

# SET-OFF IN INTERNATIONAL ARBITRATION — WHAT CAN THE ASIAN REGION LEARN?

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## A. INTRODUCTION

It has become almost trite to mention the enormity of the Internet as a repository for our collective knowledge. However, it is an interesting exercise to search the Internet for the purpose of understanding what is and is not at the forefront of our minds. A 'Google' search of the words 'Notice of Arbitration' returns around 8,150 results; 'Statement of Claim' around 122,000 and 'Defence' around 23,900,000. Contrast this with a search of 'Set-off Defence' which returns a mere 74 entries.<sup>1</sup> It is immediately acknowledged that this is far from reliable empirical evidence but it does at least serve to demonstrate one of this article's primary contentions that 'set-off defences' as a legal topic generally, but particularly in the context of international arbitration,<sup>2</sup> requires considerable exploration.

The United Nations Commission on International Trade Law ('UNCITRAL') first suggested this area warranted further consideration at its Thirty-Second

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1 All searches were conducted on 9 May 2005.

2 Searching both 'set-off defence' and 'international arbitration' reduces the results further to only 21 in number.

Session in 1999 and since then has continually referred to it as a topic for further research.<sup>3</sup> In a report on UNCITRAL deliberations in the field of international arbitration in 2000, Sorieul advised:

It was explained that sometimes in an arbitral proceeding the respondent would invoke a claim that the respondent would have against the claimant, not as a counter-claim, but as a defence for the purpose of a set-off. It was noted that, whereas it was often assumed that a claim raised for the purpose of a set-off had to be covered by the arbitration agreement, there existed rules (such as the International Arbitration Rules of the Zurich Chamber of Commerce, Article 27) that were less restrictive in that they provided that the arbitral tribunal also had jurisdiction over a set-off defence even if the claim that was set-off did not fall under the arbitration clause.

Views were expressed that it was generally regarded as a sound rule that an arbitral tribunal could take up a claim only if the claim was covered by the arbitration agreement and that, therefore, the consideration of the matter was unlikely to be productive. It was agreed that the topic should be accorded low priority.<sup>4</sup>

The soundness of the rule referred to is considered below, but it is only one of a number of aspects that must be considered. It is, therefore, unfortunate that UNCITRAL appears to have focused on this one point to determine that the issue as a whole deserves a low priority.

Berger has suggested that '[t]he reason why arbitral institutions, domestic legislatures and the UNCITRAL Working Group alike are reluctant to deal with set-off in the context of international arbitration is rooted in the particular nature of this legal institution'.<sup>5</sup> The nature to which Berger refers is the long running battle over whether a right of set-off is a procedural or substantive defence. Arbitral tribunals almost certainly have jurisdiction to hear all substantive defences, but may require extra authorisation to hear a procedural defence.<sup>6</sup>

This article begins with that debate. It examines the concept of a set-off defence, noting in particular the differences between the common law and civil

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3 See, *eg*, the various Working Group II reports on the UNCITRAL website <<http://www.unictral.org/en-index/htm>>.

4 Renaud Sorieul, 'Update on Recent Developments and Future Work by UNCITRAL in the Field of International Commercial Arbitration' (2003) 17(3) *Journal of International Arbitration* 163–184.

5 Klaus Peter Berger, 'Set-Off in International Economic Arbitration' (1999) 15(1) *Arbitration International* 53 at 54.

6 Peter Aeberli, 'Abatements, Set-offs and Counterclaims in Arbitration Proceedings', available online at <<http://www.aeberli.co.uk/articles/setoff.pdf>> p 2 (accessed 27 July 2005); see also Berger, *id* at 71.

law understandings, and its relationship to counterclaims. Part C then focuses on the treatment of set-off defences in a variety of international arbitral rules. The article then concludes with Part D which, after considering the earlier parts, suggests a number of proposals that may be adopted by institutions and arbitrators from the Asian region.

## B. UNDERSTANDING SET-OFF DEFENCES

*‘Rules are not necessarily sacred, principles are.’<sup>7</sup>*

During 2000 in a paper prepared for the Working Group for International Commercial Contracts for the new International Institute for the Unification of Private Law (‘UNIDROIT’) set of rules, Professor Jauffret-Spinosi highlighted the confusion that parties face in the context of contractual interrelationships:

The development of international commercial trade has created an assortment of Contractual interrelationships. It is no longer unusual for a party to find himself being at the same time both the creditor and the debtor to another party. The question arises whether the debt owed and the debt owing should be considered independent of each other, with each debtor obligated to perform without taking into account the existence of the debt owed to him, or whether one may consider the two debts linked because of their reciprocal nature?<sup>8</sup>

This confusion is somewhat tempered by the general recognition of a doctrine of set-off by most legal systems. At its most basic, this is a mechanism linking the reciprocal debts of two parties, thereby avoiding the need to make two overlapping payments.<sup>9</sup> Whilst this definition is relatively straightforward, the legal understanding of set-offs is not. Often considered as one of the most intricate legal institutions,<sup>10</sup> the doctrine of set-offs is plagued by complexity and arguably a lack of detailed academic attention specifically in relation to international arbitration.

The complexity of set-offs is largely derived from the fact that it is a legal doctrine which suffers from distinct treatment depending on which international legal system one is examining. This complexity is further amplified by the confusing treatment of set-offs within those legal systems.

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7 Franklin D Roosevelt (Thirty-Second President of the United States of America, 1933–1945), at <[http://en.thinkexist.com/quotation/rules\\_are\\_not\\_necessarily\\_sacred-principles\\_are/152433.html](http://en.thinkexist.com/quotation/rules_are_not_necessarily_sacred-principles_are/152433.html)> (accessed 28 July 2005).

8 Professor Camille Jauffret-Spinosi, ‘Set-off’ (2000), Paper prepared for the Working Group for the International Commercial Contracts, Meeting of the Drafting Group in Freiburg, 17–20 January 2001, p 2.

9 See ‘Discussion Paper 40: Set-Off’ (1998), Law Reform Commission New South Wales; Jauffret-Spinosi, ‘Set-off’ (2000), *supra*, n 8.

