CHAPTER 51

Setoff and Counterclaim (Compensation)

"COMPENSATIO est debiti et crediti inter se contributio," is a definition from the end of the classical Roman period. At that time, as it seems, it had become a general habit to allow a defendant in a lawsuit a defense by claiming against the plaintiff a debt due by the latter to the defendant. The history of this institution before and after this momentous stage has been agitated and has led in the modern codes to related but differentiated regulations, all parts of substantive private law. In England, an entirely independent doctrine slowly emerging shows various parallels to the Roman development, but has remained original and, in contrast to the Continental systems, confined within the framework of judicial procedure.

In this matter, we must separate not only the two groups of municipal bodies of law but also their application in conflicts law.

I. Anglo-American Law

1. Institutions Involved

The English methods of setoff and counterclaim are clothed in terms of procedural remedies to be used by a


2 MODESTINUS, Dig. 16, 2, 1.

3 BONFANTE, Istituzioni di diritto romano (ed. 8) 401.
defendant against a plaintiff. A rich and differentiated development from this origin in the United States has produced a variety of regulations of setoff, recoupment, and cross action, and of the so-called counterclaim in the "code states," comprising setoff and recoupment. The many statutory changes, differences between state and federal jurisdictions, and the influence of equity have resulted in a progressive adjustment to practical needs. Perhaps for the same reasons, however, the subject is so loaded with particularistic complications that no serious effort has ever been made to reconsider the entire matter from the viewpoint of substantive law. It still remains in the common opinion a topic of procedure, subject, as a matter of course, to the law of the forum.

Following the language of the Restatement of the Law of Contracts, we shall speak of "setoff and counterclaim," or more briefly, according to English models, of "setoff," to cover the ground taken in civil law by *compensatio*. The exceptional rules on bankruptcy and judgment debts must be reserved. Mutual accounts by agreement are a separate topic to be discussed later.

English and American lawyers are extremely firm in asserting that setoff and its associates are procedural institutions. As a particularly impressing feature, there is no extrajudicial setoff, except in case of insolvency. A debtor:

"Cannot, in the absence of agreement, apply a set-off in reduction of his debt, on a tender of the residue; but he may avail himself of such set-off by way of defence or counter-claim in an action by the creditor."\(^4\)

Undoubtedly, many a time thoughtful judges and writers have penetrated behind the procedural aspect into the situation of the parties. No one, in fact, denies that under the conditions of the law the parties have a *right* to a setoff.

\(^4\) *Jenks-Winfield* § 216.
The well-known dictum of Judge Mack (1923) may be remembered:

"The right of a counterclaim and set-off having been first introduced as a part of our procedural law, halting recognition is just beginning to be given to the fact that the right as between litigants is something more than a procedural convenience and is really a requirement of substantive justice. That the right of set-off and counterclaim is regarded in our law today as affecting, in important aspects, the substantive relations between the parties, is clearly seen in the rules as to the assignment of choses in action being subject to existing set-offs or counterclaims."

The Contracts Restatement is the most eloquent testimony to the substantive nature of the party relations involved. Nevertheless, its classification as procedural seems unchallenged.

2. Conflicts Principle

In consistency with their general attitude in the municipal sphere, common law lawyers do not hesitate to state the simple rule that setoff and counterclaim follow the law of the forum. To preclude excessive application, the meaning of this rule has been clarified by Minor: how the defense is pleaded and what effect the plea has is regulated by the procedural law of a court, but the validity and effect of each claim is measured according to the law governing it.

Only on an express or implied agreement of the original

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5 The Gloria (D. C. S. D. N. Y. 1923) 286 Fed. 188, 192. Rosenberry, J., in Shawano Oil Co. v. Citizens State Bank (1936) 223 Wis. 100, 269 N. W. 675: "A right of offset is more than a procedural matter. Under § 331.07 the plaintiff was entitled to set off . . . upon the payment of its note."


