

SET-OFF DEFENSES IN ARBITRATION – CONCLUSIONS FROM A SWISS CIVIL LAW PERSPECTIVE

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Abstract

Set-off situations are frequent in international arbitration and are treated differently in common law and civil law jurisdictions. The present article analyses set-off from a Swiss civil law perspective and offers recommendations to international arbitration practitioners. The key findings are: (i) Set-off declarations may lead to the irrevocable acknowledgment of a countervailing claim. To avoid such a legal consequence, set-off must only be declared as defense in legal proceedings together with an explicit statement that it is only made as a subsidiary submission. (ii) The highest Swiss Court acknowledges a growing trend in international arbitration to generally accept arbitral jurisdiction for set-off defenses. (iii) It appears to be reasonable to ask from a respondent, who relies on procedural advantages in connection with a subsidiary set-off defense, to comply with the applicable procedural requirements (e.g. to pay an advance on costs).

I. The Problem

Set-off defenses are a frequent issue in international arbitration. Some aspects concerning such defenses, such as the issue of jurisdiction over set-off defenses, have been much discussed in legal literature.¹ Other aspects, such as the consequence of failure to pay an advance on costs regarding set-off defenses, have remained more or less untouched by commentators. However, other problems are scarcely considered in the discussion on the previously mentioned issues: for instance, whether it is permissible to make a declaration of set-off on the condition that the main claim is justified in international arbitration proceedings [“subsidiary set-off” or in German “*Eventualverrechnung*”].

The following scenario is derived from an actual case in which the first author was involved and illustrates the issues that may arise in set-off disputes:²

A Greek Claimant sued an Austrian Respondent under the ICC Rules of Arbitration 2012 [the “**ICC Rules**”] with the place of arbitration in Zurich (Switzerland). Swiss substantive law was applicable to the merits of the case.

The Claimant requested to receive a payment from the respondent in the amount of USD 3 million. The Claimant paid its share of the advance on costs under the ICC Rules and, later, the Claimant also substituted the Respondent’s share of the advance on costs.

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¹ See, e.g., PASCAL PICHONNAZ & LOUISE GULLIFER, SET-OFF IN ARBITRATION AND COMMERCIAL TRANSACTIONS ¶ 3.01 (2014); Alexis Mourre, *The Set-off Paradox in International Arbitration*, 24 Arb. Int'l. 392 (2008); JEAN-FRANÇOIS POUDRET & SÉBASTIEN BESSON, COMPARATIVE LAW OF INTERNATIONAL ARBITRATION ¶ 317 (2007); Michael Schöll, *Set-off Defences in International Arbitration, Criteria for Best Practice – A Comparative Perspective*, in BEST PRACTICES IN INTERNATIONAL ARBITRATION 122 (Wirth ed., 2006); CHRISTOPH ZIMMERLI, DIE VERRECHNUNG IM ZIVILPROZESS UND IN DER SCHIEDSGERICHTSBARKEIT: UNTER BESONDERER BERÜCKSICHTIGUNG INTERNATIONALER VERHÄLTNISSE 201 (2003); Eugen Bucher, *Kompensation im Prozess: Zurück zum materiellen Recht*, in EINHEIT UND VIELFALT DES RECHTS, FESTSCHRIFT FÜR REINHOLD GEIMERZUM 65. GEBURTSTAG 97 (2002); Klaus Peter Berger, *Set-Off in International Economic Arbitration*, 15 Arb. Int'l. 64 (1999); DOMENIC GROSS, DAS RECHTLICHE SCHICKSAL VON VERRECHNUNGSANSPRÜCHEN IM SCHIEDSVERFAHREN 37 (1999).

² Names of parties, countries involved and subject matter are modified to safeguard confidentiality.

The Respondent requested that the claim should be dismissed. As a subsidiary position,³ the Respondent submitted that the claim should be set off against the Respondent's own alleged countervailing claim against the Claimant in the amount of USD 4 million.

At some point, it appeared that the set-off claim would require the arbitral tribunal to consider “*additional matters*” in the sense of Article 36 paragraph 7 of the ICC Rules. The ICC Secretariat thus increased the global advance on costs. The Claimant immediately requested separate advances to avoid its pre-financing of the Respondent's set-off defense. The Respondent objected and argued that, irrespective of any advance payments, the arbitral tribunal was legally bound to consider its set-off defense as a matter of Swiss substantive law. The Claimant, on the other hand, was of the view that in the absence of the (separate) advance payment by the Respondent, the tribunal should not, as a matter of procedural law, consider the set-off defense, but rather limit its jurisdiction and only consider the main claim.

It was undisputed that the Respondent had declared its unconditional set-off vis-à-vis the Claimant several months before the arbitration proceedings started.

Variation: The Respondent had not declared its unconditional set-off before the proceedings had begun, but rather merely requested, during the proceedings, that the tribunal should set off its countervailing claim only if and to the extent that the main claim was found to be justified (in German: “*Eventualverrechnung*”).

This case example illustrates the principal questions that arise in set-off situations:

1. What is the nature of a set-off defense? To what extent is it a matter of procedural law and to what extent a matter of substantive law? The following analysis will demonstrate that there are fundamental differences between common law and civil law systems in this respect which practitioners should be aware of.
2. When further analysing the problem from a civil law perspective, the question arises as to whether or not set-off may be declared in a subsidiary (and thus conditional) manner during arbitration proceedings. The answer to this question is not obvious since set-off is usually a substantive legal concept in civil law jurisdictions, which must be declared in an unconditional manner.⁴
3. The issue as to what extent an arbitral tribunal has jurisdiction and therefore, has authority to preside over a set-off claim is a typical problem and shall also be briefly discussed in the following analysis.
4. Based on the analysis of the aforementioned issues, the present article proposes an approach to resolve the problem of whether or not an arbitral tribunal needs to decide a set-off defense, if the (separate) advance for such defense was not paid.

³ For the present article, the authors relied on the *Glossary of Arbitration and ADR Terms and Abbreviations*, in ASA SPECIAL SERIES No. 30 (3d ed., 2008) for legal terminology. In legal practice, the term “alternative” position is also commonplace to express a position that is submitted as subsidiary vis-à-vis the principal position.

⁴ See, e.g., OBLIGATIONENRECHT [OR] [CODE OF OBLIGATIONS], art. 120 (Switz.); BURGERLICHES GESTZBUCH [BGB] [CIVIL CODE], § 387 (Ger.); ALLGEMEINES BURGERLICHES GESTZBUCH [ABGB] [CIVIL CODE] § 1438 (Austria) and CODE CIVIL [C. CIV.] [CIVIL CODE] art. 1290 (Fr.).

5. Finally, the authors propose practical recommendations for arbitrators and counsel who have to deal with set-off issues in international arbitration proceedings based on a so-called “*Conditionality Test*”.

II. Analysis

A. Nature of Set-Off: The Civil Law Approach from a Swiss Legal Perspective

i. The Ratio Legis of the Set-Off and the Civil Law Approach in Contrast to the Common Law Approach

The idea behind the legal concept of set-off is straightforward: where two parties owe each other sums of money⁵ or performance of identical obligations (provided that both claims are due), they do not need to perform a specific exchange of these sums or goods. Instead, both or at least one of the obligations become extinct (through court order, declaration or *ipso iure*) which means that nothing or just the balance is owed by one of the parties.