10 Berger, *supra*, n 5 at 53.

While an analysis may suggest that the difference in treatment of set-offs between common and civil law countries is gradually becoming blurred, this paper will consider the observable differences.

### 1. *Set-off Defences in Common Law*

In common law jurisdictions, set-off is divided into two categories, namely set-off by law and equitable set-off. 'Set-off at law' is a purely procedural defence, which merely links the reciprocal debts of both parties to achieve a balance, whereas equitable set-off operates as a substantive defence against the respondent's liability to pay a debt otherwise due and may be invoked independently of any order of the court or arbitral tribunal.<sup>11</sup>

Set-off provided by law can be traced back to insolvency legislation in England in 1705.<sup>12</sup> In Australia, s 86 of the Bankruptcy Act 1966 (Cth) contains the modern equivalent:

- (1) Subject to this section, where there have been mutual credits, mutual debts or other mutual dealings between a person who has become bankrupt and a person claiming to prove a debt in the bankruptcy ... (b) the sum due from the one party shall be set-off against any sum due from the other party; ...

Meagher, Gummow and Lehane (in their capacity as academic authors) have identified four types of equitable set-offs in common law jurisdictions:

- (1) where equity recognises a right of set-off which exists at law;
- (2) where an equitable set-off exists by analogy with a legal set-off;
- (3) where an equitable set-off exists by agreement; and
- (4) where true equitable set-off can be said to exist.<sup>13</sup>

Despite the fact that the notion of set-off does appear to have a distinct common law lineage, it, like many legal doctrines in this modern age, has not escaped the influence of other legal systems. For example, in Australia equitable set-off does not require there to be a judgment debt, a position attributable to the influence of Roman law.<sup>14</sup>

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11 Berger, *id* at 57.

12 An Act for the Naturalization of the most Excellent Princess Sophia, Electress and Duchess Dowager of Hanover, and the Issue of Her Body (1705).

13 Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (3rd Ed, 1987), Butterworths, Sydney, in 'Discussion Paper 40: Set-Off', *supra*, n 9.

14 *Stehar Knitting Mills Pty Ltd v Southern Textile Converters Pty Ltd* [1981] 2 NSWLR 514 at 518, NSW (CA), per Hutley JA, in The Hon Arthur R Emmett, 'Roman Traces in Australian Law' (2001) 20 Australian Bar Review 1 at 3.

## 2. *Set-off Defences in Civil Law*

In civil law jurisdictions such as Japan, Korea, France and Germany, set-offs are generally treated as part of the sphere of substantive law and are recognised as a defence against a claim, not a counter-attack.<sup>15</sup> The development of set-offs as a legal principle in civil law countries stemmed from the recognition of set-off as a generally acknowledged remedy of Roman law.<sup>16</sup> In his paper, Karrer succinctly demonstrates the treatment of set-offs by civil law countries:<sup>17</sup>

Generally, if a Respondent has a claim against Claimant that exceeds Claimant's alleged claim, Respondent may, as a defense, set-off his claim to the full extinction of Claimant's claim (to the extent that it would exist except for the set-off). Respondent may also counterclaim for the excess of his claim against Claimant that has not been extinguished by Respondent's declaration of set-off.

However, across civil law jurisdictions there is not a unitary treatment of set-offs in their operation. For example, in civil law countries such as Japan, Korea and Germany, set-offs are created by a voluntary election of a party as a form of securitisation of a debt.<sup>18</sup> Here the distinctive feature is that a set-off is invoked by unilateral declaration by a party and operates extra-judicially.<sup>19</sup> Parties to a contract have the freedom to declare that a set-off will operate automatically with the creation of a second reciprocal debt or can even exclude the right to a set-off by mutual agreement.

In comparison, in civil law countries such as France, Russia, Belgium and Spain, set-offs are effected *ipso jure*, that is arise automatically by operation of law. However, a party must still affirmatively assert its existence for it to be used in judicial proceedings.<sup>20</sup>

## 3. *Contrasting the Counterclaim*

It is not uncommon to find set-off defences referred to in the same paragraph as a counterclaim. An appreciation of the differences, however subtle they may be, can inform our understanding of the set-off defence. It is important

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15 Berger, *supra*, n 5 at 59. Civil law countries which recognise set-off as a part of substantive law include Germany, France, Russia, Belgium, Spain, Netherlands, Switzerland, Japan and Korea.

16 Pierre Karrer, 'Arbitration Saves! Costs: Poker and Hide-and-Seek' (1986) 3(1) *Journal of International Arbitration* at 38; Berger, *supra*, n 5.

17 Karrer, *ibid.*

18 See the German Civil Code (*Bürgerliches Gesetzbuch*), s 388.

19 Note: exceptions exist, *eg*, set-offs cannot be unilaterally invoked against damages awarded for intentional torts, *etc.*

20 See French Civil Code, art 1290.

to note here that there are different species of counterclaim. A counterclaim may be one for specific performance, it may be one for restitution of goods, or it may be one for money. It is this last species of counterclaim that bears a striking similarity to a set-off defence and which is discussed below.

The primary similarity between set-offs and counterclaims is that both are designed to avoid circuitry of action and both have the effect of linking reciprocal debts. However, there are distinct differences between the two mechanisms. A counterclaim is an instrument which will allow a respondent to raise an independent sub-claim, therefore creating the potential for two separate judgments. In comparison, a set-off defence will only allow a respondent to reduce the potential amount for which it is liable and will not allow a respondent to initiate a claim to recover in their own right. In essence, the life of a set-off is dependent on the main claim and if, for example, an arbitral tribunal finds that it does not have jurisdiction to hear the dispute a set-off will not be heard.

