

Applicability of set-off defence in international arbitration

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Introduction

International Arbitration is a mechanism for resolving disputes between parties belonging to different countries. These parties intend to adopt different legal systems. The two most widespread legal systems are common law and civil law systems.

Set-off is a defence either to the whole or part of the claim depending on the defendant's claim, which entails the mutual extinction of claims, either in full or part. Set-off defence is one of the modes available for defending claims of the Claimant in international arbitration, in a 'defensive' manner when compared to the other modes such as a mere denial or preference of a counterclaim in an 'offensive' manner.

The necessity of a set-off defence has been noted as most common in international arbitration. However, the common law and civil law jurisdictions treat the set-off defence differently. Under the common law jurisdictions, the set-off is seen either as a 'procedural' defence known as "set-off at law" or as a 'substantive' defence, the "equitable set-off", with different legal requirements, whereas, in civil law jurisdictions, the 'substantive law', plays a prominent role in administering the set-off defence in international arbitration. The present article restricts its analysis to civil law jurisdiction from a Swiss law perspective.

The problem

Set-off acts as a 'shield' and acts as a self-help remedy to the defendant in rebutting the claim of the Claimant, this is always limited to the amount of the original claim raised by the Claimant before the Arbitration Tribunal. Predominantly, the set-off defense is entertained only when the claimant's claim exists. The set-off defense is quite common in international arbitration.

The following are key problems to be addressed in determining the applicability of set-off defense:

- a) Whether the Nature of set-off defense depicts as a matter of procedural law or substantive law?

- b) Whether set-off under Swiss Law is considered as acknowledgement of the Main Claim?
- c) Whether set-off may be declared in a subsidiary manner during arbitral proceedings?
- d) Whether the arbitration tribunal has jurisdiction to entertain the set-off defense?

Nature of set-off: the civil law approach from a Swiss legal perspective

The nature of set-off is where two parties claim each other sums of money or perform identical obligations the parties do not need to perform either a specific exchange of these sums or goods. In general, the nature of set-off is understood as a defensive tool against the main claim. The nature of set-off if allowed & established has the following implications:

- a) As the set-off is limited in amount to the main claim raised by the Claimant, any amount of claim over the same is not possible.
- b) The Arbitration Tribunal need not issue separate awards on a claim and set-off defence.
- c) In case the main claim of the Claimant is either withdrawn or is not made out, the set-off need not be adjudicated upon.
- d) Resultantly, the set-off provides a defence to the claim and operates as a “shield” and not as a “sword” as in the case of counterclaim defence.

When the set-off is normally raised by the defendant/ respondent, the claimant also may raise a set-off against a counterclaim initiated by the defendant/ respondent as held in the case of [ICC Award No.3540 of 1980](#).

Common law jurisdictions

The starting point for the development of set-off in common law is the equitable character of set-off that arises out of the closely related transactions by the courts of equity as held in the case of [Rawson v. Samuel \[1841\] Cr.&Ph. 161](#); *Supreme Court of Judicature Act 1873, s. 24*. The set-off exist in two types known as:

- (1) set-off at law (or) legal set-off – a procedural defense that considers the balance due between the parties, and
- (2) equitable set-off (or) transaction set-off – a substantive defense invoked without the requirement of any order from an arbitration tribunal.

These two concepts not only differ in their legal nature but also have differing legal prerequisites.

Civil law jurisdictions

Whereas the *ratio legis* of the set-off and the civil law jurisdiction approaches are in contrast to the common law approach. The basis for consideration of set-off as a principle in civil law

jurisdiction has emerged from the recognition of set-off acknowledged by the Roman law as a legal remedy.

The substantive law governs the set-off in most civil law jurisdictions. The objective is to unilaterally extinguish the substantive obligations between the parties.

The significant difference in the development of set-off in civil law jurisdictions can be noted from the countries such as France, Belgium, Spain, the set-off is effected *ipso jure*, i.e. without the need of any declaration by one of the parties, whereas in countries like Germany, Switzerland, Japan, Korea, Netherlands etc., one of the parties are required to declare the set-off defence.

Though the *ratio legis* remains the same, the legal nature and the legal prerequisites vary in respect of the common law jurisdiction and civil law jurisdiction thereby leading the set-off to intricacies.