In common law jurisdictions, two types of set-off exist: (i) the so-called “*set-off at law*”, which is a procedural defense that aims to take account of the balance due between the parties⁶ and (ii) the so-called “*equitable set-off*” (also referred to as “*transaction set-off*”), which is a substantive defense and may be invoked without the need of any order from an arbitral tribunal or a state court judge.⁷

The concepts of *set-off at law* and *equitable set-off* are not only different in their legal nature, but also have different legal prerequisites. The present article does not aim to investigate into the specific characteristics of these common law set-off instruments, but will rather concentrate on the civil law perspective from a Swiss point of view.⁸

In most civil law jurisdictions, set-off is primarily governed by the substantive law. It is considered as a means to unilaterally extinguish substantive obligations that exist between the parties.⁹ At the same time, it must be noted that the concept of set-off has developed slightly differently in various civil law jurisdictions. While in Italy, Belgium and Spain the effects of set-off emerge *ipso jure*, in Switzerland, Germany, the Netherlands, Japan, Korea and the Scandinavian countries, set-off must be *declared* by one of the parties.¹⁰

Therefore, as a preliminary conclusion, it can be noted that legal concepts differ when it comes to set-off. While the *ratio legis* remains basically the same, the legal nature and the prerequisites may vary to a considerable extent. This is the reason why in international arbitration proceedings, where arbitrators and legal counsel may come from different legal backgrounds, set-off situations often lead to complex legal discussions and sometimes even to misunderstandings.

⁵ In general, it is not required that the claims be in the same currency, at least under Swiss law; *see* BERNHARD BERGER, ALLGEMEINES SCHULDRECHT ¶ 1370 (2012).

⁶ PICHONNAZ & GULLIFER, *supra* note 1, ¶ 2.26; Berger, *supra* note 1, at 56.

⁷ *Id.*

⁸ *Id.*

⁹ PICHONNAZ & GULLIFER, *supra* note 1, ¶ 2.20; BERGER, *supra* note 5, ¶ 1394; JEAN-MARC SCHALLER, EINWENDUNGEN UND EINREDEN IM SCHWEIZERISCHEN SCHULDRECHT (2010), ¶¶ 519 and 529; Berger, *supra* note 1, at 55.

¹⁰ POUDRET & BESSON, *supra* note 1, ¶ 317; Berger, *supra* note 1, at 55. For the special case of France, where three different variations of set-off exist, *see* POUDRET & BESSON, *supra* note 1, ¶ 317.

ii. Set-Off under Swiss Law is Considered as Acknowledgment of the Main Claim

Pursuant to Swiss substantive law, set-off is only legally available if two countervailing claims between the same parties exist.¹¹ The requirement that both the main claim and the countervailing set-off claim must exist¹² is of decisive importance.

It is thus generally accepted that any (unconditional) substantive set-off declaration entails an acknowledgment of the main claim by the party who declares set-off.¹³ This seems to be the prevailing legal opinion in other civil law jurisdictions also, as, for example, in Austria.¹⁴

This legal particularity has to be kept in mind when further analysing the questions at issue.

iii. Distinction between Set-Off Defense and Counterclaim

When set-off is declared in legal proceedings, it must be strictly distinguished from counterclaims.

Set-off shows, irrespective of whether it is qualified as having substantive or procedural nature, a merely defensive character. If set-off is declared and all the requirements are met, the extinction of the main claim and the countervailing claim results to the extent that they cancel each other out.¹⁵ The countervailing set-off claim only operates up to the amount of the main claim. It cannot have any effects that go beyond the main claim as a matter of law.¹⁶

In contrast thereto, the counterclaim is an offensive action to positively attack the counterparty. It represents an independent, substantive claim against the counterparty, while the main claim remains disputed.¹⁷

iv. The Law Applicable to Set-Off Claims from a Swiss Civil Law Perspective

In order to define the nature and the prerequisites of set-off in arbitration proceedings, the applicable law must be established. In this respect, the law applicable to the (procedural) admissibility of set-off on one hand, and the law applicable to the substance of the set-off claim on the other, must be distinguished.¹⁸

¹¹ See II.B.i. (below) for the complete prerequisites for set-off under Swiss law.

¹² BERGER, *supra* note 5, ¶ 1366.

¹³ MARCO STACHER, BERNE COMMENTARY ON CIVIL PROCEDURE CODE, VOLUME III, ART. 353-399 CPC AND ART. 407 CPC ¶ 30 to art. 377 (2014), with reference to VIKTOR AEPLI, ZURICH COMMENTARY ON CODE OF OBLIGATIONS, BD. V/1H/1, art. 114-126 CO ¶¶ 72 and 83 to art. 124 (3d ed., 1991). See, for an in-depth discussion of the entanglements between substantive and procedural aspects of set-off, CORINNE ZELLWEGER-GUTKNECHT, HAUSHEER & WALTER, BERNE COMMENTARY ON CODE OF OBLIGATIONS, BD. VI/1/7/2, art. 120-126 CO ¶ 118 to art. 120-126 (2012). But see, for a different opinion, SCHÖLL, *supra* note 1, at 100 and Bucher, *supra* note 1, at 105.

¹⁴ CHRISTIAN KOLLER, AUFRECHNUNG UND WIDERKLAGEIM SCHIEDSVERFAHREN, UNTER BESONDERER BERÜCKSICHTIGUNG DES SCHIEDSORTS ÖSTERREICH 39 (2009) (however, Koller does not follow the mentioned prevailing opinion).

¹⁵ PICHONNAZ & GULLIFER, *supra* note 1, ¶ 2.08; BERNHARD BERGER & STEFANIE PFISTERER, SWISS RULES OF INTERNATIONAL ARBITRATION, COMMENTARY ¶ 14 to art. 19 (Zuberbühler et al. eds., 2d ed., 2013); BERGER, *supra* note 5, ¶ 1394; SCHALLER, *supra* note 9, ¶¶ 519 and 529.

¹⁶ POUDRET & BESSON, *supra* note 1, ¶ 318.

¹⁷ STACHER, *supra* note 13, ¶ 19 to art. 377; BERGER & PFISTERER, *supra* note 15, ¶ 15 to art. 19.

¹⁸ Berger, *supra* note 1, at 61.

The procedural admissibility of the set-off defense is governed by the applicable *lex arbitri*,¹⁹ i.e. the procedural arbitration law at the seat²⁰ of the arbitration. Within the boundaries of the mandatory provisions of the applicable *lex arbitri*, agreements of the parties (including references to arbitration rules) may also be relevant in this respect.²¹

With regard to the question of which substantive law is applicable to set-off in international arbitration proceedings with the seat in Switzerland, the arbitral tribunal has to apply the law chosen by the parties (Article 187 paragraph 1 PILS). If there is no such choice of law, the law to which the case has the closest connection must be applied (Article 187 paragraph 1 PILS). While arbitrators have considerable discretion²² to decide which law should be applied to set-off, they might be inspired (amongst other sources) by the classical conflict of legal provisions provided for in the Swiss PILS used in proceedings before state courts.²³

Thereby, arbitrators will find that the Swiss legislator made an express choice as to which law should be applicable to an international set-off defense before state courts. According to Article 148 paragraph 2 of PILS, in the absence of any choice by the parties, the law applicable to the substance of an international set-off is the law that governs the claim against which set-off is asserted (i.e. the main claim). For example, if Swiss law applied to the main claim of Claimant and Respondent asserted a countervailing claim for the purpose of set-off, Swiss law would also apply to the set-off claim.²⁴ However, as in international practice, most set-off claims are governed by an express choice of law clause; the mentioned conflict of law concept is hardly ever applied in international arbitration proceedings.