As Berger suggests:

Set-off, whether of substantive or a procedural quality, is not a device to attack but a mere defence of the respondent against the claimant's claim. It can be used only 'as a shield, not as a sword'.<sup>21</sup>

A traditional and generally accepted difference is that set-off defences are limited to the value of the claim whereas counterclaims are not.<sup>22</sup> However, the appropriateness of limiting set-off defences in this way should now be questioned. There are strong practical reasons for allowing the excess of a set-off to be awarded. First amongst those is procedural efficiency. In addition legislatures are beginning to recognise this utility; for example, within certain Australian jurisdictions judgment can be given in favour of the defendant for any excess.<sup>23</sup>

### C. REVIEWING THE RULES

*'Hell, there are no rules here — we're trying to accomplish something.'*<sup>24</sup>

Parties opting for arbitration have a choice between using an institution to administer the arbitration (institutional arbitration) or proceeding on an *ad hoc* basis. Whilst it is not within the scope of this paper to review why

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21 Berger, *supra*, n 5 at 56, citing *Stooke v Taylor* (1880) 5 QB 569 at 575.

22 Karrer, *supra*, n 16 at 40.

23 Jurisdictions include Victoria, Queensland, South Australia, Northern Territory and the Australian Capital Territory; cf Bernard Cairns, *Australian Civil Procedure* (6th Ed, 2005), Lawbook Co, p 213.

24 Thomas Edison (American inventor and industrialist, 1847–1931), at <[http://zaadz.com/quotes/authors/thomas\\_edison/](http://zaadz.com/quotes/authors/thomas_edison/)> (accessed 29 July 2005).

parties may prefer institutional arbitration to *ad hoc* arbitration, it is important to appreciate some of the reasons parties may tend towards the former.

An advantage of choosing an institutional arbitration may be that certain arbitral institutions may be known to parties by reputation, and that the parties might draw some comfort from that familiarity. Similarly, a party's legal counsel might be familiar with a particular institution. Additionally, one might also expect that arbitral institutions, which are in the business of administering arbitration, should be at the forefront of developments in arbitration. It is on the basis of this last hypothesis that we now turn to conduct a review of the treatment of set-off defences by the major international arbitral institutions by an analysis of their rules.

The rules of 34 different arbitral institutions that purport to conduct international arbitrations have been analysed. For the purposes of this article it is possible to group the various institutional rules into three categories: those that are based on the UNCITRAL Arbitration Rules; those that do not mention set-off defences at all; and those that specifically address set-off defences. The complete list of each category appears as Schedule A at the end of this article.

### 1. *Rules Based on UNCITRAL Arbitration Rules*

The UNCITRAL Arbitration Rules make a total of two references to the ability of a party to raise a set-off defence:

Article 19(3)

In his statement of defence, or at a later stage in the arbitral proceedings if the arbitral tribunal decides that the delay was justified under the circumstances, the respondent may make a counter-claim arising out of the same contract or rely on a claim arising out of the same contract for the purpose of a set-off.

Article 19(4)

The provisions of article 18, paragraph 2, shall apply to a counter-claim and a claim relied on for the purpose of a set-off.

The key expression to note in the UNCITRAL Arbitration Rules is 'arising out of the same contract'. This phrase is used in relation to both counterclaims and set-offs and, on a very strict and literal interpretation, may be problematic. It is interesting that the wording differs from the model arbitration clause that accompanies the UNCITRAL Arbitration Rules. That clause refers to claims 'arising out of or relating to'. The difference appears to have effectively gone unnoticed in the official commentaries. In the UNCITRAL Report of its Thirty-Second Session, the issue of set-offs is specifically discussed.<sup>25</sup> At para 76 the Commission notes:

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25 A/CN.9/460.

The UNCITRAL Arbitration Rules take a more restrictive position [than the Zurich Chamber of Commerce Rules] in that the respondent may rely on a claim for the purpose of a set-off if the claim arises out of the same contract (art.19). The Rules do not state expressly that the set-off claim must be covered by the same arbitration agreement as the main claim. If the parties have modelled the arbitration agreement on the model arbitration clause which appears in the footnote to article 1 of the Rules (and have thereby submitted to arbitration the disputes arising out of the contract), both the principal claim and the claim invoked for the purpose of a set-off would be covered by the same arbitration agreement.

The quoted paragraph above also contains a footnote in which the model clause is stated. It is curious, therefore, that despite specifically drawing attention to the words of the arbitration clause no comment is made of this difference. The difference is significant because the omission has the potential effect of limiting not only the available set-off defences but also counterclaims, which it is not believed would have been intended. Jurisprudence worldwide is littered with examples of judgments seeking to interpret a solitary word or a short phrase. In doing so, that phrase might be restated many times in many different ways using many different words. Thus, when draftsmen specifically identify alternatives it can reasonably be assumed that they are meant to mean different things. In this instance, 'arising out of' is not the same as 'relating to'. It is most certainly a narrower term. As an example the Australian courts have considered the differences in language of this kind at great length.

Allsop J of the Federal Court of Australia in *Incitec Ltd v Alkimos Shipping Corp*<sup>26</sup> considered this very point in detail. In that decision, his Honour undertook an analysis of various phrases used in arbitration agreements. Although lengthy, relevant parts of that decision are extracted below. The passage provides a convenient review of the Australian cases called upon to deal with this issue.

Before turning to the case law, it is apposite to note that this is a clause agreed between international commercial parties ... These participants in international commerce who did not share a common domestic legal system chose one of the leading dispute resolution centres in the world and one of the leading centres for maritime arbitration. ... No fact is apparent which would lead one to expect from the surrounding circumstances that the parties were intending any narrow construction to be given to the words or to conclude that the clause was directed to some part of the mutual commercial affairs of the parties reflected in the time charter, and not another.

The above considerations tend in favour of giving the words in question a wide or generous construction. The words ['in connection with'] also lead one to conclude that what was intended was a reach of some width and liberality.

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26 (2004) 206 ALR 558.

