 13:104 Notes.

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set-off is automatic, legal doctrine and case-law have led to a situation very close to set-off by notice. This has been shown to be the case in Italian law,\textsuperscript{134} in Spanish law,\textsuperscript{135} and even in French law.\textsuperscript{136}

6 The solution of the PICC should be welcomed. Set-off triggered by an extra-judicial notice is economically more efficient than an automatic set-off regime\textsuperscript{137} and, doctrinally, more coherent with the idea that the obligations are discharged because of the will of one party. It also avoids unnecessary recourse to a court or an arbitral tribunal.\textsuperscript{138}

2. Form of notice of set-off

7 According to Art 1.10(1), notice of set-off may be given by any means appropriate to the circumstances. It does not have to be in oral or written form; it can also be the result of any other conduct, as long as the other party can objectively understand that it has been notified of set-off through these means. Notice is subject to the receipt principle under Art 1.10(2). This means that notice of set-off is effective when it reaches the other party.\textsuperscript{139} The general considerations with respect to this principle apply to the notice of set-off.\textsuperscript{140}

8 Even if notice has not been given before the filing of a suit, the notice of set-off can still be effective without regard to any formal requirements; however, it must be invoked according to the relevant formalities and at the moment required by the applicable procedural rules for the court to take it into account in the current legal proceedings. If these rules are disregarded, the judge does not have to deal with the question of set-off (and the other party’s obligation). The defendant can, however, bring up the other party’s obligation in another proceeding.\textsuperscript{141}

9 The notice of set-off has to be distinguished from the filing of a counterclaim, which achieves more than a set-off defence in proceedings because it may lead to the court requiring the claimant to pay the larger amount of the counterclaim.\textsuperscript{142}


\textsuperscript{135} cf Art 1202 Spanish Cc; L Diez-Picazo, Sistema de derecho civil, vol 2 (4th edn, 1985) 554; Parra Lucan (n 6 above) 316; see also the summary of TS 15 February 2005 (JUR 2005/73203) in [2005] ERPL 564.

\textsuperscript{136} Pichonnaz (n 12 above) paras 1756–1758; Mendegris (n 127 above) para 130; Cass com 6 February 1996 (93-21627), D 1998, 87.

\textsuperscript{137} Pichonnaz (n 12 above) para 2010.

\textsuperscript{138} Bonell (n 100 above) 23; Berger (n 107 above) 24.

\textsuperscript{139} Off Cmt 2 to Art 1.10, p 28.

\textsuperscript{140} See Off Cmt to Art 1.10, pp 27–29.


\textsuperscript{142} See para 5 above and above Art 8.1 para 2.
Chapter 8: Set-off

Art 8.3

3. Time to give notice ('anticipatory notice')

According to the Official Comment, notice must be sent after the requirements for set-off are fulfilled. However, this is not expressly set out in Art 8.3. Comments on an early draft of Chapter 8 of the PICC mentioned that 'the first party cannot declare set-off for the future'. Moreover, they claimed that notice cannot be conditional. This might reflect the underlying idea that notice of set-off definitively modifies the content of the relationship between both parties (Gestaltungsgerecht). Since the notice has a direct effect on discharging the whole or part of the parties' obligations, it is important to have certainty. Certainty would not be achieved if the parties could decide when the condition precedent affecting the notice would be fulfilled. However, it is therefore possible to envisage a notice given for a specific date in the future. This would not reduce certainty, as long as it is clear for the parties that the requirements for set-off are fulfilled at the time when notice is given.

Even if Art 8.3 does not make it an explicit requirement, the rationale for the whole doctrine of set-off suggests that notice should be given only once all the other requirements are fulfilled. In principle, nothing prevents a party from giving notice of set-off with a specific date in the future on which set-off will take place. It is, however, difficult to see why the party should do so. Especially when the obligations are expressed in different currencies, any party generally has to notify set-off as soon as possible in order to avoid exchange rate fluctuations.

In this respect, the PICC have chosen a safer solution than Art 13:104 PECL, since the Comments to the PECL state that 'a debtor whose claim is not yet due may declare set-off, but such declaration only takes effect when the claim becomes due (declaring set-off early)'. This creates uncertainty and should only be possible with set-off by agreement.