In the following, the authors will assume that Swiss *lex arbitri* and Swiss substantive law apply, unless where stated otherwise.

B. Subsidiary Set-Off Defenses (“Eventualverrechnung” in Legal Proceedings

i. Starting Position under Swiss law

In Switzerland, as a typical civil law jurisdiction, the legal concept of set-off is governed by substantive law.²⁵ It is provided for in Articles 120-126 of the Swiss Code of Obligations [“CO”].

Article 120 paragraphs 1 and 2 of the CO provide:

Where two persons owe each other sums of money or performance of identical obligations, and provided that both claims have fallen due, each party may set off his debt against his claim.

¹⁹ NIGEL BLACKABY ET AL., REDFERN AND HUNTER ON INTERNATIONAL ARBITRATION ¶ 3.42 (2015).

²⁰ *Id.* ¶ 3.53.

²¹ Christian Koller, *Contemplations on Set-off and Counterclaim*, in AUSTRIAN ARBITRATION YEARBOOK 66 (Klausegger et al. eds., 2008); Berger, *supra* note 1, at 61.

²² BERNHARD BERGER & FRANZ KELLERHALS, INTERNATIONAL AND DOMESTIC ARBITRATION IN SWITZERLAND (3d ed., 2015), ¶ 1413.

²³ KURT SIEHR, DAS INTERNATIONALE PRIVATRECHT DER SCHWEIZ 721 (2002).

²⁴ In contrast to that, according to the French and Belgian conflict of law rules, set-off would have to be justified both under the laws applicable to the main and the countervailing claim. The latter method follows the so-called “cumulative theory”; see Koller, *supra* note 21, at 67; Berger, *supra* note 1, at 61. In this constellation, if the main claim would be governed by Belgian or French law and the countervailing claim by the laws of India, the set-off would need to be justified under both legislations.

²⁵ Decision 63 II 139, ¶¶ 2 and 3.c (Swiss Federal Tribunal) (March 17, 1937).

The debtor may assert his right of set-off even if the countervailing claim is contested.²⁶

In addition, set-off has to be declared to the counterparty (Article 124 paragraph 1 CO):

A set-off takes place only if the debtor notifies the creditor of his intention to exercise his right of set-off.²⁷

According to Article 124 paragraph 2 of the CO, once the debtor has declared set-off, “*to the extent that they cancel each other out, the claim and countervailing claim are deemed to have been satisfied as of the time they first became susceptible to set-off*”.²⁸

Hence, if the requirements for set-off are met and set-off is properly declared, the main claim and the countervailing claim are extinct to the extent that they cancel each other out as a matter of substantive law.²⁹

It should further be noted that pursuant to Swiss law, the set-off declaration is a so-called transformation right, i.e. a right to transform a legal relationship in a unilateral and legally binding manner, without the consent of the counterparty (“*Gestaltungsrecht*; “*droit formateur*”).³⁰ This is an exception to the general principle of *pacta sunt servanda*, which states that all parties to an agreement must consent to transformation of their legal relationship in a legally binding manner.³¹

The transformation declaration, by which the transformation right is unilaterally exercised, must be unconditional, irrevocable and is subject to receipt by the counterparty.³² The legal reason for these limitations is found in the need to protect the counterparty which should (at least) know with certainty if, when and how a legal relationship has been unilaterally transformed.³³

As already mentioned above, under Swiss law, an unconditional substantive set-off declaration entails an acknowledgment of the main claim by the party declaring such set-off (see above section II.A.ii).

These legal particularities of substantive set-off, which are triggered by its qualification as a transformation right, do not seem to fit when a set-off is declared in legal proceedings. In legal proceedings, the respondent typically does *not* want to acknowledge the main claim in the first place. The respondent is only prepared to accept the acknowledging effect of a set-off

²⁶ See the official translation of the Swiss Code of Obligations *available at* <https://www.admin.ch/opc/en/classified-compilation/19110009/index.html>.

²⁷ *Id.* The declaration can also be qualified as a requirement, *see* WOLFGANG PETER, BASLE COMMENTARY ON CODE OF OBLIGATIONS ¶ 16 to art. 120 (Honsell et al. eds., 5th ed., 2011); AEPLI, *supra* note 13, ¶ 7 to art. 124.

²⁸ See for the official translation, *supra* note 26. The concept of the retrospective effect of set-off has been criticized as a legally uncertain construct, *see* PETER, *supra* note 27, ¶¶ 5-6 to art. 124. This concept has been explicitly rejected for Article 8.3 of the UNIDROIT Principles regarding set-off, *see* KLAUS PETER BERGER, *Set-Off*, in UNIDROIT PRINCIPLES: NEW DEVELOPMENTS AND APPLICATIONS sec. IV (2005).

²⁹ BERGER, *supra* note 5, ¶ 1394; SCHALLER, *supra* note 9, ¶¶ 519 and 529.

³⁰ Decision 4C-90/2005, ¶ 4 (Swiss Federal Tribunal) (June 22, 2005); Decision 107 Ib 98, ¶ 8.d (Swiss Federal Tribunal) (Dec. 14, 1993); BERGER, *supra* note 5, ¶¶ 1393-1394 and ¶¶ 100-104; PETER, *supra* note 27, ¶¶ 1 and 3 to art. 124; SCHALLER, *supra* note 9, ¶¶ 518-519; AEPLI, *supra* note 13, ¶¶ 13 and 16 to art. 124.

³¹ BERGER, *supra* note 5, ¶¶ 175-178.

³² BERGER, *supra* note 5, ¶ 1394; PETER, *supra* note 27, ¶¶ 1 and 3 to art. 124; SCHALLER, *supra* note 9, ¶ 532.

³³ Decision 4C-90/2005, ¶ 4 (Swiss Federal Tribunal) (June 22, 2005); PETER, *supra* note 27, ¶ 3 to art. 124. *See also* *supra* note 28 regarding the retrospective effect of set-off and the related uncertainties.

declaration (as described above) if the main claim is considered as justified by the arbitral tribunal. Consequently, in legal proceedings, the respondent has often a strong interest in asserting set-off only *under the condition* that the arbitral tribunal finds the main claim to be justified.