In *IBM Australia Ltd v National Distribution Services Ltd* (1991) 22 NSWLR 466; 100 ALR 361; 20 IPR 95 the New South Wales Court of Appeal considered the words ‘any controversy or claim arising out of or related to this agreement or the breach thereof’ in a domestic arbitration clause. It is unnecessary to examine the precise dispute in issue there. Kirby P (as his Honour then was) at NSWLR 472; ALR 366; IPR 100 noted the trend of judicial authority to give some width to arbitration clauses; his Honour noted the width of the words ‘related to’; and his Honour examined the relevant English and Australian authorities. His Honour was of the view that such a clause was not to be narrowly construed: at NSWLR 477; ALR 371; IPR 105. Clarke JA noted that the words ‘in relation to’ or ‘related to’ are of the widest import and should not, in the absence of compelling reason to the contrary, be read down: [emphasis in original] at NSWLR 483; ALR 377; IPR 111. Handley JA expressed similar views at NSWLR 487; ALR 381; IPR 115. *The same could be said about the words ‘or in connection with’, ...* [emphasis in original].

In *Paper Products Pty Ltd v Tomlinsons (Rockdale) Ltd* (1993) 43 FCR 439; 116 ALR 163 French J after reviewing *IBM* and other modern English and Australian authorities noted the profound change in the last quarter of the twentieth century in the relationship between the courts and arbitral procedures. French J expressed the view that with elastic words in an arbitration clause (such as here) a liberal approach to assessing what fell within them should be taken: see FCR 498; ALR 172. I respectfully agree.

In *Ethiopian Oilseeds & Pulses Export Corp v Rio Del Mar Foods Inc* [1990] 1 Lloyd’s Rep 86 Hirst J (as he then was) considered an arbitration clause using the words ‘out of or under the contract’. Hirst J reviewed the English authorities at 90ff, noting the wide construction given to ‘arising out of’ (at 95–6), which included claims in tort.

... *The words [‘arising out of’] are plainly wider than the expression of an intention to arbitrate only disputes over the terms of the time charter. To this extent what might be seen to be the narrower expression ‘arising from’ [emphasis in original] was not used: cf Hi-Fert Pty Ltd v Kiunkiang Maritime Carriers Inc* (1998) 90 FCR 1; 159 ALR 142.

The 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: see also *Ashville Investments Ltd v Elmer Contractors Ltd* [1989] QB 488; [1988] 2 All ER 577; *Dowell Australia Ltd v Triden Contractors Pty Ltd* [1982] 1 NSWLR 508 at 515; *Roose Industries Ltd v Ready Mixed Concrete Ltd* [1974] 2 NZLR 246; *Wealands v CLC Contractors Ltd* [1999] 2 Lloyd’s Rep 739; *Societe Commerciale de Reassurance v Eras International Ltd* [1992] 2 All ER 82.<sup>27</sup>

In light of this position, and, in particular, the emphasised passages above, the new rules of the Australian Centre for International Commercial Arbitration (‘ACICA Rules’) have addressed this issue. The ACICA Rules, while based on the UNCITRAL Arbitration Rules, have adopted different language in the model arbitration clause and the relevant art 22. In both instances, the phrase ‘arising out of, relating to or in connection with the contract’ is used.

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27 *Id* at 563–564.

Another slight variation in wording can be found in the rules of the Permanent Court of Arbitration attached to the Chamber of Commerce and Industry of Slovenia.<sup>28</sup> Article 30(1) states:

The defendant may file a counterclaim or raise a defence of set-off, provided such counterclaim or defence of set-off *arises out of a legal relation* covered by the arbitration agreement. [Emphasis added.]

Without intending to be overly pedantic about phraseology, this too is clearly broader than the original UNCITRAL version. Unfortunately, there does not appear to be any commentary on these rules, and, in particular, what motivated the difference.<sup>29</sup> It seems likely that phrased in this way art 30(1) would also overcome the potential drafting anomaly in the original UNCITRAL version referred to above.

One of the inherent advantages of international arbitration is the level of pragmatism that is both afforded and indeed expected of arbitrators.<sup>30</sup> For this reason arbitrators may be inclined to take a robust view and simply decide that, provided the counterclaim or set-off fall within the arbitration clause, then they can be heard. However, to provide a legal basis to that finding, the arbitral tribunal (or court as the case may be) would be called upon to determine whether the decision to use the rules implicitly varied the arbitration agreement — or whether the arbitration agreement varies the rules.

Although in the view of this author the latter approach should almost always be taken, reasonably persuasive arguments could be built for the former position. It is a generally accepted proposition that, unless otherwise stated, it is the rules in force at the time of submission that will apply to the arbitration.<sup>31</sup> By analogy, this could suggest that the wording of the rules takes priority. Additionally, parties will have at least constructive knowledge of the wording of the rules before incorporating them into their arbitration agreement. Therefore, if they had intended the scope of a specific rule to be varied, this should have been clearly noted.

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28 Available online at <<http://www.sloarbitration.org/english/introduction/rules.html>> (accessed 13 May 2005).

29 E-mail enquires were made of the Permanent Court of Arbitration attached to the Chamber of Commerce and Industry of Slovenia; however, these did not provide any indication.

30 See, *eg*, observations by Emmanuel Gaillard, 'The Role of the Arbitrator in Determining the Applicable Law' in *The Leading Arbitrators' Guide to International Arbitration* (Lawrence Newman and Richard Hill eds) (2004), Juris Publishing, p 185.

31 See, *eg*, the Singaporean case of *Jurong Engineering Ltd v Black & Veatch Singapore Pte Ltd* [2003] SGHC 292.

Whether an arbitral tribunal would readily accept what is essentially a very technical legal argument is uncertain. However, the mere possibility of confusion demonstrates the need for clarification. What is abundantly clear, however, when using the UNCITRAL Arbitration Rules is that the set-off defence must be connected in some way to the contract that is the subject of the main claim.

## ***2. Rules that Do Not Refer to Set-off Defences***

There were 15 sets of rules that made no mention whatsoever of set-off defences.<sup>32</sup> The Singapore International Arbitration Centre ('SIAC'), the London Court of International Arbitration ('LCIA'), the American Arbitration Association ('AAA'), and the German Institution of Arbitration ('DIS') are notable inclusions. Additionally, and very interestingly, the preponderance of institutional rules from the Asian region are found in this category. Intuitively this may suggest a cultural bias against the notion of a set-off. However, there is no empirical evidence to support this suggestion. Indeed, to the contrary, the right to set-off is considered a substantive right in many of these jurisdictions, pointing to a conclusion that it is quite well accepted.