II. Other modes of set-off

Art 8.3 does not indicate what happens if the first party gives notice of set-off after the beginning of insolvency proceedings (see paras 14–19 below). Nor does it address the issue of set-off by agreement and contracting out of set-off (see paras 20–21 below).

1. Set-off within insolvency proceedings

(a) The relationship between the PICC and domestic insolvency rules. The PICC do not address the question whether set-off may operate despite insolvency or bankruptcy

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143 Off Cmt to Art 8.3, p 261.
145 ibid; Off Cmt to Art 8.3, p 261.
146 Pichonnaz (n 3 above) 294.
147 PECL Art 13:104 Notes.
148 Pichonnaz (n 3 above) 294.
proceedings. This might give rise to difficult problems if national systems have specific provisions for set-off in bankruptcy situations.\textsuperscript{149}

15 In English law, taken here as an example of these difficulties, set-off operates automatically according to s 323 of the UK Insolvency Act 1986 and rule 4.90 of the UK Insolvency Rules 1986 (as revised in 2005).\textsuperscript{150} Thus, as soon as an individual or a company is insolvent, the insolvency set-off replaces all other set-off possibilities. The set-off is then substantive and automatic, as clearly expressed by the House of Lords in \textit{Stein v Blake}\textsuperscript{151} and now firmly established.\textsuperscript{152} What is the position when the PICC are the applicable law to the contract, but the insolvency proceedings of one party are regulated by the English insolvency regime? The set-off rules of the PICC may well be set aside by the specific national rules on insolvency. Set-off then operates automatically at the date of the bankruptcy decree in England, despite the fact that the parties have chosen to apply the PICC.

16 This might well also occur under the \textit{European Insolvency Regulation}.\textsuperscript{153} Its Art 4(2)(d) states that the applicable law 'shall determine the conditions under which set-offs may be invoked'. Thus, despite the fact that the applicable law to the contract may be the PICC, the applicable national or supranational law governs the conditions for set-off.

17 Since the PICC have put forward a system which differs to a greater or lesser extent from most of the national systems, the \textit{decrees on insolvency may create other conditions for set-off} between the parties. Thus, even if, at first sight, the drafters' choice not to include rules on set-off in insolvency proceedings\textsuperscript{154} may seem wise, the result is that in case of insolvency the parties may be faced with another applicable law to the question of set-off, which may surprise them.

18 (b) The security effect of set-off in insolvency. The prospective effect of set-off underlines its main purpose of being a way to facilitate performance.\textsuperscript{155} However, because set-off in bankruptcy cases may not be governed by the PICC, the so-called security effect of set-off may continue to exist. Indeed, if the first party is allowed to set off after its obligor has been affected by a decree of bankruptcy or insolvency, that party is privileged:\textsuperscript{156} instead of getting only a percentage of the amount of its right, it gets the full amount of the insolvent party's obligation by means of set-off with a reciprocal obligation. This


\textsuperscript{150} Derham (n 35 above) para 7 n 33.


\textsuperscript{152} ibid 223; Derham (n 35 above) para 6.81 n 349.


\textsuperscript{154} Off Cmt 5 to Art 8.1, p 258.

\textsuperscript{155} See above, Introduction to Chapter 8 para 6; also Art 8.1 para 15.

\textsuperscript{156} Pichonnaz (n 12 above) para 2128, especially 2134; Pichonnaz (n 3 above) 296; Derham (n 35 above) para 6.12; \textit{Stein v Blake} [1996] AC 243, 251, HL: bankruptcy set-off enables a creditor 'to use his indebtedness to the bankrupt as a form of security'.
is clearly a breach of the principle of equal treatment of the insolvent’s obligees (par conditio creditorum), which is considered questionable by many authors.\textsuperscript{158}

The European Insolvency Regulation produces this security effect, which is openly recognized by para 26 of its preamble.\textsuperscript{159} Accordingly, Art 6(1) of this Regulation states that the ‘opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor’s claim’. The mere possibility of set-off does therefore give a valuable position to the obligee of an insolvent party, despite the fact that the PICC wanted to exclude this surety function of set-off. It would therefore be better not to allow set-off in insolvent proceedings from the day of the decree of insolvency.\textsuperscript{160}