Two questions arise against this background: First, is it possible to submit conditional set-off declarations in Swiss court proceedings (irrespective of the nature of set-off as an unconditional transformation right)? Second, if so, would such a rule also apply to international arbitration proceedings? These questions are addressed forthwith.

ii. State of Discussion

According to long-standing practice of the Swiss Federal Tribunal, set-off can be asserted as a subsidiary (and thus conditional) submission in state court proceedings:³⁴

*One has to distinguish between the set-off declaration (*Verrechnungserklärung*), which is addressed to the creditor and which leads to the extinction of the claims that have been set off according to Art.124 para. 2 CO, and the set-off defense (*Verrechnungseinwendung*) which is addressed to the judge in order to introduce the question of set-off in the proceedings (on this distinction, see Viktor Aepli, *Commentary of Berne*, sec. 117 of the preliminary remarks on Art. 120-126 CO). These two manifestations of will can, but do not have to be simultaneous. The admissibility of the first manifestation arises out of substantive law, that of the second manifestation out of procedural law. [...] This set-off defense can also be submitted as a merely subsidiary defense. This is the case when the defendant contests the main claim and for the case that all his arguments are going to be dismissed, he submits subsidiarily either a previously made set-off declaration, or submits such a declaration in the proceedings as an additional legal remedy. (emphasis added)*

The opinion of the Swiss Federal Tribunal on the admissibility of a subsidiary set-off defense in state court proceedings appears to be widely undisputed among Swiss legal scholars.³⁵

It is especially also acknowledged that (i) the set-off declaration as a right to extinguish the main and countervailing claim (“*Verrechnungserklärung*”) and (ii) the set-off defense in legal proceedings (“*rechtsaufhebende Einwendung*”) are two different manifestations of will which must be distinguished.³⁶

³⁴ Decision 4A_290/2007, ¶ 8.3.1 (with further references) (Swiss Federal Tribunal) (Dec. 10, 2007) (informal translation) (Original wording in French: “Il convient de distinguer la déclaration de compensation (*Verrechnungserklärung*), qui est adressée au créancier et qui entraîne l’extinction des dettes compensées dans la mesure fixée à l’art. 124 para. 2 CO, de l’objection de compensation (*Verrechnungseinwendung*), qui est adressée au juge en vue d’introduire la question de la compensation dans le procès (sur cette distinction, cf. Viktor Aepli, *Commentaire bernois*, n. 117 des remarques préliminaires aux art. 120-126 CO). Les deux manifestations de volonté peuvent certes être concomitantes, mais elles ne le sont pas nécessairement. La validité de la première relève du droit matériel, celle de la seconde du droit de procédure. [...]. Cette objection peut aussi n’être soulevée qu’à titre éventuel. Il en va ainsi lorsque le compensant conteste la demande et, pour le cas où ses arguments seraient rejetés, fait valoir subsidiairement la compensation déclarée antérieurement ou dans le procès comme moyen supplémentaire [...]”).

³⁵ See ZELLWEGER-GUTKNECHT, *supra* note 13, ¶ 185 to art. 120-126; PETER, *supra* note 27, ¶ 3 to art. 124; SCHALLER, *supra* note 9, ¶¶ 914-915; ZIMMERLI, *supra* note 1, at 113; HEIDI KERSTIN JAUCH, AUFRECHNUNG UND VERRECHNUNG IN DER SCHIEDSGERICHTSBARKEIT, EINERECHTSVERGLEICHENDE STUDIE DEUTSCHLAND / SCHWEIZ 55 (2001).

³⁶ See SCHALLER, *supra* note 9, 532-544 for an in-depth discussion.

The same is true, in principle, for the laws of other civil law jurisdictions, such as Germany³⁷ and Austria.³⁸

To the best of the authors' knowledge, there has been no specific legal literature on whether or not the opinion of the Swiss Federal Tribunal also applies to Swiss international arbitration proceedings.³⁹

iii. Analysis

Considering the mentioned state of the discussion, two issues require further analysis: First, is the legal reasoning of the Swiss Federal Tribunal for state court proceedings also valid for international arbitration proceedings? Second, is the legal reasoning of the Swiss Federal Tribunal entirely consistent?

In the view of the authors, the first question must be answered in the affirmative. Subsidiary set-off defenses should also be admitted in Swiss (and applicable *mutatis mutandis* in other) international arbitration proceedings, using the concept developed by the Swiss Federal Tribunal by analogy, for the following reasons: First, the Swiss *lex arbitri* for international arbitration proceedings does not provide for any divergent rule that would justify any separate approach for arbitral proceedings. Second, the respondents in arbitral proceedings have the very same needs and interests in submitting subsidiary set-off defenses as in state court proceedings.⁴⁰ Third, state courts and arbitral tribunals are both authoritative decision making bodies that can be addressed by the parties. Hence, the authors are of the view that a subsidiary “*set-off defense (Verrechnungseinwendung) which is addressed to the judge*”⁴¹ must also be admissible in international (and domestic) arbitration proceedings.

With respect to the second question, the authors note that the Swiss Federal Tribunal states: “*This set-off defense can also be submitted as a merely subsidiary defense. This is the case when the defendant contests the main claim and for the case that all his arguments are going to be dismissed, he submits subsidiarily either a previously made set-off declaration, or submits such a declaration in the proceedings as an additional legal remedy.*”⁴² It is reasonable to say that it must be admissible for a respondent to declare subsidiary and thus conditional set-off defense vis-à-vis the arbitrator (or judge) in legal proceedings. Otherwise, a respondent would, in a first procedure, have to contest the main claim and if it is not successful, it would, in a second procedure, have to claim for its countervailing (set-off) claim. This is not a cost-effective solution and the legal reasoning of the Swiss Federal Tribunal rightly appears to take this problem into account.

At the same time, the Swiss Federal Tribunal also refers to the situation where “*a previously made set-off declaration*” exists, when addressing the possibility of subsidiary set-off defenses.⁴³ This

³⁷ SEBASTIAN STOLZKE, AUFRECHNUNG UND WIDERKLAGE IN DER SCHIEDSGERICHTSBARKEIT IN: SCHRIFTENREIHE DER DEUTSCHEN INSTITUTION FÜR SCHIEDSGERICHTSBARKEIT, GERMAN INSTITUTION OF ARBITRATION 86 (2006).

³⁸ KOLLER, *supra* note 14, at 40.

³⁹ For a discussion from a German point of view, see STOLZKE, *supra* note 37, at 88.

⁴⁰ See above section II.B.i.

⁴¹ See above section II.B.ii.

⁴² *Id.*

⁴³ *Id.*

distinction of the Swiss Federal Tribunal between a set-off declaration made before the initiation of the proceedings on one hand and a procedural set-off defense only raised in the proceedings on the other, is perfectly accurate from a procedural point of view.

The authors understand the distinction of the Swiss Federal Tribunal as follows: in a situation where a set-off has been declared before the initiation of the proceedings, the respondent will (if the set-off is successful), most probably lose its principal position from a substantive point of view because any unconditional set-off, which was declared before the initiation of legal proceedings, implies acknowledgment of the countervailing claim (i.e. the main claim in the legal proceedings).⁴⁴

In the authors' opinion, the distinction of the Swiss Federal Tribunal cannot mean that the unconditional character of a set-off declared before the initiation of the proceedings, could be reversed in legal proceedings. This would be in blatant contradiction to the firm principles of Swiss law regarding transformation rights.⁴⁵

The authors further understand the Swiss Federal Tribunal's findings in the way that the subsidiary set-off defense is only declared vis-à-vis the judge or the arbitrator, but not vis-à-vis the counterparty. Only once the main claim is found to be justified and the subsidiary set-off defense is effectively considered by the judge or the arbitrator, it is also deemed as declared vis-à-vis the counterparty. Following this understanding, the authors conclude that the Swiss Federal Tribunal's argumentation, which justifies subsidiary set-off defenses in legal proceedings, is consistent in the above discussed manner.

iv. Conclusion

A clear distinction must be drawn between (i) substantive set-off declarations addressed to the counterparty before the initiation of the proceedings and (ii) procedural set-off defenses addressed to the judge or arbitral tribunal. The former are unconditional and imply an acknowledgment of the main claim as a matter of substantive law. The latter may be submitted as a subsidiary defense (and thus subject to the findings of the decision maker on the main claim) in state courts and/or arbitration proceedings.