Set-off under Swiss law is considered as acknowledgment of the main claim

Switzerland adopts the civil law jurisdiction according to which the 'substantive law' governs the set-off. [Article 21\(5\)](#) of the Swiss Rules provided legal certainty by removing the potential lack of jurisdiction of the arbitral tribunal by adopting the set-off through "substantive glasses". According to which the arbitral tribunal shall have jurisdiction to entertain a set-off defense irrespective of the scope of the arbitration clause and even in cases where the contractual relationship of the parties falls within another arbitration agreement scope or a forum selection clause. The set-off is available only when the two countervailing claims between the same parties exist. Thus the requirement of existence of main claim and countervailing claim is of critical importance under the Swiss substantive law, the same is in the case of Austria and other countries adopting civil law jurisdiction. The countervailing claim of set-off however is capped to the extent of the main claim. Any unconditional substantive set-off declaration automatically necessitates the acknowledgment of existence of the main claim by the party declaring set-off.

The Applicable law in respect of 'procedural admissibility' of set-off and the 'law applicable to the substance' of the set-off claim must be established in order to define the prerequisites and nature of set-off in arbitration proceedings. While the applicable *lex arbitri* governs the procedural admissibility of set-off defense; the arbitral tribunal has to apply the applicable substantive law chosen by the parties in international arbitration proceedings as provided for under [Article 187\(1\)](#) of the Private International Law of Switzerland (PILS). According to which, in the absence of choice by the parties, the arbitration tribunal shall apply the law to which the action is most closely connected. [Chapter 12](#) of the Swiss Federal Court of Private International law governs the international arbitration with its seat situated in Switzerland. The law applicable for set-off may be decided by the arbitral tribunal at its discretion, as provided for under [Article 187\(2\)](#) of PILS.

The Arbitrators often prefer the conflict of legal provisions under the Swiss PILs used before the state courts in the international set-off defense. [Article 148\(2\)](#) of PILs provides for in the

absence of any specific choice by the parties and in case of extinction by set-off, the law applicable to the substance which governs the main claim against which the set-off has been emphasized. For example, let us assume a case wherein the Swiss law is applicable to the main claim and the respondent/ defendant raised a countervailing claim as set-off defence, the Swiss law would be applicable for the set-off claim as well. On the contrary, under the French and Belgian conflict of law rules a different approach is adopted to determine the law applicable to '*compensation légale*', according to which the set-off is required to be justified both under the laws applicable to the main and the countervailing claim, called as "cumulative theory". The conflict of law concept has been applied in very rare instances in international arbitration. The international practice recognises in majority the set-off defense is governed by express choice of law clause.

Subsidiary set-off defense

i. Starting position under Swiss law

The set-off concept is governed by substantive law in Switzerland. The law often used to regulate international contracts which is considered neutral to the parties is the "Swiss Code of Obligations", ("CO"), which is a portion of the second part of the Swiss law. Articles 120-126 of the CO deals with set-off.

Pursuant to Art.120(1) of CO on set-off, where two persons owe each other sums of money or performance of identical obligations and provided that both of the assertions are due, both the parties may prefer to set-off its debt against its claim. Further even if the countervailing claim is contested, the debtor may assert his right of set-off under Art.120(2) of CO. The time barred claim may be set-off under Art.120(3) of CO. The '*effect of set-off*' is provided for under Art.124 of CO. Only if the party seeking set-off notifies the other of its intent to exercise his right to set-off could be effected as per Art.124(1) of CO. As per Art.124(2) "Once the set-off has been declared, to the extent that the claim and countervailing claim cancel each other out are deemed to have been satisfied until the time, they became susceptible to set-off. If the requirements stipulated under the CO are met and set-off has been declared, as a matter of substantive law, the main claim and the countervailing claim are deemed to be extinct to the extent that they are cancelled out.

Pursuant to the Swiss law, the declaration of set-off is called a 'transformation right', a right to transform a legal relationship, in a legally binding manner, without taking the consent of the counterparty. However, this is an exception to the general principle of *pacta sunt servanda* that requires 'all the parties' to an agreement must consent, in a legally binding manner for transformation of their legal relations. Thus the transformation declaration is considered as a unilateral exercise which must be irrevocable, unconditional and the same shall have been received by the counterparty. The unconditional substantive set-off declaration, this necessitates acknowledgment of the main claim by the party who declares set-off.