7 Minor 525 § 211.
parties to an instrument, may setoff be considered an equity attaching to the instrument.\(^8\)

3. Foreign Compensation in Common Law Courts

How should civil law compensation, a substantive institution, be treated in a common law court? Authority is scarce. But the oldest American decision relating to the matter recognized a setoff allowed in a sister state and expressly stated that the setoff "does not relate to the form of proceeding but goes to the merits of the case; and shews, that no recovery ought to be had. So far from relating to the form of the remedy, it shews there ought to be no remedy."\(^9\) This line of thinking seldom has been followed,\(^10\) but may be regarded as allowing a common law court to admit an allegation that compensation has been achieved under the law of a civil law country.\(^11\) At least, the writers seem in agreement that foreign discharge of an obligation by compensation is recognizable.\(^12\) Moreover, if two debts face each other in compensable condition according to French law governing both debts, their extinction may be claimed by either party in an American court. It is immaterial where either debt arose. But if the two debts are governed by different laws, it may be doubtful which law, or whether

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\(^8\) MINOR 526; FALCONBRIDGE, Conflict of Laws 325 n. (q).
\(^10\) United States: Fidelity Insurance, Trust & Safe-Deposit Co. v. Mechanics' Savings Bank (C. C. A. 3d 1899) 97 Fed. 297, 56 L. R. A. 228: the statutory liability of a stockholder, resident of Pennsylvania, to the creditor of an insolvent Kansas corporation would have been extinguished by the claim of the stockholder against the corporation for the payment of bonds under Kansas law, governing both claims; this equitable defense is recognized. To interpret it as a defense at law, in order to serve in the federal court, has been disapproved. See Anglo-American Land, M. and A. Co. v. Lombard (C. C. A. 8th 1904) 132 Fed. 721, 733.
\(^11\) England: Allen v. Kemble (1848) 6 Moo. P. C. C. 314, 321: discharge of a debt by compensation under Roman Dutch law was recognized, although the decision is inconclusive with respect to the conflicts rule, FALCONBRIDGE, Conflict of Laws 326.
\(^12\) DICEY 679 and illus. 3.
both simultaneously, should be applied. This is a problem very controversial in Europe, which we must consider later.

On the other hand, it has been concluded that the law of the forum is free to authorize, by its judicial discretion, a setoff not permissible in the governing foreign law.13

4. Application in Civil Law Courts

The Continental literature, aware of the different characterization of setoff and compensation in the unanimous Anglo-American view has responded by assuming that the English and American remedies are inapplicable in civil law courts. Generally, it seems to be felt that such a court has to apply the law of the forum, on an assumed renvoi from the governing law.14

This solution has been challenged, however. In a thorough comparative study, conforming to the standards reaffirmed in the present work, Gerhard Kegel15 has examined the general function and two of the main conditions of compensation and the common law remedies in question. As a result of his analysis, the author states that, under present concepts of analytical jurisprudence, counterclaim in England, New Jersey, Arkansas, and Connecticut is in fact a strictly procedural defense, but English and American setoff and recoupment, and counterclaim in the code states, contain a mixture of substantive and procedural elements. He draws this conclusion from the common roots of setoff in judicial practice and in bankruptcy law which is a substantive institution, the analogous structure of setoff in bankruptcy and insolvency cases, the language of certain decisions, and the existence of extrajudicial setoff in installment sales and bank accounts. Despite some doubts, the author is inclined

14 Neuner, Privatrecht und Prozessrecht (1925) 59, 133; Dölle, supra n. 1, at 34.
15 Kegel, supra n. 1, esp. 41 ff.
to think that it should be possible to extract the substantive rules and apply them in a civil law court.\textsuperscript{16} For instance, conflicts law as understood on the Continent, may be able to observe the rules usual in a specific American court on the question whether the defendant may plead a debt which is owed by or owing to certain third persons.\textsuperscript{17} In contrast, the requirement of a liquidated sum, where it still exists, is so dominated by procedural convenience as to dissuade us from transplanting it to a foreign forum.\textsuperscript{18} This interesting inquiry deserves to be extended to the remaining problems. Some day a common platform will be found.