2. Set-off by agreement

Chapter 8 of the PICC does not specifically refer to set-off by agreement, also called contractual (or conventional) set-off. The Official Comment merely states that ‘the parties may achieve the effects of set-off by agreement’ even if the conditions of Art 8.1 are not met. Chapter 8 of the PICC thus does not undermine the party autonomy principle expressed in Art 1.1. Parties can always decide to set off obligations for which the requirements of Art 8.1 are not met. Contractual set-off may take place in various situations: for example, set-off with obligations that are not ascertained and not matured, or set-off in contracts between several parties (‘netting’).\textsuperscript{161} The parties may also decide that obligations are set off automatically at specific dates or only by way of a judicial decision. Every national legal system accepts the idea of contractual set-off.\textsuperscript{162} Some jurisdictions admit set-off based on an implicit agreement, as it has been used in England to develop the doctrine of equitable set-off.\textsuperscript{163} Thus, set-off by agreement may be considered a general principle of law.

In accordance with the principle of party autonomy under Art 1.1, parties may also contract out of set-off either in general or in certain circumstances.\textsuperscript{164} This ground of exclusion is also accepted under Art 13:107(a) PECL. Given the importance of set-off in business practice, an exclusion of set-off should only be accepted where it is clearly indicated by the contract. This position conforms to the approach of the PICC, which attempt to favour set-off in

\textsuperscript{157} Pichonnaz (n 10 above) 115; Pichonnaz (n 12 above) para 2131; Pichonnaz (n 3 above) 296; Zimmermann (n 15 above) 726; Zimmermann (n 1 above) 44.

\textsuperscript{158} For English law see Derham (n 35 above) para 6.12; Pichonnaz (n 12 above) para 2131, especially 2134; Pichonnaz (n 3 above) 296; Zimmermann (n 1 above) 44.

\textsuperscript{159} Council Reg 1346/2000 (n 149 above): ‘If a set-off is not permitted under the law of the opening State, a creditor should nevertheless be entitled to the set-off if it is possible under the law applicable to the claim of the insolvent debtor. In this way, set-off will acquire a kind of guarantee function based on legal provisions on which the creditor concerned can rely at the time the claim arises’.

\textsuperscript{160} For such a proposal, see Pichonnaz (n 10 above) 107.

\textsuperscript{161} For German law and civil law perspectives, see Berger (n 107 above) 21; for the common law, see Derham (n 35 above) paras 16.01–16.93.

\textsuperscript{162} Wood (n 3 above) 121.

\textsuperscript{163} Downam v Matthews (1721) Prec Ch 580 = 24 ER 260, Ch; Hawkins v Freeman (1723) 2 Eq Ab 10 = 22 ER 9, Ch; Jeff v Woods (1723) 2 P Wms 128 = 24 ER 668, Ch; Wallis v Bastard (1853) 4 De G & M 251 = 43 ER 503, Ch; Derham (n 35 above) para 3.03; Pichonnaz (n 12 above) para 1944.

\textsuperscript{164} Berger (n 107 above) 25.

\textsuperscript{157} Pichonnaz (n 10 above) 115; Pichonnaz (n 12 above) para 2131; Pichonnaz (n 3 above) 296; Zimmermann (n 15 above) 726; Zimmermann (n 1 above) 44.

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\textsuperscript{162} Wood (n 3 above) 121.

\textsuperscript{163} Downam v Matthews (1721) Prec Ch 580 = 24 ER 260, Ch; Hawkins v Freeman (1723) 2 Eq Ab 10 = 22 ER 9, Ch; Jeff v Woods (1723) 2 P Wms 128 = 24 ER 668, Ch; Wallis v Bastard (1853) 4 De G & M 251 = 43 ER 503, Ch; Derham (n 35 above) para 3.03; Pichonnaz (n 12 above) para 1944.