By way of example and as alluded to above, it is well established in Japanese law that set-off is a substantive right:

The fundamental right of set-off under Japanese law is established by the Civil Code, which provides that, if two persons are bound to each other by obligations which are of the same kind (e.g., monetary obligations denominated in the same currency) and both of which are due, each obligor may be relieved of his obligation by set-off to the extent that such obligation does not exceed the obligation owed to such obligor.<sup>33</sup>

It appears relatively clear that the draftsmen of the rules in this category felt it unnecessary to deal with the set-off issue, or alternatively preferable to avoid it completely. This may in turn be a product of considering set-off to be a substantive issue which would be governed by the substantive law. One can only speculate, but, unfortunately, mere speculation is not particularly helpful to the inquiry.

Two points should be emphasised at this juncture. The mere fact that the substantive law of the seat of arbitration recognises set-offs as a substantive matter will not automatically mean it can be claimed in an arbitration.

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32 The Japanese Commercial Arbitration Association ('JCAA') Rules are included in this category although the institution expects to also administer arbitrations run in accordance with the UNCITRAL Arbitration Rules.

33 Yasuhei Taniguchi, 'Good Faith and Abuse of Procedural Rights in Japanese Civil Procedure' 8 *Tul J Int'l & Comp L* 167 at 177.

Secondly, the failure of institutional rules to mention a set-off defence would not in and of itself preclude a party from bringing one.

To elaborate, it would not be sufficient to simply argue that as the Japanese Civil Code specifically permits set-offs, a set-off defence would be available in any arbitration conducted where Japan is the nominated seat. The proposition is too broad. The *lex arbitri* does not encompass each and every law of the seat of an arbitration; it relates only to the arbitration laws of that seat.

Where the arbitral rules are silent on the matter, the party seeking to raise the set-off defence may be called upon to prove it is permitted to do so by the law of the seat of arbitration. In practice, this will often mean demonstrating that it is not barred as opposed to being positively permitted. Alternatively, the party may be able to argue that it is entitled to the defence pursuant to the substantive law of the contract. Either way, the failure of the arbitral rules to deal with the issue potentially adds an unnecessary layer of adjudication to the dispute.

### 3. *Rules that Specifically Refer to Set-off Defences*

It is interesting to note that those arbitral rules that do specifically address set-off defences do not do so in a particularly consistent fashion. There are a number that strongly (explicitly or implicitly) indicate that a set-off can only arise where it would also fall within the scope of the arbitration agreement.<sup>34</sup> This position reflects the 'sound rule' referred to by UNCITRAL and mentioned in the introduction to this article. This group, which comprises mainly Scandinavian institutions, is in sharp distinction to the Arbitration Court at the Economic Chamber of the Czech Republic.

Section 28(3) of the Czech Republic rules could be interpreted to state the exact opposite:

Provisions, governing the counter-claim shall be applied, *mutatis mutandis* to the defence of set-off raised by the defendants, provided such defence *is based on legal relations other than the main claim* of the Claimants. [Emphasis added.]

Perhaps the most radical treatment of set-off defences can be found in the relatively new Swiss Rules of Arbitration ('Swiss Rules').

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<sup>34</sup> Court of Arbitration at the Bulgarian Chamber of Commerce and Industry; The Arbitration Institute of the Central Chamber of Commerce of Finland; Arbitration Institute of the Stockholm Chamber of Commerce; Arbitration and Dispute Resolution Institute of the Oslo Chamber of Commerce; Court of Arbitration attached to the Hungarian Chamber of Commerce and Industry; and The Permanent Arbitration Court at the Croatian Chamber of Economy.

In 2003, the Chambers of Commerce of Basel, Bern, Geneva, Ticino, Vaud and Zurich agreed to adopt a unified set of arbitration rules which would replace the previous individual rules of the six Chambers of Commerce in Switzerland. The Swiss Rules came into force on 1 January 2004 and were intended to increase the attractiveness of Switzerland as a venue for settling disputes arising from international contracts.<sup>35</sup>

The Swiss Rules are predominantly based on the UNCITRAL Arbitration Rules; however, they do contain notable differences, in particular, art 21(5):

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.

This article purports to give an arbitral tribunal jurisdiction to hear a set-off defence even where the relationship from which the alleged defence arises is not within the scope of the arbitration clause. Furthermore, that defence may properly be the object of another arbitration or forum selection clause.

Commentators have suggested that an immediate observable advantage of art 21(5) is that it increases the effectiveness of arbitration by allowing for a broad jurisdiction with respect to set-off defences.<sup>36</sup> Others have applauded art 21(5) as a clarification that avoids the debate on the availability of such a defence where rules are silent on this point.<sup>37</sup>

However, there are also concerns about this feature of the Swiss Rules. Article 21(5) may give rise to disputes about the respective application of distinct and different dispute resolution mechanisms.<sup>38</sup> As noted above, the article attempts to potentially impose an arbitral tribunal's jurisdiction upon other contracts and legal relationships. In doing so, art 21(5) could be said to be to contrary to party autonomy.

From the review of existing arbitral rules in this part of the article, it can be seen that there does not yet appear to be a rule which adequately deals with the problems of set-offs in international arbitration.

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35 Urs Weber-Stehcer, 'Swiss Rules of International Arbitration — A Short Overview on the Arbitration Rules of the Chambers of Commerce and Industry of Switzerland of January 1, 2004' (Wenger & Vieli website, November 2004) available online at <[http://www.wengerlaw.ch/downloads/publications/pdf/en/wv-swiss\\_rules.pdf](http://www.wengerlaw.ch/downloads/publications/pdf/en/wv-swiss_rules.pdf)> (accessed 27 July 2005).

36 Matthias Scherer, 'New Rules on International Arbitration in Switzerland' (2004) 7(4) *International Arbitration Law Review* 119 at 123.

37 Laurence Burger, 'The New Swiss Rules of International Arbitration: A Comparative Analysis' 19(6) *Mealey's International Arbitration Report* (June 2004), pp 1–7.