However, in situations in which an unconditional set-off declaration was already expressed vis-à-vis the counterparty before the initiation of the proceedings, the subsidiary procedural submission of a set-off defense does not affect (or even reverse) the unconditional effect of the acknowledgment of the main claim pursuant to the substantive law.

C. Arbitral Jurisdiction for Set-Off Claims

i. Starting Position

The arbitration agreement is the foundation of the arbitrators' jurisdiction.⁴⁶

⁴⁴ See above section II.A.ii.

⁴⁵ See above section II.B.i.

⁴⁶ BLACKABY, *supra* note 19, ¶ 2.01; GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION 250 (2d ed., 2014); POUDRET & BESSON, *supra* note 1, ¶ 149.

According to the Swiss Tribunal Federal, the *essentialia negotii* of the arbitration agreement are as follows:⁴⁷

An arbitration clause is an agreement by which two determined or determinable parties agree to submit one or several existing or future disputes to the binding jurisdiction of an arbitral tribunal to the exclusion of the original state jurisdiction, on the basis of a legal order determined directly or indirectly (BGE 130 III 66 at 3.1 p. 70). It is decisive that the intention of the parties should be expressed to have an arbitral tribunal, i.e. not a state court, decide certain disputes (BGE 129 III 675 at 2.3 p. 679 ff).

It follows that the general rule for commercial arbitration goes: No arbitration agreement – no arbitral jurisdiction.⁴⁸

At the same time, the Swiss Federal Tribunal also developed the principle of “*le juge de l'action est le juge de l'exception*” (in English: *the judge of the main claim shall also be the judge of any objections thereto*). According to this concentration principle, the judicial body having jurisdiction over the main claim also has jurisdiction over the objections and defenses against such claim.⁴⁹

The two aforementioned fundamental principles stated by the Swiss Federal Tribunal are in conflict with each other: The requirement of a clear intention by the parties to refer a dispute to arbitration may frequently conflict with the principle of “*le juge de l'action est le juge de l'exception*”, namely, in all cases where set-off defenses are not covered by the same or a similar arbitration agreement.

ii. State of Discussion

As already pointed out at the outset, there has been a lively discussion on whether or not an arbitral tribunal has jurisdiction over a set-off claim, although such claim does not fall within the scope of the arbitration agreement (or an arbitration agreement with similar content as the arbitration agreement covering the main claim).

When approaching the issue from a Swiss legal perspective, it is first noted that Chapter 12 of the Swiss PILS lacks any provisions addressing the issue of jurisdiction of the arbitral tribunal

⁴⁷ BGE 138 III 29, ¶ 2.2.3 (Swiss Federal Tribunal) (Nov. 7, 2011) (informal translation).

⁴⁸ Similarly, Redfern and Hunter hold that there must be a clear intention of the parties to resolve their disputes by arbitration, *see* BLACKABY, *supra* note 19, ¶ 2.76. According to Redfern and Hunter, the arbitration agreement confers a mandate upon the tribunal to decide specific disputes within the scope of the arbitration agreement. If the arbitral tribunal goes beyond this mandate, it risks the future recognition and enforcement of the arbitral award; *see* BLACKABY, *supra* note 19, ¶ 2.63. Such risk would particularly exist in the presently discussed set-off constellations, if the countervailing set-off claim would be considered as being beyond the scope of the arbitration agreement. In this regard, Born points out that the objection to the jurisdiction of the arbitral tribunal (presently due to the lack of consent to submit the countervailing set-off claim to a specific arbitration) must be raised at the commencement of the proceedings. Otherwise, there would be a tacit consent through participation in the proceedings; *see* GARY B. BORN, INTERNATIONAL ARBITRATION: LAW AND PRACTICE 74 (2d ed., 2016); BORN, *supra* note 46, at 2222. To understand the Swiss Federal Tribunal's practice in an international context, see Born on the issues of lack of consent to arbitrate and scope of the arbitration agreement in BORN, *supra* note 46, at 763-767 and 1331-1332 (with specific reference to the Swiss Federal Tribunal's practice).

⁴⁹ Decision 85 II 103, ¶ 2.b (Swiss Federal Tribunal) (May 5, 1959) (“[...] il incombe en principe à l'autorité chargée de statuer sur la prétention principale de se prononcer sur l'existence de la créance opposée en compensation: le juge de l'action est le juge de l'exception”).

over set-off claims.⁵⁰ Consequently, arbitral tribunals in international arbitration proceedings have to examine whether the parties explicitly agreed on this issue, be it directly by a provision in the arbitration agreement or by reference to institutional arbitration rules.⁵¹

In general, there are three types of institutional arbitration rules:⁵²

rules restricting set-off to cross-claims covered by the same arbitration agreement, rules conferring jurisdiction upon the arbitral tribunal to decide on set-off claims irrespective of jurisdictional provisos of the cross-claim and rules not addressing set-off.

Article 3 paragraph 2 of the 2009 AAA/ICDR International Arbitration Rules, which restricts the arbitral tribunal's jurisdiction over set-off claims, falls under the first type of rule.⁵³ Article 21 paragraph 5 of the 2012 Swiss Rules follows the liberal approach and confers jurisdiction upon the arbitral tribunal to decide on set-off claims and falls under the second type.⁵⁴ However, the majority of the institutional arbitration rules fall under the third type of rules: the 2010 UNCITRAL Arbitration Rules,⁵⁵ the 2013 VIAC Rules of Arbitration,⁵⁶ the 2014 ICC Rules of Arbitration,⁵⁷ the 1998 DIS Rules,⁵⁸ the 2014 LCIA Arbitration Rules,⁵⁹ or the 2016 ICA Rules of Arbitration,⁶⁰ to name just a few. All these rules do not give an answer as to whether the arbitral

⁵⁰ BERGER, *supra* note 5, ¶ 526; POUDRET & BESSON, *supra* note 1, ¶ 322. According to Jauch and Zimmerli, the lack of a provision addressing the issue of set-off in Chapter 12 of the Swiss PILS was intentional; see JAUCH, *supra* note 35, at 158 and ZIMMERLI, *supra* note 1, at 129.

⁵¹ STACHER, *supra* note 13, ¶ 44 to art. 377; FELIX DASSER, BASLE COMMENTARY ON INTERNATIONAL PRIVATE LAW (Honsell et al. eds., 3d ed., 2013), ¶ 21 to art. 148; Berger, *supra* note 1, at 61.

⁵² KOLLER, *supra* note 21, at 70.