\textsuperscript{164} Berger (n 107 above) 25.
general and do not even require specification of the obligations that are set off (Art 8.4). The requirement of a clear exclusion might, however, be less of a high hurdle than the 'clear wording' required under English law to rebut the presumption that set-off is not excluded.\(^{165}\)

Limits to the contracting out of set-off are set by the principles of interpretation and by the provisions on standard terms in Chapters 4 and 2 of the PICC. Art 2.1.20 might render ineffective a contracting out of set-off contained in standard terms, if the other party could not reasonably have expected it and has not expressly accepted it.\(^{166}\)

### III. Burden of proof

\(22\) Since set-off is triggered by the notice of one party, this party invokes its right not to pay in cash, but to set-off its obligation. Therefore, the first party has to prove that notice has been given. The principles on notice in Art 1.10 apply with regard to the moment when notice becomes effective. The first party must therefore prove that notice was 'given to [the other] person orally or delivered at that person's place of business or mailing address' in accordance with Art 1.10(3).

\(^{165}\) Derham (n 35 above) para 5.79, relying on Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd [1974] AC 689, HL: 'clear express words must be used in order to rebut this presumption [ie that the defences are not excluded].'

\(^{166}\) Berger (n 107 above) 25.
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. If no such declaration is made, the set-off will relate to all the obligations proportionally.

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III. Burden of proof

1. Multiple obligations of the other party
2. Multiple obligations of the first party
3. Multiple obligations on both sides
4. The specification of the notice

The basic requirements about the content of the notice of set-off are not contained in Art 8.4. First, notice of set-off should express the declaration of will by the first party to discharge the reciprocal obligations by way of set-off. According to Art 1.10, this does not necessarily have to be done in writing.\(^\text{167}\) Second, notice may contain an indication of the currency in which set-off is made,\(^\text{168}\) as well as the date and place for the exchange rate when reciprocal obligations are in different currencies.\(^\text{169}\) Finally, notice may contain an indication of which obligations are discharged by way of set-off if there are several obligations on one side or the other. Art 8.4 deals specifically with this point. According to the principle of party autonomy under Art 1.1, the first party has the right, but not the duty, to determine the obligations that are discharged by its notice of set-off.

The PECL are less favourable to set-off, since Art 13:105(1) PECL states that set-off is ineffective if the first party does not identify the other party's obligation to which the set-off relates.\(^\text{170}\) A 2001 draft of the PICC resembled Art 13:105 PECL,\(^\text{171}\) then, further drafts of the PICC in April 2002, November 2002, and April 2003 required only 'sufficient

\(^{167}\) See above, Art 1.10 paras 2-5.  
\(^{168}\) See above, Art 8.2 para 6.  
\(^{169}\) ibid paras 8-10.  
\(^{170}\) For a discussion of this provision, see Pichonnaz (n 12 above) paras 2172 (welcoming the solution in the PECL) and 2186; Pichonnaz (n 3 above) 299; Zimmermann (n 1 above) 60.  

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specification' for the notice to be effective. It was only in the final draft of September 2003 that clear specification of the other party's obligations was removed as a requirement for the effectiveness of set-off. Instead, in the absence of determination by the first party, Art 8.4(2) clarifies the order in which the obligations are considered (see paras 13–17 below).

5 The indication of the grounds and the amount of set-off are not requirements for set-off, although the Official Comment implies that the other party must be able to infer from the notice the grounds for set-off and the amount of it. This statement is a leftover from earlier drafts of the Official Comment to Art 8.4. However, the early drafts of Art 8.4 required that notice be specific enough to be effective, so the indication of grounds and amounts might thus have been a requirement for the validity of the notice. This passage of the Official Comment does not make sense under the ultimate blackletter version of the PICC.

6 This is so for two reasons. First, the amount up to which set-off operates is indicated by Art 8.5(2). Although it is desirable as a matter of clarity to indicate the resulting amount of set-off, it cannot be a requirement for validity. An incorrect indication has no effect on the amount discharged by set-off, unless the other party agrees to a partial discharge of the reciprocal obligations, which would transform the set-off by notice into a set-off by agreement. Second, the indication of the 'grounds for set-off' (an expression the meaning of which is not clear) is not mentioned anywhere as a requirement for validity. It might have been important in the early draft of Art 8.4 to specify the grounds for set-off in order to identify the appropriate obligations to be discharged. However, since this is no longer a requirement anymore in the final version, no indication of the grounds for set-off is needed.