38 Scherer, *supra*, n 36 at 123.

#### D. COMMENTS AND CONCLUSION

*'In words, as fashions, the same rule will hold,  
Alike fantastic if too new or old:  
Be not the first by whom the new are tried,  
Nor yet the last to lay the old aside.'*<sup>39</sup>

It has been suggested that:

arbitral institutions, domestic legislatures and the UNCITRAL Working Group, eager to ensure the 'user-friendliness' of their respective rules by ensuring a minimum of interference with domestic laws, have refrained from tackling the issue of set-off in international ... arbitration, where aspects of procedural and substantive law are inextricably intertwined.<sup>40</sup>

If this observation is accurate, it is a disappointing one. Rather than shying away, these bodies should be embracing the challenge, and institutions in the Asian region are particularly well placed to do so.

There are two principal concerns that arise from the general failure of institutions and legislatures alike to address this issue. First, if these bodies do not take the leadership on addressing complex issues such as set-off defences in international arbitration, there is a very real risk that those issues will never receive the attention they deserve. The second and more serious concern is the inference that those leading the development of arbitration do not consider the world of international commerce sufficiently sophisticated to deal with complex issues. This is a particularly serious charge and is raised only as an inference; by no means is it intended to suggest a deliberate or conscious approach. However, an observation such as the one quoted above demonstrates that it is not difficult to interpret elements of 'parental protection' into the decision to avoid the tough issues.

The job of drafting rules is not an easy one, and indeed made all the more difficult when dealing with complex issues. There are many competing factors that must be considered. Arbitral rules must be pitched at a level where both the initiated and uninitiated can fully utilise them. Innovation is extremely important but, at the same time, potentially controversial. Arbitral institutions are competitors. The rules of an institution is the product it sells, the administration of an arbitration is the service it provides — these must be marketable. To be a trailblazer is a difficult thing and in this regard the Swiss

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39 Alexander Pope (English poet, 1688–1744) at <[http://en.thinkexist.com/quotation/in\\_words-as\\_fashions-the\\_same\\_rule\\_will\\_hold/162067.html](http://en.thinkexist.com/quotation/in_words-as_fashions-the_same_rule_will_hold/162067.html)> (accessed 27 July 2005).

40 Berger, *supra*, n 5 at 54.

Rules are to be commended. However, as noted above, whilst the intent of the Swiss Rules is laudable, the approach taken is problematic.

It could be argued that the approach in the Swiss Rules is merely a sophisticated extension of UNCITRAL's 'sound rule' referred to in the introduction to this article. There is certainly a compelling logic to that rule. An arbitral tribunal, unlike a domestic court, is dependent upon the parties' agreement for jurisdiction. Often referred to as subjective arbitrability this is arguably one of the most fundamental tenets of arbitration. If the scope of the arbitration agreement is not wide enough to cover the set-off defence, then it cannot be raised. It is as simple as that — or is it?

If one adopts the view that the arbitral rules are effectively incorporated as terms into an arbitration agreement, then when choosing the Swiss Rules the parties are deliberately expanding the scope of their agreement. There appears to be nothing wrong with this legal reasoning.<sup>41</sup>

The difficulty with the Swiss Rules lies in the scope of the extension. The Swiss Rules themselves do not give any guidance in this regard, other than to rely on the meaning of the phrase 'set-off defence'. That any attempt to arrive at a general definition of that term is extremely problematic has already been discussed at length above. Furthermore, it is unclear where one should look for the appropriate definition. It would seem most appropriate to look to the law governing the arbitration agreement. This may or may not be the same as the substantive law governing the contract over which the parties may be in dispute. The doctrine of separability is now a well-recognised principle of international commercial arbitration.<sup>42</sup> Arbitration clauses, therefore, have a proper law unto themselves.<sup>43</sup> Once the governing law has been identified, terms such as 'set-off defence' should be interpreted in accordance with that body of law. As a result, a different meaning may be given to the term each time. While this arguably makes the rules quintessentially international, it also makes their application far from certain and predictable.

A better approach can be found partly by analogy to the research and practical developments into the scope of arbitration agreements. The expression 'partly by analogy' is used, as it is this article's contention that the ability to raise a set-off defence must, in any event, be within the scope of the

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41 Redfern and Hunter *et al*, *Law and Practice of International Commercial Arbitration* (4th Ed, 2004), Sweet & Maxwell, p 56 [1-100].

42 Horacio Grigera Naon, 'Choice of Law: Problems in International Commercial Arbitration' *Recueil des cours/Academie de Droit International*, Vol 289, pp 9–395 at 40.

43 See, for instance, Michael Pryles, 'Choice of Law Issues in International Arbitration' (1997) 63(3) *Journal of the Chartered Institute of Arbitrators* 200 at 202.

arbitration agreement. How one finds that to be the parties' intention is the challenge.

Blessing when discussing the 'Group of Contracts' doctrine observed:

The question arises whether the arbitration clause contained in only one contract is 'good enough' to cover the other contracts. A leading case is *Société Ouest-Africaine des Bétons Industriels (SOABI) v. Republic of Senegal*, [Case No ARB/82/1 (ICSID)] where the conclusion was that the arbitration clause contained in one contract had to be extended to the quite different contract between the same parties which pertained to one and the same project, thus forming a certain *unité économique*.<sup>44</sup>

... To make this kind of determination, the relevant contracts will have to be interpreted against the background of the entire landscape within which these contracts are situated, and having regard to any usages which the parties might have established, and the ultimate decision will have to come from an answer to the question whether it was within (or, as the case may be, outside) the objectively fair and subjectively reasonable expectations of both parties to conclude that the arbitration clause contained in one contract can (or cannot) be seen as an 'umbrella' for other or separate contracts between them.<sup>45</sup>

It is this article's contention that a similar approach to set-off defences should be positively promoted in the rules of arbitral institutions. Specifically addressing the issue of set-off defences has the potential to significantly overcome the need for a discussion of whether the defence is procedural or substantive. If the general position that an arbitral tribunal will always have the ability to hear substantive defences is accepted, then it only remains to enable procedural defence of set-off. This is done merely by permitting it in the rules. However, there must be a discernable limit to ensure parties are not caught by surprise. This limit could and indeed should be beyond the bounds of the initial contract, even where there is an alternative arbitration agreement or forum selection clause, as the Swiss Rules contemplate. The question then becomes not whether this offends party autonomy, but rather a decision of fact as to the parties' true intention.

