Title: III.1 - Set-off

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(a) If two parties have claims against each other (reciprocal claims) that are of an identical nature, each party may set-off its claim against the other party's cross-claim, provided the party making use of its right to set-off is entitled to demand the other party's performance under its claim and is entitled to effect performance under the other party's cross-claim.

(b) If the parties have reciprocal claims in different currencies, a party may exercise its right of set-off, provided that both currencies are freely convertible and the parties have not agreed that the party making use of its right of set-off shall pay only in a specified currency.

(c) The right to set-off reciprocal claims is effected by notice to the other party. The notice must specify the reciprocal claims to which it relates.

(d) A claim in relation to which the period of prescription has expired may nonetheless be set-off by the creditor, unless the debtor of that claim has invoked prescription prior to the notice of arbitration.

(e) Set-off extinguishes the reciprocal claims up to the amount of the lesser claim as from the time of notice.

(f) A notice pursuant to para. (c) above is ineffective if the contract out of which the cross-claim arises contains an explicit or implicit (e.g. a "net cash against..." clause) prohibition of set-off or if set-off is prohibited by the applicable law.

(g) The parties may also effect set-off of reciprocal claims irrespective of the requirements under para. (a) above by contractual consent.

Commentary:
1 The right to set-off reciprocal claims is based on the idea that it would be against good faith if a creditor requires performance of an obligation from his debtor if the creditor would have to return immediately what he has received from the debtor because that debtor has a cross-claim against it ("dolo agit, qui petit, quod statim redditurus est").

2 The requirements for set-off are a natural consequence of the specific nature of this legal right. Set-off first requires reciprocal claims existing between two parties. With respect to these reciprocal claims, set-off has a dual function. With respect to the claim of the party making use of its right of set-off, it is a means of private enforcement. For that reason, the other party's obligation under that claim must be due, i.e. the off-setting party has the right to demand performance and the other party has no defence against that request. In other words, private enforcement of the claim by way of set-off cannot be imposed on the other party if the party declaring the set-off would not be entitled to performance by the other party under the claim absent the set-off. With respect to the cross-claim of the other party, set-off is a means of performance by the party declaring the set-off. In case of claims for the payment of money, the other party does not receive the amount to which it is entitled, for example by payment in cash or through bank transfer, but is freed of its obligation vis-à-vis the party declaring the set-off. For that reason, the party declaring the set-off must be entitled to perform with respect to the the cross-claim which the other party has against it.

3 The expiry of the limitation period for a given claim does not in it self extinguish the right of the creditor of that claim to use it for purposes of set-off. However, the situation is different if the debtor has invoked the expiry of the limitation period as a defence by asserting it against the creditor. In that scenario, the debtor has made the limitation period effective by refusing performance based on the limitation defence. Consequently, the claim can no longer be enforced by way of set-off.

4 The right to set-off is to be exercised by notice to the other party. The notice requirement follows from the need for legal certainty and the autonomy of the parties to decide if, when and to what extent reciprocal claims shall be set-off against one another. Provided that the prerequisites of set-off are met, the reciprocal claims are extinguished up to the amount of...
the lesser claim from the time of the notice.

5 The right to set-off can be excluded by explicit or tacit agreement of the parties or by law. It goes without saying that set-off is only permissible if each party has the authority to dispose of that party’s claim for the purpose of the set-off. Therefore, set-off is excluded if creditors of one of the parties have acquired rights with respect to the claims which one party intends to subject to a set-off. The right to set-off cannot be exercised against a cross-claim that arises from an intentional wrongful act of the party declaring the set-off. It is an inherent feature of such claims that they must be paid in cash by the wrongdoer. For the same reason, the right to set-off cannot be exercised against a cross-claim to the extent that this claim is not capable of attachment.

6 The setting-off of reciprocal claims can also be effected by an agreement of the parties. This follows from the fundamental principle of party autonomy (Principle IV.1.1). Contractual set-off can be effected in two different ways. Such an agreement may have the effect of directly extinguishing the claims to be set-off, whether such claims exist at the moment the set-off contract is concluded or arise in the future. Such set-off agreements for present and/or future claims are very common between businessmen who are in a permanent business relationship out of which reciprocal claims arise on a frequent basis for both parties (“current account”). Netting clauses in international financial market contracts, such as the close-out netting provisions contained in the ISDA Master Agreements, are frequently based on such a set-off agreement. Instead of extinguishing existing and/or future claims, a party-agreement on set-off may also give one party the unilateral right to declare set-off vis-à-vis the other party in the future. In both cases, the requirements set forth in para. (a) for a set-off by unilateral notice to the other side must not be met because they are not mandatory and may be modified or overridden by agreement of the parties.