II. Consequences of absence of determination by the first party

7 Contrary to some national systems and to the PECL, the absence of specification of the obligations by the first party does not bar the discharging effect of the notice. There are three different situations in which the absence of specification is problematic: first, where the other party has multiple obligations; second, where the first party has multiple obligations; and third, where both parties have multiple obligations.

8 Art 8.4(2) deals only with one situation. It is not clear what Art 8.4(2) means by 'the obligations against which set-off is exercised'; since set-off is exercised by the first party (which gives notice), it should be used 'against the first party's obligation'. By using set-off, the first party can avoid paying one or several of its obligations. Thus, the wording suggests that Art 8.4(2) envisages the situation of multiple obligations of the first party. However, this literal interpretation contradicts the Official Comment, which says that in the default

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174 See Off Cmt to Art 8.4, p 262: 'The other party ... must know the grounds ...'; see also the French version of Off Cmt to Art 8.4, p 270: 'L'autre partie ... doit être informée de l'identité ...'.
175 See above, Art 8.3 para 20–21.

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Art 8.4

situation (ie in the absence of any indication) ‘all the obligations of the other party will be discharged by set-off proportionally’. Thus, the Official Comment envisages the situation of the other party having multiple obligations. The Illustration also suggests that Art 8.4(2) deals with the situation where the other party owes multiple obligations. Finally, the April 2003 draft of the PICC made a distinction between the lack of specification of the obligation of the other party, which made the notice ineffective under the draft Art 4(2), and the lack of specification of the obligation of the first party, which would make the rules in Art 6.1.12 apply with appropriate modifications under the draft Art 4(3). The only Illustration for Art 8.4 in this 2003 draft is entitled ‘Obligations owed by the other party’ and it corresponds to Illustrations 1 and 2 of the published version of the Official Comment. For all these reasons, the drafting of Art 8.4(2) appears deficient and it seems that Art 8.4(2) governs only the situation of multiple obligations of the other party.

1. Multiple obligations of the other party

Art 8.4(2) deals only with this situation (see para 9 above). If the first party, as an obligee, has not specified which of the other party’s (multiple) obligations are discharged by means of set-off, the other party (as an obligor) may declare which of its obligations are discharged. This solution differs from Art 13:105(1) PECL, which states that in the absence of a declaration the notice is ineffective (see para 4 above). The notice should comply with the general requirements for notice set out in Art 1.10. The choice of the other party is thus effective upon receipt by the first party. Since no specific form is required, interpretation of the other party’s conduct might also lead to the assumption that such a notice has been made.

Notice should be given within a reasonable time. Reasonableness depends on the specific circumstances. The Official Comment gives no indication as to how long this reasonable time might last. A couple of days or weeks might well be sufficient.

According to Art 8.4(2)(2), in the absence of indication by the first party and a declaration by the other party within a reasonable time, set-off discharges all of the other party’s obligations in the same proportion up to the value of the first party’s obligation. In theory, there are two possibilities of calculating the proportion: either by having regard only to the principal amount owing under all obligations, or by taking into account both the principal amount and any interest that has accrued as well. The Official Comment is silent on this issue. The Illustration to Art 8.4(2) does not indicate whether the other party must pay interest on the obligations that are due or not. Since set-off has the same effect for the other party as if it had performed its obligations, the principle underlying the default rule of Art 6.1.12(3) should apply. It would therefore be equitable to calculate the proportion by

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176 Off Cmt 1 to Art 8.4, p 262 (emphasis added).
177 Illustration 1 to Art 8.4: ‘[the first party] has to indicate in the notice which of the three obligations owed by [the other party] it wants to set off’.
179 ibid 9.
180 For a similar result, see Berger (n 107 above) 24 (without providing reasons).
181 Off Cmt 2 to Art 8.4; pp 262–263.
182 Off Cmt to Art 6.1.12, p 169; see above, Art 6.1.12 para 12.
taking into account both the principal amount and the interest owing under each of the other party's obligations, since the obligations may have different interest rates and be due at different times. This would take reasonable account of both parties' interests.