⁵³ AAA/ICDR International Dispute Resolution Procedures, Including Mediation and Arbitration Rules, Amended and Effective as of June 1, 2009, *see art. 3, ¶ 2 of the International Arbitration Rules* (“[...] a respondent may make counterclaims or assert setoffs as to any claim covered by the agreement to arbitrate [...]”). However, in the current version of the same rules, amended and effective as of June 1, 2014, the wording has been adapted so that only counterclaims have to be covered by the arbitration agreement, but not set-off claims (“[...] Respondent may make any counterclaims covered by the agreement to arbitrate or assert any setoffs [...]”).

⁵⁴ BERGER & PFISTERER, *supra* note 15, ¶ 32 to art. 21. For a discussion of the Swiss Rules *see also* PICHONNAZ & GULLIFER, *supra* note 1, ¶¶ 3.73-3.76; Maxi Scherer, *The Award and the Courts, Set-Off in International Arbitration*, in AUSTRIAN YEARBOOK ON INTERNATIONAL ARBITRATION 460 (Zeiler et al. eds., 2015).

⁵⁵ *See* 2010 UNCITRAL Arbitration Rules, art. 21, ¶ 3. The UNCITRAL Arbitration Rules are often applied in ad-hoc arbitration proceedings; Berger, *supra* note 1, at 64 (Klaus Peter Berger refers to the deliberations of the Working Group on the old UNCITRAL Rules and points out that the idea was to restrict the scope of the arbitration clause to set-off claims which arise out of the same contract as provided in the main claim. According to Klaus Peter Berger, the Working Group intended to deprive respondent of the possibility to unilaterally enlarge the arbitrator's jurisdiction). However, according to an analysis of the 2010 UNCITRAL Rules by Pichonnaz and Gullifer, the new wording “provided that the arbitral tribunal has jurisdiction over it” was a compromise. The idea was that the arbitral tribunal “could take account of the situation where the claim had been extinguished by the set-off”; *see* PICHONNAZ & GULLIFER, *supra* note 1, ¶¶ 3.63-3.69.

⁵⁶ VIAC Rules of Arbitration, art. 45 (2013) [*bereinafter* “VIAC Rules”].

⁵⁷ Set-off is merely implied in ICC Rules of Arbitration (2012), art. 36, ¶ 7 [*bereinafter* “ICC Rules”], a provision regarding the advance on costs of the arbitration. *See* PICHONNAZ & GULLIFER, *supra* note 1, ¶¶ 3.70-3.72.

⁵⁸ *See* GEORG VON SEGESSER & AILEEN TRUTTMANN, INTERNATIONAL ARBITRATION IN SWITZERLAND, A HANDBOOK FOR PRACTITIONERS 404 (Geisinger & Voser eds., 2013) (According to Von Segesser and Truttmann, the arbitral tribunal decides on the admissibility (i. e. jurisdiction) of a set-off claim by analogy to art. 10, ¶ 2 of the DIS Rules regarding counterclaim).

⁵⁹ 2014 LCIA Arbitration Rules, art. 2, ¶ 1(iii) [*bereinafter* “LCIA Rules”] (does not directly address the issue of jurisdiction over a set-off defense). *See* PICHONNAZ & GULLIFER, *supra* note 1, ¶¶ 3.77-3.78.

⁶⁰ Rules of Arbitration of the Indian Council of Arbitration (2016), art. 5, ¶ 1(iv) [*bereinafter* “ICA Rules”] (also does not directly address the issue of jurisdiction over a set-off defense).

tribunal has jurisdiction over set-off claims, if they are not governed by the same arbitration agreement as the main claim.

Thus, if neither an express agreement by the parties, nor reference to arbitration rules contain relevant provisions to resolve the issue, the arbitral tribunal must balance the principles of (i) clear intention of the parties to refer a dispute to arbitration and (ii) “*le juge de l'action est le juge de l'exception*”.⁶¹

When considering the question of jurisdiction over set-off claims, arbitral tribunals can rely on a great deal of scholarly writing that dates before 2011.⁶² However, the legal scholars at that time focused mainly on the substantive and procedural aspects of set-off, whereas the concept of “*le juge de l'action est le juge de l'exception*” has hardly been discussed in this context.⁶³

In the view of the authors, the legal situation (at least in Switzerland) has recently developed and authoritative sources of inspiration are available that should be considered; namely, the Swiss legislator made an express choice in 2011 regarding domestic arbitration, and also the Swiss Federal Tribunal made a statement in 2011:

First, before the Swiss Code of Civil Procedure [“**CCP**”] was introduced in 2011, the so-called Concordat on Arbitration [“**Concordat**”] had governed Swiss domestic arbitration proceedings. Article 29 of the Concordat provided that arbitral tribunals could only hear set-off defenses if all claims concerned were covered by arbitration agreements both having similar content.⁶⁴ Hence, the Concordat favored the principle that only claims covered by arbitration agreements could be admitted by arbitral tribunals. However, since 2011, the CCP has actually inverted the balance of the two principles: Article 377 CCP provides that the “*arbitral tribunal has jurisdiction to decide the set-off defence, even if the claim to be set off does not fall within the scope of the arbitration agreement or is subject to another arbitration agreement or an agreement on jurisdiction*”.⁶⁵ Hence, the Swiss legislator has explicitly chosen to favor the principle of “*le juge de l'action est le juge de l'exception*” in set-off situations.

Second, recent legislation of the Swiss Federal Tribunal suggests a similar approach: The highest Swiss judges held in an international arbitration matter in an *obiter dictum* that the principle of “*le juge de l'action est le juge de l'exception*” is increasingly also accepted in connection with set-off defenses in international arbitration.⁶⁶

⁶¹ See above section II.C.i.

⁶² Mourre, *supra* note 1, at 392; POUDRET & BESSON, *supra* note 1, ¶ 317; Schöll, *supra* note 1, at 122; ZIMMERLI, *supra* note 1, at 201; Bucher, *supra* note 1, at 97; Berger, *supra* note 1, at. 64; GROSS, *supra* note 1, at 37.

⁶³ See authors mentioned in *supra* note 62. Mourre, *supra* note 1, at 392 (Mourre refused to apply the principle of “*le juge de l'action est le juge de l'exception*” in the context of set-off claims saying that “the arbitrator's power does not directly derive from law, but from the parties' consent”).

⁶⁴ POUDRET & BESSON, *supra* note 1, ¶ 321.

⁶⁵ See the official translation of the Swiss Civil Procedure Code available at <https://www.admin.ch/opc/en/classified-compilation/20061121/index.html>.

⁶⁶ Decision 4A_482/2010, ¶ 4.3.1 (Swiss Federal Tribunal) (Feb. 7, 2011).

Based on these legal developments, recent Swiss publications rightly conclude that arbitral tribunals have jurisdiction over any set-off defenses that lead – if successful – to the substantive extinction of the main claim.⁶⁷

iii. Conclusion

Arbitral jurisdiction for set-off claims which lead to the substantive extinction of the main claim applies as a rule based on the principle “*le juge de l'action est le juge de l'exception*”.⁶⁸ However, arbitral jurisdiction for set-off claims which do not lead to the substantive extinction of the main claim most probably does not apply in the absence of any valid arbitration agreement for such a set-off claim.