Historically though the set-off operation was considered automatic, recently the set-off defense does not operate automatically, but operated only after declaration by the party preferring set-off as per Art.124(1) of CO. In legal proceedings, the respondent is required to declare the set-off only if the main claim is considered as justified by the arbitration tribunal,

which gives considerable interest in asserting the set-off defense. In the backdrop, two questions need to be addressed is:

1. Whether conditional set-off declarations can be submitted in Swiss court proceedings, regardless of unconditional transformation right under the Swiss law?
2. If conditional set-off declarations can be submitted, whether the rule applies to international arbitration proceedings as well?

ii. State of Discussion

The set-off defense through a judicial declaration has effect either *ex tunc* or *ex nunc*. The Swiss Federal Tribunal recognises the set-off can be asserted as a subsidiary/ condition submission in state court proceedings as a long-standing practice and as held in the case of Swiss Federal Tribunal Decision 4A_290/2007, dated Dec. 10, 2007, wherein it is held that:

“A distinction should be made between the declaration of set-off, which is addressed to the creditor and which entails the extinction of the offset debts to the extent set out in Article 124 (2) CO, and the set-off defense, which is addressed to the judge with a view to introducing the question of compensation in the trial (Articles 120-126 of CO). The two manifestations of will can certainly be concomitant, but they are not necessarily so. The validity of the first falls under substantive law, that of the second under procedural law. [...]. This objection may also be raised only on a contingency basis. This is the case when the compensator contests the request and, in the event that his arguments are rejected, alternatively asserts the compensation declared previously or in the proceedings as an additional legal remedy [...].”

The opinion of the Swiss Federal Tribunal has clarified that (i) the set-off declaration as a right to extinguish the main claim and the countervailing claim and; (ii) the set-off defense in legal proceedings are two manifestations of will to be distinguished. The laws of other civil law jurisdictions such as Austria and Germany also follow the same principle.

iii. Analysis

Two issues on legal reasoning of the Swiss Federal Tribunal which require further analysis on the aforesaid state of discussion includes:

(1) Whether the legal reasoning for state court proceedings are applicable for international arbitration proceedings?

As per the concept developed by the Swiss Federal Tribunal, the subsidiary set-off defenses should be admitted in Swiss and similarly in other international arbitration proceedings, for the following reasons:

- (i) The Swiss *lex arbitri* does not provide for any divergent rule that would justify any separate approach for arbitral proceedings.
- (ii) The respondents in arbitral and the state court proceedings have the very same interests and needs in submitting subsidiary set-off defenses.
- (iii) As the arbitral tribunals and state courts are both ‘authoritative decision making bodies’ the subsidiary set-off defense is permitted in both the proceedings.

(2) Whether the legal reasoning is entirely consistent?

The set-off defense can be submitted merely as a 'subsidiary defense', either as a previously made set-off declaration, or submits such a declaration in the proceedings as an additional legal remedy, when the defendant contests the main claim and it is likely that all his arguments are to be dismissed. Considering the cost-effective solution of the legal reasoning of the Swiss Federal Tribunal, with regard to the complications involved in the requirement of the respondent to contest the main claim, in case of failure it may have to claim for countervailing claim as a second procedure. Hence the respondent is permitted to declare subsidiary and conditional set-off defense before the arbitrator as well as in legal proceedings making the legal reasoning entirely consistent.

The Swiss Federal Tribunal considers the previously made set-off declaration (i.e. before the initiation of the proceedings), wherein the respondent loses its position from a substantive point of view as the unconditional set-off implies acknowledgment of the countervailing claim. This distinction by the Swiss Federal Tribunal cannot be construed as the unconditional set-off declared before the initiation of the proceedings, be reversed in a subsequent legal proceeding, which would be contrary to the transformation rights under the principles of Swiss law. In view of which the findings by the Swiss Federal Tribunal evidence that the subsidiary set-off defense is declared only against the judge or arbitrator and not against the counterparty. However if the main claim and the subsidiary defense are effectively considered by the judge or arbitrator, it is deemed to be declared against the counterparty. Based on the above stance, the authors conclude that the argumentation by the Swiss Federal Tribunal justified the subsidiary set-off defense to be consistent in legal proceedings.