Drafting a clause with this effect is not a particularly easy task. Within the Asian region, the ACICA position of including the expression 'arising out of, relating to or in connection with the contract' is certainly a very positive development. However, even this is likely to be constrained in instances where the related contract has a different dispute resolution clause, or indeed

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44 Marc Blessing, 'The Law Applicable to Arbitration Clause' in *Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention* (Albert Jan van den Berg ed, Vol 9, 1999), Kluwer Law International, p 177.

45 Blessing, *id* at 179.

a varying arbitration clause — that is, one that calls for arbitration at a different seat or with different rules. Additionally, it would still be necessary to have reference to the substantive law governing the arbitration agreement to interpret such expressions. However, in the view of this author it is far more preferable to be analysing those expressions rather than embarking upon a thorough and extensive investigation of the nature of a set-off defence in any one jurisdiction.

In addition to providing guidance to the parties on how the arbitration is to be run, one of the other very important functions of rules is to create an awareness of likely issues. This reason alone should be sufficient to persuade institutions to include reference to set-offs in their rules. If parties do not wish to follow the path proposed by a set of rules it is completely within the parties' power to vary it. The standard retort to an argument of this kind is that it ignores the reality that when negotiating contracts parties are relatively uninterested in dispute resolution clauses. While that is almost certainly true, it is also the case that parties will not infrequently have already included set-off clauses in their contracts. In most cases, such clauses would be seen to be a variation of the proscribed arbitral rule.

Every arbitration practitioner should have an awareness of the debate involving set-off in international arbitration. Institutional international arbitration can still be said to be in its formative years in the Asian region. The average age of the prominent international arbitration institutions is only about 20 years. The region has a very real opportunity to introduce fresh and innovative perspectives on problems that have arisen in Europe and America. In any event, international arbitration as a discipline is both dynamic and pragmatic. The challenge lies ahead.

## SCHEDULE A

*(Sorted alphabetically by country within each category)*

### **1. Rules Based on UNCITRAL Arbitration Rules**

- Australian Centre for International Commercial Arbitration ('ACICA')<sup>46</sup>  
— See discussion in main article at p 149.
- The Cairo Regional Centre for International Commercial Arbitration ('CRCICA')<sup>47</sup>
- Hong Kong International Arbitral Centre ('HKIAC')

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46 Available online at <<http://www.acica.org.au/arbitration-rules.html>> (accessed 6 October 2005).

47 Available online at <[http://www.crcica.org.eg/Pamphlet-Eng.htm#Arb\\_Procs](http://www.crcica.org.eg/Pamphlet-Eng.htm#Arb_Procs)> (accessed 13 May 2005).

- HKIAC also uses the UNCITRAL Arbitration Rules in conjunction with a set of amendments.<sup>48</sup> There is no reference to set-off defences in the amendments.
- Regional Centre for Arbitration Kuala Lumpur ('RCAKL')
  - RCAKL uses the UNCITRAL Arbitration Rules in conjunction with a set of amendments tailored specifically for RCAKL.<sup>49</sup> The amendments do not affect the operational provisions relating to set-off defences. The amending r 7(6), however, does refer to set-off defences by specifically including them in the calculation of the amount in dispute for costs purposes. Counterclaims are similarly dealt with in this rule, thus maintaining the ostensible dichotomy between the two.
- St Petersburg International Commercial Arbitration Court<sup>50</sup>
- Polish Chamber of Commerce ('PCC')<sup>51</sup>
- The Permanent Court of Arbitration attached to the Chamber of Commerce and Industry of Slovenia<sup>52</sup>

## ***2. Rules that Do Not Refer to Set-off Defences***

- Vienna International Arbitral Centre ('VIAC')<sup>53</sup>
- Belgian Center for Arbitration and Mediation ('CEPANI')<sup>54</sup>
- British Columbia International Commercial Arbitration Centre ('BCICAC')<sup>55</sup>
- China International Economic and Trade Arbitration Commission ('CIETAC')<sup>56</sup>
- Danish Institute of Arbitration<sup>57</sup>

48 Available online at <[http://www.hkiac.org/pdf/e\\_arbitrationrules.pdf](http://www.hkiac.org/pdf/e_arbitrationrules.pdf)> (accessed 13 May 2005).

49 Available online at <<http://www.rcakl.org.my/rules.html>> (accessed 13 May 2005).

50 Available online at <<http://www.pravocom.spb.ru/English/index.html>> (accessed 13 May 2005).

51 Available online at <[http://www.kig.pl/english/activities\\_court.htm#](http://www.kig.pl/english/activities_court.htm#)> (accessed 13 May 2005).