At the same time, the Swiss legislator and Swiss legal scholars hardly seem to distinguish between the (i) unconditional substantive set-off declarations (addressed to the counterparty) and (ii) subsidiary procedural set-off defenses (addressed to the arbitral tribunal). This issue remains to be analysed particularly with a view to the problem of the separated advance on costs.

D. Advance on Costs for Set-Off Claims

i. Starting Position

In the case example described at the outset, the Respondent accepts jurisdiction of the arbitral tribunal. It submits a set-off defense to counter the main claim which is based on a previous unconditional set-off declaration vis-à-vis the counterparty. In the variation of the case, the Respondent only submits its set-off defense (which was not expressed previously) to the arbitral tribunal under the condition that the tribunal considers the main claim as justified (i.e. in a subsidiary manner, which is admissible pursuant to Swiss *lex arbitri*⁶⁹).

The Claimant is of the opinion that a separate advance on costs must be paid by the respondent regarding the set-off defense. The claimant argues that if such advance is not paid, then the arbitral tribunal shall decline its jurisdiction over the set-off claim.

Submission of a set-off claim by the respondent typically leads to an increase in the workload of the arbitral tribunal. This means that more time has to be spent by the arbitrators to assess the case. Together with the amount in dispute, time is increasingly becoming one of the decisive factors when the arbitrators' and the institution's fees are fixed.⁷⁰ The workload of the arbitrator can significantly increase if the arbitrator needs to assess an additional claim based on a legal relationship which differs from that of the main claim. The ICC Rules, for example, provide for the following provision in these situations: “[...] set-off shall be taken into account in determining the advance to cover the costs of the arbitration in the same way as a separate claim insofar as it may require the arbitral tribunal to consider additional matters”.⁷¹ Other major arbitration rules take a similar

⁶⁷ BERGER, *supra* note 5, ¶ 522; STACHER, *supra* note 13, ¶ 2 to art. 377; PICHONNAZ & GULLIFER, *supra* note 1, ¶¶ 3.49 3.61; MARKUS SCHOTT & MAURICE COURVOISIER, BASLE COMMENTARY ON INTERNATIONAL PRIVATE LAW ¶ 85 to art. 186 (Honsell et al. eds., 3d ed., 2013); BERNHARD BERGER, BERNE COMMENTARY ON CIVIL PROCEDURE CODE, VOLUME I ¶ 56 to art. 17 (2012).

⁶⁸ See above section II.C.ii.

⁶⁹ See above section II.B.iii.

⁷⁰ BLACKABY, *supra* note 19, ¶ 4.24.

⁷¹ ICC Rules, art. 36, ¶ 7.

approach.⁷² It follows that introduction of set-off claims, which require the arbitral tribunal to consider additional matters, increase the amount of the advance on costs to be provided by the parties.

If the respondent does not participate in the pre-financing of the arbitration proceedings, the claimant may resort to Article 36 paragraph 3 of the ICC Rules and request the institution to “fix separate advances on costs for the claims and the counterclaims”. If the request is granted, each party has to pay the advance on costs for its respective claims and set-off claims.

If separate advances are ordered by the institution and the respondent definitely refuses to pay the separate advance for the set-off claim, such claim is considered as withdrawn.⁷³ At the same time, if the main claim did not exist anymore as a matter of substantive law (due to a valid set-off), the arbitral tribunal would have to award a non-existing claim.

In such a scenario, the arbitral tribunal is in a delicate situation: it either assesses the set-off defense without being paid for its efforts, or it does not deal with the set-off defense and risks awarding a claim which was extinguished in the past as a matter of substantive set-off.

ii. State of Discussion

There has been little discussion on the effect of set-off on the advance of costs.⁷⁴

Swiss scholars submit that separate advances on costs are rarely appropriate in cases of a set-off defense, because the set-off defense “entails [an] automatic extinction of the main claim when it is validly raised” according to Swiss law.⁷⁵ They suggest that the set-off defense “as a rule, must be considered even if the respondent fails to pay its share of the advance”⁷⁶.

In contrast, a German author submitted in the 1990s that by referring to the ICC Rules, “the parties agree that the set-off shall only be entertained by the tribunal if the advance for the set-off has been paid”⁷⁷. It has also been stated by scholars that the unrestricted admission of jurisdiction over a set-off defense could “frighten the claimant into settlement and add immediate financial burdens through the arbitral advance on costs”⁷⁸.

⁷² Swiss Rules, Appendix B, art. 2, ¶ 4; VIAC Rules, art. 44, ¶ 6.

⁷³ ICC Rules, art. 36, ¶ 6.

⁷⁴ For a general introduction on the topic of advance on costs, see BORN, *supra* note 46, at 2247.

⁷⁵ Micha Bühler & Marco Stacher, *Costs in International Arbitration*, in ARBITRATION IN SWITZERLAND, THE PRACTITIONER'S GUIDE ¶ 32 (Arroyo ed., 2013); MARCO STACHER, SWISS RULES OF INTERNATIONAL ARBITRATION, COMMENTARY ¶ 11 to art. 41 (Zuberbühler et al. eds., 2d ed., 2013); BERGER & PFISTERER, *supra* note 15, ¶ 16 to art. 19.

⁷⁶ Bühler & Stacher, *supra* note 76, ¶ 11 to art. 41.

⁷⁷ Berger, *supra* note 1, at 81; see also Klaus Peter Berger, *Die Aufrechnung im Internationalen Schiedsverfahren*, in RECHT DER INTERNATIONALEN WIRTSCHAFT 431 (Wegerich & Baumgärtner eds., 1998). See also PITTEL, LA COMPÉTENCE DU JUGE ET DE L'ARBITRE EN MATIÈRE DE COMPENSATION, ÉTUDE DE DROIT INTERNE ET INTERNATIONAL ¶ 344 (2001).

⁷⁸ Michael Pyles & Jeff Waincymer, *Multiple Claims in Arbitration Between the Same Parties*, 14 ICCA Congress Series 484 (2009) (Paper presented at Van Den Berg: 50 Years of the New York Convention: ICCA International Arbitration Conference).

iii. Analysis

In the view of the authors, the distinction made by the Swiss Federal Tribunal between (i) unconditional substantive set-off declarations (solely addressed to the counterparty) and (ii) subsidiary procedural set-off defenses (addressed – initially – solely to the arbitral tribunal)⁷⁹ is of considerable significance to the present issue:

1. In the first case, the party declaring unconditional set-off acknowledges the main claim as a matter of substantive law.⁸⁰ It takes the risk that the (acknowledged) main claim will be awarded, while the potentially disputed countervailing claim may not be awarded (e.g. for lack of evidence).
2. In the second case, the party declaring the subsidiary set-off (i.e. set-off only under the condition that the main claim is found to be justified by the tribunal, without initially declaring unconditional set-off vis-à-vis the counterparty) *avoids* the risk of the first case. Indeed, this party uses the services of the arbitral tribunal precisely in order to avoid the risk that the main claim will be considered as acknowledged (and thus awarded), while the set-off claim may be dismissed as unproven. In this scenario, at the moment of the award, the arbitral tribunal shall only consider the set-off claim if both claims are justified, but it shall not consider the set-off claim if the main claim is not justified *per se*. The party addressing the arbitral tribunal in this manner primarily relies on procedural law, and only relies on substantive law under the mentioned condition that both claims are justified.⁸¹ This makes an important difference compared to the first situation of an unconditional set-off declaration.