iv. Inference

In light of the above, a clear difference between substantive & procedural set-off defense is noted as:

- a) Substantive set-off declarations are to be addressed to the counterparty before initiation of the proceedings. This unconditional declaration evidenced acknowledgment of the main claim. The arbitral tribunal considers the substantive and unconditional set-off irrespective of any separate advance payments on the set-off claim.
- b) Procedural set-off declarations are to be addressed to the judge or arbitral tribunal. This declaration may be submitted as a subsidiary defense subject to decision by the Judge or arbitral tribunal, as the case may be. This however does not affect the unconditional effect of acknowledgment of main claim pursuant to substantive law. The arbitral tribunal depends on the separate advance payment under the procedural law.

Arbitral jurisdiction for set-off defense is based on the principle "le juge de l'action est le juge de l'exception" (judge of the main claim shall also be the judge for any objections thereto) leading to substantive extinction of the main claim as held by the highest Swiss judges in international arbitration matters.

Case law

In [Stemcor UK Ltd v Global Holdings Ltd and Pramod Mittal](#), the Hon'ble English High Court considered the application by the Claimant in respect of its claim for sums payable as per two guarantees and the Defendant's application for stay of court proceedings, pending the resolution of related arbitration proceedings commenced subsequently with regard to the debts underlying the guarantees in question. The Court granted stay pleaded by the Defendant pending outcome of the arbitration and also held that the Claimant had not established any real prospect of chance of success in Defendant's set-off defense. On the contrary, the defendant established ample discretionary grounds for ordering a stay which would otherwise duplicate a pending reference in arbitration as held by the Court of Appeal in the case of *Alfred McAlpine* that "*unless the circumstances justify both sets of proceedings in a particular case*". The Claimant need not pursue a claim against the guarantors by English Court proceedings, as even if it is unsuccessful in Arbitration, it would still have the right to pursue its claim before the Court. In order to arrive at this decision, certain crucial factors considered by the Court are:

1. The risk involved in conflicting decisions;
2. The parallel proceedings would waste the courts time and resources;
3. The arbitration proceedings to be more advanced than the court proceedings, as the Claimant delayed progression in the court's action;
4. The liability depends on the decision of the set-off as a matter of principle and better resolved in Arbitration with access to the relevant documents and witnesses examination in detail.

The case also demonstrated that the Court considered the forum (arbitration) before which the proceedings were expeditiously progressing instead of looking in the forum in which the proceedings were first commenced (court proceedings).

Conclusion

Based on the above analysis, the "Conditionality Test" is reasonable in order to determine and distinguish two types of set-off in international arbitration namely unconditional and conditional set-off declarations and hence whether the set-off source concerns common law or civil law jurisdiction and whether it is substantive or procedural nature is immaterial. A few of the stark differences in respect of unconditional and conditional set-off declarations are:

S.No.	Unconditional set-off declaration	Conditional set-off declaration
1	Entails acknowledgment of main claim reducing the subject matter to whether set-off is justified. The main claim would be defunct, if justified else the main claim exists and must be awarded.	Does not acknowledge the main claim and respondent has the option to pursue the set-off claim in legal proceedings separately, even if the main claim is dismissed.
2	Does not require an active role of the arbitration tribunal.	The active role of the arbitration tribunal is essential. The tribunal shall at the time of award make the calculation of set-off.

3	Considered irrespective of any specific procedural requirements.	Requires actions of the arbitral tribunals associated with procedural requirements.
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The above test helps in distinguishing different types of set-off which ultimately have different legal effects. The distinction helps in international arbitral proceedings arising out of different jurisdictions and application of specific laws.

Thus, the distinctions and applicability of the type of set-off defense aims to provide the following recommendations to the parties and the legal counsels to be aware of in international arbitration:

- (1) Different legislations often lead to irrevocable acknowledgment of main claim, unless they are not expressed in the legal proceedings specifying that they are made only as a 'subsidiary' submission.
- (2) With regard to the issue of jurisdiction, the rule "*the judge of the action is also the judge of the objection*" seems to have prominence in international arbitration. In which case, the counsel for the respondent shall necessarily ensure any potential cross claims even before another forum.
- (3) In order to make the set-off to be considered by an arbitral tribunal, the respondent shall have to comply with the procedural rules seeking appropriate action for consideration by the tribunal.

References

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