52 Available online at <<http://www.sloarbitration.org/english/introduction/rules.html>> (accessed 13 May 2005).

53 Available online at <<http://wko.at/arbitration/engl/arbrules.htm#counter>> (accessed 13 May 2005).

54 Available online at <<http://www.cepani.be/EN/default.aspx>> (accessed 13 May 2005).

55 Available online at <<http://www.bcicac.com/cfm/index.cfm?L=89&P=212>> (accessed 14 June 2005).

56 Available online at <<http://www.cietac.org.cn/english/rules/rules.htm>> (accessed 13 May 2005).

57 Available online at <<http://www.denarbitra.dk/index.asp?lang=GB&id=237&KatId=88>> (accessed 13 May 2005).

- Estonian Chamber of Commerce and Industry<sup>58</sup>
- The German Institution of Arbitration ('DIS')<sup>59</sup>
- The Indian Council of Arbitration ('ICA')<sup>60</sup>
- The Venice Court of National and International Arbitration<sup>61</sup>
- Japanese Commercial Arbitration Association ('JCAA')<sup>62</sup>
  - JCAA arbitrations can be conducted in accordance with the JCAA Commercial Arbitration Rules or the UNICTRAL Arbitration Rules. The JCAA Commercial Arbitration Rules do not make any reference to set-off defences. However, international arbitrations may alternatively be conducted pursuant to the UNCITRAL Arbitration Rules.
- Korean Commercial Arbitration Board ('KCAB')<sup>63</sup>
- London Court of International Arbitration ('LCIA')<sup>64</sup>
- Court of International Commercial Arbitration attached to the Chamber of Commerce and Industry of Romania and Bucharest<sup>65</sup>
- Singapore International Arbitration Centre ('SIAC')<sup>66</sup>
- American Arbitration Association ('AAA')<sup>67</sup>
- Dubai International Arbitration Centre ('DIAC')<sup>68</sup>
- Arbitration Rules of the Vietnam Arbitration Center at the Chamber of Commerce and Industry of Vietnam<sup>69</sup>

### ***3. Rules that Specifically Refer to Set-off Defences***

- Court of Arbitration at the Bulgarian Chamber of Commerce and Industry<sup>70</sup>

58 Available online at <<http://www.koda.ee/?id=1389>> (accessed 13 May 2005).

59 Available online at <<http://www.dis-arb.de/>> (accessed 13 May 2005).

60 Available online at <<http://www.ficci.com/icanet/rules.htm>> (accessed 13 May 2005).

61 Available online at <<http://www.venca.it/rules.htm>> (accessed 13 May 2005).

62 Available online at <<http://www.jcaa.or.jp/e/arbitration-e/kisoku-e/kisoku-e.html>> (accessed 6 October 2005).

63 Available online at <[http://www.kcab.or.kr/English/M6/M6\\_S2.asp](http://www.kcab.or.kr/English/M6/M6_S2.asp)> (accessed 13 May 2005).

64 Available online at <<http://www.lcia-arbitration.com>> (accessed 6 October 2005).

65 Available online at <<http://www.ccir.ro/ccir/departs/eng/arbitration/rulesarb.htm>> (accessed 13 May 2005).

66 Available online at <<http://www.siac.org.sg/rules2.htm>> (accessed 6 October 2005).

67 Available online at <[http://www.adr.org/sp.asp?id=22090#Intl\\_Arb\\_Rules](http://www.adr.org/sp.asp?id=22090#Intl_Arb_Rules)> (accessed 13 May 2005).

68 Available online at <[http://diac.eneas.ae/rule\\_en.html](http://diac.eneas.ae/rule_en.html)> (accessed 13 May 2005).

69 Available online at <[http://132.204.136.33/pub/03/en/F\\_7005.htm](http://132.204.136.33/pub/03/en/F_7005.htm)> (accessed 14 June 2005).

70 Available online at <<http://www.bcci.bg/arbitration/index.html>> (accessed 13 May 2005).

- Addresses set-offs in much the same way as UNCITRAL Arbitration Rules. Note that a set-off must still be within the jurisdiction of the Court of Arbitration (in other words, it must be covered by the arbitration agreement)
- The Permanent Arbitration Court at the Croatian Chamber of Economy<sup>71</sup>
  - Also known as the Zagreb Rules — these make reference to set-off defences under heading of counterclaim. But specifically state it must also arise from arbitration agreement.
- Arbitration Court at the Economic Chamber of the Czech Republic<sup>72</sup>
- The Arbitration Institute of the Central Chamber of Commerce of Finland<sup>73</sup>
  - Mentions set-off and specifically states it can only be raised if the arbitration agreement covers such a demand for set off.
- International Chamber of Commerce Court of Arbitration ('ICC')<sup>74</sup>
  - ICC Rules deal with set-off only in the context of costs — implying they can be raised.
- Court of Arbitration attached to the Hungarian Chamber of Commerce and Industry<sup>75</sup>
- Chamber of National and International Arbitration of Milan<sup>76</sup>
  - Mentions set-off in calculation of value of dispute. Annexure A (para 5) appears to suggest set-off can be higher than the original claim.
- Arbitration and Dispute Resolution Institute of the Oslo Chamber of Commerce<sup>77</sup>
  - Set-off is mentioned but not elaborated upon.
- Arbitration Institute of the Stockholm Chamber of Commerce<sup>78</sup>
- Swiss Arbitration Rules<sup>79</sup>
  - See discussion in main article at p 153.

71 Available online at <<http://www.hgk.hr/komora/eng/eng.htm>> (accessed 13 May 2005).

72 Available online at <[http://www.arbcourt.cz/en/en\\_index2.htm](http://www.arbcourt.cz/en/en_index2.htm)> (accessed 13 May 2005).

73 Available online at <[http://www.arbitration.fi/FCCC\\_Rules\\_English.pdf](http://www.arbitration.fi/FCCC_Rules_English.pdf)> (accessed 13 May 2005).

74 Available online at <<http://www.iccwbo.org/court/english/rules/rules.asp>> (accessed 6 October 2005).

75 Available online at <[http://132.204.136.33/pub/03/en/F\\_9959.htm](http://132.204.136.33/pub/03/en/F_9959.htm)> (accessed 14 June 2005).

76 Available online at <[http://www.camera-arbitrale.com/upload/file/435/217887/FILENAME/Arbitration\\_Rules.pdf](http://www.camera-arbitrale.com/upload/file/435/217887/FILENAME/Arbitration_Rules.pdf)> (accessed 13 May 2005).

77 Available online at <<http://www.chamber.no/tekster.cfm?artid=53>> (accessed 13 May 2005).

78 Available online at <[http://www.sccinstitute.com/\\_upload/shared\\_files/regler/web\\_A4\\_vanliga\\_2004\\_eng.pdf](http://www.sccinstitute.com/_upload/shared_files/regler/web_A4_vanliga_2004_eng.pdf)> (accessed 13 May 2005).

79 Available online at <[http://www.swissarbitration.ch/pdf/SRIA\\_english.pdf](http://www.swissarbitration.ch/pdf/SRIA_english.pdf)> (accessed 13 May 2005).