13 If the other party declares which of its obligations should be discharged only after the lapse of 'reasonable time', Art 8.4(2) seems to impose a proportional discharge of the obligations. However, if the first party agrees to the choice made by the other party, it seems appropriate (under the party autonomy principle) to accept the other party's declaration as effective. Indeed, when the first party accepts the choice of the other party, the choice reflects both parties' interests in a better way than the default rule (proportional discharge). In some cases, acknowledgement by the first party may change the original conditions of the obligation, especially when the other party chooses to discharge another obligation than the one which is already due.

2. Multiple obligations of the first party

14 Art 8.4(2) does not deal specifically with the situation where the first party has multiple obligations (see para 9 above). In the April 2003 draft of the PICC, Art 6(3) stated that 'if the notice does not specify the obligation the first party wants to set off, the rules in Art 6.1.12 will apply with appropriate modifications'. Since by giving notice of set-off, the first party uses a means to pay its obligations, it seems self-evident that the rules on imputation of performance under Art 6.1.12 should apply. This is probably the reason why in the final version any reference to Art 6.1.12 has been omitted. In that situation, Art 13:105(2) PECL declares Art 7:109 PECL on the appropriation of performance similarly applicable.

15 As a consequence, if the first party (the obligor of the multiple obligations) specifies the obligations that should be discharged, it fulfils the requirement of Art 8.4(1). However, it has to be decided whether the principal amount owing under those obligations or any interest that has accrued will be discharged first. In the absence of any precision on that point, the principle set out in Art 6.1.12 applies: set-off first discharges any expenses, then any interest due and finally the principal amount owing.

16 Where no specification is made by the first party, Art 6.1.12 applies. Thus, the other party may within a reasonable time after notice of set-off declare to the first party the obligation to which it imputes the performance, provided that the obligation is due: Art 6.1.12(2). The solution is therefore similar to the situation where the other party has multiple obligations (see para 10 above).

17 In the absence of any specification from one or the other party within a reasonable time, the order set out in Art 6.1.12(3) applies. Thus, the only difference with the situation of multiple obligations of the other party is that, before discharging the first party's obligations proportionally, it should be considered whether one or several obligations are due at

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184 For a discussion of Art 13:105(2) PECL, see Pichonnaz (n 12 above) paras 2167, 2187; Pichonnaz (n 3 above) 299; Zimmermann (n 1 above) 60.
185 See also Berger (n 107 above) 24.
different times, or whether one of them provides less security or is more burdensome for the first party.

If the other party declares after the lapse of a 'reasonable time' which of the first party's obligations should be discharged, Art 6.1.12(3) seems to require the use of the default rule. However, if the first party agrees to the choice made by the other party, it seems appropriate (under the party autonomy principle) to accept the other party's declaration as effective. Indeed, when the first party accepts the choice of the other party, the choice reflects both parties' interests in a better way than the default rule.\(^{186}\)

3. Multiple obligations on both sides

Where there are multiple obligations on both sides, the rules set out for each side's obligations apply concurrently. This means basically that the first party must specify in the notice of set-off which obligations are discharged partly or totally according to Art 8.4(1). In the absence of specification by the first party, the other party may make this decision for all obligations, since the solution is the same as in Art 8.4(2) (for multiple obligations of the other party) and in Art 6.1.12(2) (for multiple obligations of the first party). Finally, in the absence of any specification, the first party's obligations are discharged according to Art 6.1.12(3), and the other party's obligations are discharged proportionally up to the first party's obligations according to Art 8.4(2).

III. Burden of proof

If the first party wants the effects of set-off to derogate from the default rule of Art 8.4(2), it has to prove that the notice specified to which obligations it was related. If such proof has not been given, then the other party must prove that (a) it declared to the first party to which obligations set-off should relate, and (b) that this declaration was made within a reasonable time. In the absence of such proof, the default rule of the last sentence of Art 8.4(2) applies.

\(^{186}\) See para 12 above in case of multiple obligations of the other party.
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.