Consequently, the test of whether a set-off defense is stated in an unconditional manner or whether it is stated as a subsidiary position and thus as a conditional defense, shows whether a party exclusively relies on substantive law or whether it relies on procedural law in the first place. This test, which the authors propose to refer to as “Conditionality Test”, is helpful in finding an appropriate solution for the present issue of the separated advances on costs in case of set-off.

It is widely undisputed that the refusal to pay advances on costs results in *procedural* consequences: In situations of separate advances, the claims or set-off defenses of a party which fails to pay its advance are typically not heard and dealt within the relevant proceedings.⁸² At the same time, the authors are not aware of any scholarly opinion, pursuant to which the non-payment of an advance would affect the substance of a claim. Therefore, the non-admissibility of the set-off in the mentioned second scenario would not lead to a substantial deprivation of the respondent in the sense that it could assert its set-off claim anytime again in the future, except from the on-going proceedings.

⁷⁹ See above section II.B.ii.

⁸⁰ See above the Decision of the Swiss Federal Tribunal in section II.B.ii.

⁸¹ *Id.* See for a different understanding, STACHER, *supra* note 13, ¶ 2 to art. 377 (Stacher holds that the existence of the main claim depends on the countervailing set-off claim. Stacher submits that the set-off defense has to be decided as a preliminary issue by the arbitral tribunal).

⁸² See, e.g., ICC Rules, art. 36, ¶ 6; Swiss Rules, art. 41, ¶ 4; DIS Rules, art. 25; VIAC Rules, art. 42, ¶ 3 and ICA Rules, art. 3, ¶¶ 3 and 4.

Against this background, the “Conditionality Test” offers a reasonable solution for the issue on the advance on costs in case of set-off as defined herein above:⁸³

1. If a party declares unconditional set-off exclusively based on substantive law, the arbitral tribunal needs to consider the potential extinction of the main claim based on substantive law irrespective of any advance payments. Otherwise, the tribunal might award a non-existing (main) claim which appears to be unreasonable and may prove difficult to be corrected at a later stage.⁸⁴
2. However, if a party exclusively declares subsidiary set-off, it relies on procedural law in the first place and addresses the arbitral tribunal⁸⁵ *in order to improve its own position* in the proceedings.⁸⁶ In such a situation, the main claim has not been extinct as a matter of substantive law, yet. Only if the arbitral tribunal – based on procedural law – considers the subsidiary set-off defense as requested by the respective party, the extinguishing effect based on substantive law is triggered (most probably only at the moment when the award is rendered; in German “Urteilszeitpunkt”). In other words, the party declaring a subsidiary set-off requests an activity by the tribunal based on procedural law. Consideration of such a procedural request may well depend on an advance payment as the substantive extinction of the main claim will *not* be effected if the arbitral tribunal remains inactive.

iv. Conclusion

Consequently, judicial consideration of substantive and unconditional set-off declared before the time of the award must *not* depend on any advance payments. The arbitral tribunal has to take it into consideration, irrespective of any advance payments. At the same time, it is the view of the authors that judicial consideration of a merely subsidiary set-off defense based on procedural law may well depend on an advance payment as foreseen in many institutional arbitration rules.

III. Final Conclusions and Recommendations

A. The “Conditionality Test” is Helpful in International Arbitration

Based on the above analysis, the authors are of the view that the “Conditionality Test”, namely the distinction between (i) conditional and (ii) unconditional set-off declarations, is reasonable in order to distinguish two entirely different types of set-off in international arbitration. Thereby, it makes no difference whether the source of one or the other type of set-off is common law, civil law, and whether it is of procedural or substantive legal nature.

⁸³ See section II.D.i (above).

⁸⁴ For similar opinions, see BERGER & PFISTERER, *supra* note 15, ¶ 16 to art. 19; STACHER, *supra* note 72, ¶ 11 to art. 41 (Berger, Pfisterer and Stacher hold that if separate advances for set-off situations are to be allowed, set-off defenses would have to be considered in any case as they automatically entail extinction of the main claim as a matter of substantive law). *But see* PITTEL, *supra* note 78, ¶ 344; Berger, *supra* note 1, at 81 (Pittet and Kl. P. Berger are of the contrary opinion that the arbitrators can disregard the set-off if no separate advance on costs is paid, irrespective of whether the set-off was declared during or prior to the arbitration). *See also* DASSER, *supra* note 52, ¶ 28 and AEPLI, *supra* note 13, ¶ 118 to art. 120 (Dasser and Aepli are of the opinion that in general, it is irrelevant whether set-off has been declared prior or during the proceedings. However, these two authors do not specifically consider the situation of cost advance in set-off constellations, and merely make this statement with regard to the tribunal's jurisdiction.).

⁸⁵ See above the Decision of the Swiss Federal Tribunal in section II.B.ii.

⁸⁶ See above section II.D.iii.

The first unconditional type of set-off entails acknowledgment of the main claim and, therefore, reduces the subject matter of a dispute to the question of whether or not the set-off claim is justified. If so, the main claim is extinct. If not, the main claim still exists and must be awarded.

The second conditional type of set-off does *not* entail acknowledgment of the main claim and leaves all options open for the respondent. If the main claim is dismissed, respondent still has the option to pursue the set-off claim in separate legal proceedings.

While the unconditional type of set-off does not require an active role of the arbitral tribunal, the conditional type of set-off requires that the arbitral tribunal, at the moment of the award, makes the calculation of the set-off on behalf of the respondent. In consideration of the mentioned differences and, in particular, the benefits of a respondent who submits a conditional set-off defense, it appears to be reasonable to treat such a respondent differently from a respondent who submits an unconditional set-off defense.

Generally speaking, the unconditional set-off should be considered irrespective of any procedural requirements, while the conditional set-off, which requires actions of the arbitral tribunal, may well be tied to procedural requirements. The different treatment in the situation of the separated advances is one example, but there are likely to be additional ones.

To sum it up: the “Conditionality Test” offers a means to distinguish different types of set-off which have truly different legal effects. The said test might be particularly helpful in international arbitration proceedings as it offers a distinction that is valid irrespective of the different judicial traditions or the application of specific laws.

B. The Following Should be Considered by International Arbitration Practitioners

The first and foremost recommendation concerns – again – the issue of conditionality: Legal counsel should be aware that there are legislations in which set-off declarations lead to the irrevocable acknowledgment of a main claim if they are not expressed in legal proceedings together with an explicit statement that they are only made as a subsidiary submission.

The second recommendation concerns the issue of jurisdiction: The rule that “*the judge of the action is also the judge of the objection*” appears to gain ground in international arbitration. Therefore, counsel for respondents may want to positively ask their clients for potential cross claims even if they are subject to a different dispute resolution mechanism than the main claim.

The third recommendation concerns arbitral tribunals: When facing set-off defenses in connection with procedural impediments (such as the unpaid separate advance), it may be useful to consider whether or not the respondent requires any action from the arbitral tribunal. Only if this is the case, the respondent needs to comply with procedural rules in order to make the set-off perfect.