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I. The discharging effect

1. The principle

Art 8.5(1) states the main consequence of set-off, which is to discharge the obligations. This is generally understood to be the result of set-off, and thus constitutes a general principle of law. In order for the discharging effect of set-off to take place, the requirements of Art 8.1, as well as notice by the first party under Art 8.3, must be fulfilled. Thus, indirectly, Art 8.5 recalls that it is not a judgment or an arbitral award that discharges the obligation (making set-off a procedural device), but the result of meeting the substantive requirements. Art 8.5 therefore shows that set-off is understood by the PICC to be a substantive device. 187

2. The scope of the discharging effect

The discharging effect of set-off may affect one or several obligations of one or both parties, as envisaged by Art 8.4. If an obligation is discharged totally, all related rights (especially real or personal securities) are discharged. 188 The set-off may also discharge an obligation merely partially if the reciprocal obligations are not of the same amount. Art 8.5(2) states clearly that if the amount of the reciprocal obligation differs, set-off discharges the obligation up to the smaller amount.

3. This raises two issues. First, the amount of the lesser obligation is the result of adding the principal amount owing under one or more obligations of one party as well as the interest accruing under these obligations. Second, partial discharge is always possible; the remaining part of the obligation remains valid. 189 Thus, in derogation from Art 6.1.3(1), the other

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187 See above, Art 8.3 para 2.
188 Off Cmt 2 to Art 8.5, p 264.
189 See also Parra Lucan (n 6 above) 336.
party (the obligee) may not reject performance by means of set-off because the obligation owed to it would only be partially discharged. Moreover, the other party cannot reject performance by means of set-off if the first party’s obligation, which will be partially discharged, is not yet due; Art 8.1 expressly allows set-off in such a situation.\footnote{190} Finally, derogating from the principle of Art 6.1.2, the first party may partially discharge several of its obligations by specifying these obligations according to Art 8.4(1), even if this party could instead totally discharge one of its obligations.

3. Prospective effect

The obligations are discharged at the time the notice of set-off is received, according to Art 8.5(3) in connection with Art 1.10. Thus, set-off does not operate retroactively, but merely prospectively. The solution is comparable to Art 13:106 PECL.\footnote{191} This approach does not reflect a general principle of law, since most of the civil law systems where set-off is triggered by notice acknowledge a retroactive effect,\footnote{192} with the notable exception of Swedish law and the laws of other Nordic countries.\footnote{193} However, the prospective effect of set-off constitutes the commercially most efficient and equitable solution.\footnote{194} It should thus not be contracted out of by the parties. It is the most appropriate approach for at least three reasons.

First, in a system of set-off based on an extra-judicial notice of set-off, the obligor may decide when it wants to give notice for discharging its obligation. The same is true for performance, and set-off should therefore have the same effects as performance. The retroactive effect known to civilian systems was partially justified with procedural particularities for invoking set-off in the nineteenth century (exceptio compensationis); these particularities no longer exist under the PICC.\footnote{195}

Second, set-off should be equivalent to performance.\footnote{196} However, in legal systems where set-off by notice has a retroactive effect, the first party benefits from a security, since from the moment reciprocal obligations can be setoff, it is certain to get performance, even in case of bankruptcy of the other party.\footnote{197} The prospective effect of set-off does not completely

\footnote{190} See above, Art. 8.1 paras 25–26.
\footnote{191} On Art 13:106 PECL, see Parra Lucan (n 6 above) 322; Pichonnaz (n 12 above) para 2179; Pichonnaz (n 3 above) 295; Zimmermann (n 1 above) 36.
\footnote{192} eg § 389 German CC; Art 124(2) Swiss CO; Art 6:129(1) Dutch CC; Art 441 Greek CC; Art 854 Portuguese CC; for Austrian law, see Dullinger (n 132 above) 96.
\footnote{193} For Swedish law, see S Lindskog, Königsegg (2nd edn, 1993) 565; K Rodhe, Obligationenrätt (1984) 71. For Danish and Finnish law see PECL Art 13:106 Notes; Zimmermann (n 15 above) 719.
\footnote{194} For this argument with regard to Arts 13:101–13:107 PECL, see Pichonnaz (n 12 above) para 2178; Pichonnaz (n 3 above) 295; P Pichonnaz, ‘The retroactive effect of set-off (compensation)’ (2000) 68 Tijdschrift voor rechtsgeschiedenis 552, 560; Zimmermann (n 1 above) 39. For Austrian law, see P Bydlinski, ‘Die Aufrechnung mit verjäherten Forderungen: Wirklich kein Änderungsbedarf?’ (1996) AcP 276; Dullinger (n 132 above) 172; for German law, see Gernhuber (n 96 above) paras 229, 309; for Swiss law see von Wyss (n 131 above) 39.
\footnote{195} Pichonnaz (n 12 above) para 2113; Pichonnaz (n 3 above) 295; Pichonnaz (n 12 above) 560.
\footnote{196} See above, Introduction to Chapter 8 para 6.
\footnote{197} See above, Art 8.3 paras 18–19.
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remove this security effect, since in most systems set-off is possible after the decree of 
bankruptcy according to national rules, which will displace the PICC. 198

7 Third, it is not clear why an obligor should not pay interest for any delay after the time it 
can set off by notice but does not do so. The fact that set-off is a means of performance 
should lead to the same consequences. The prospective effect should induce the parties to 
set off as soon as they can, which will enhance certainty in commercial relationships. Thus, 
under the PICC an obligor who is in delay is not unduly privileged as far as the payment of 
interest is concerned.

II. Specific consequences

8 The prospective effect of set-off leads to specific consequences which are mentioned by the 
Official Comment. 199

9 Interest (on both obligations) continues to accrue until notice of set-off is given; it stops 
accruing only when notice is received by the other party according to Art 1.10(2). 200 Since 
the rate of interest may differ between the reciprocal obligations, the party paying a higher 
rate is well advised to give notice of set-off as soon as possible. 201

10 The consequences of late performance set out in Chapter 7 of the PICC apply, when 
appropriate, until notice of set-off is given. 202 Thus, interest for failure to pay money (under 
Art 7.4.9) or full compensation for additional damages (under Arts 7.4.1 and 7.4.9) might 
be claimed for the period before the notice of set-off. The right to terminate a contract for 
non-performance may also be exerted, despite the fact that a party could have given notice 
of set-off, but has not done so. 203

11 The contractual consequences of agreed payment for non-performance also apply, even if 
the contract refers only to late payment, 204 since set-off is considered as a means to perform. 205 
For instance, if the contract provides that a party is to pay a specified sum to the aggrieved 
party for late performance (Art 7.4.13), this is due for the period before the notice of 
set-off.

12 If the other party performs its obligation after receiving notice of set-off, it may reclaim its 
performance in most legal systems if that performance is made without knowledge or by

198 ibid paras 14–17.
199 Off Cmt 2 to Art 8.5, p 264.
200 The same is true for the PECL: PECL Art 13:106 Notes; Parra Lucan (n 6 above) 327; Pichonnaz (n 3 
above) 297; Zimmermann (n 1 above) 41.
201 Off Cmt 2 to Art 8.5, p 264; see also PECL Art 13:106 Notes.
202 See also PECL Art 13:106 Notes; Parra Lucan (n 6 above) 328; Pichonnaz (n 12 above) para 2138; 
Zimmermann (n 1 above) 41.
203 For a different solution, see Art 6:134 Dutch Cc; see also Pichonnaz (n 12 above) para 2138.
204 For the PECL, see PECL Art 13:106 Notes; Parra Lucan (n 6 above) 329; Pichonnaz (n 12 above) para 
2195; Zimmermann (n 1 above) 41.
205 See above, Introduction to Chapter 8 para 6.
mistake, since the performance then has no legal ground.\textsuperscript{206} Of course, if performance has been made before notice of set-off has been received, it is valid and set-off may either have no effect or have a different one, depending on which obligation has been performed (if there are multiple obligations on one or the other side).

The specific consequence of set-off when the obligee of an obligation for which the limitation period has expired gives notice of set-off is dealt with under Art 10.10.\textsuperscript{207}

III. Burden of proof

If both the proof that the requirements for set-off are fulfilled and the proof that notice has been declared is given, the effects of set-off as such need not be proven. However, the time from which the discharging effect of set-off takes place depends on when notice reaches the other party (under Art 1.10). If the first party argues that notice has been received before the time acknowledged by the other party, it must prove it.

\textsuperscript{206} Off Cmt 2 to Art 8.5, p 264; for the PECL, see PECL Art 13:106 Notes; Parra Lucan (n 6 above) 330; Pichonnaz (n 3 above) 297; Zimmermann (n 1 above) 42.

\textsuperscript{207} See above, Art 8.1 paras 33–34.