In the meantime, so long as no American court applies the rules of another state on this subject, it will be inadvisable for a civil law court to proceed differently. The difficulty of extracting the substantive rules or of ascertaining the actual law of an American state is very great.\textsuperscript{19} Any attempt to transform setoff and counterclaim into pure private law, seems premature. In the phase reached by these institutions up to the present time, foreign conflicts law ought to leave them totally unobserved.

All European writers seem to agree, however, that in a case governed by English or American law compensation is not effective except if invoked as a defense or by cross-action in court.\textsuperscript{20} In such cases, the court treats compensation as pleaded exclusively on the ground of a procedural party declaration, not on the ground of an extrajudicial act and,

\begin{itemize}
\item \textsuperscript{16} KEGEL, \textit{supra} n. 1, 48 f.
\item \textsuperscript{17} \textit{Id.} at 153.
\item \textsuperscript{18} \textit{Id.} at 174.
\item \textsuperscript{19} As an example, it may be considered that in the United States, even where a claim barred by a statute of limitations may be used for pleading setoff, various theories exist concerning the effect of the plea. While the question whether a claim barred by limitation may be pleaded is substantive in the Continental view, the effect of a successful plea, in an American court, representing a claim exceeding the plaintiff's demand regards the extent of the bar procedurally conceived. For three different solutions of the latter problem, see \textit{Wood}, \textit{Limitations} 307 ns. 15-17.
\item \textsuperscript{20} DÖLLE, \textit{supra} n. 1, 42.
\end{itemize}
hence, applies its own procedural rules involving unconditional and conditional compensation,—the latter occurring when the defendant avails himself of his counterclaim only on the condition that the plaintiff's claim is held effective. The private law of the forum serves to fill the gaps left by the procedural rules.

II. Civil Law

1. Institutions Involved

“Compensatio” of debts appears in various kinds, the most important of which are at present effectuated either by operation of law or by extrajudicial informal declaration of either party. “Legal compensation” stems from the unconsidered generalization, in the Corpus Juris, of a classical dictum, “ipso iure compensatur,” which had been said of a certain type of banker who was compelled by the Praetor, in suing customers, to restrict his petitions to the balance of current accounts. 21 This slogan, as finally adopted in the French and Austrian Civil Codes and many subsequent laws, 22 means that the two debts extinguish each other at the first moment of their coexistence in compensable condition. Although this construction still produces its consequences if the compensation is considered “definitely” established, its peculiar automatic working has been abandoned. The defendant in a lawsuit must invoke the fact of the compensation or be deemed to renounce it and revive the discharged debt. 23

21 GaIUS IV §§ 64-68; LENEL, Edictum perpetuum § 100; Dig. 16, 2, 21; C. 4, 31, 14; PERNICE, Labeo, Vol. II, 1, 279; LENEL, Palingenesia Paulus No. 1273.
22 Argentina: C. C. art. 818.
Austria: C. C. §§ 1438 ff.
Brazil: C. C. art. 1009.
France: C. C. arts. 1290 ff.
Italy: C. C. (1865) art. 1285; C. C. (1942) art. 1241 says even expressly: “i due debiti si estinguono.”
Portugal: C. C. art. 768.
23 2 Colin et CAPITANT 123; Planiol et Ripert, 7 Traité Pratique 623.
The modern type of compensation proclaimed by the German Civil Code$^{24}$ rests upon a declaration of one party to the other, either extrajudicially or in pleading. When this is done, the effect is retroactive so that the debts are deemed extinguished as of the first moment of their simultaneous existence in the condition required for setoff. Thus, in both the French and German systems, for instance, the running of interests of any percentage is terminated on both sides from that time.

The conditions in the civil law systems also are roughly the same, to the extent that two persons must be reciprocally and personally bound by obligations, existent and enforceable, to the payment of money or other fungible things of like nature.

These parallels in operation and prerequisites have afforded a sufficient basis for the dominant conflicts doctrine in Europe, comprising all Continental laws in a joint conflicts rule concerning compensation.$^{25}$ What the rule should prescribe, is another question.

2. Conflicts Theories

As usual, a variety of theories has been set forth.$^{26}$ At present, only three deserve mention and only two of these seriously compete for prevalence.

As in common law, the law governing the debt will determine whether it is in existence, mature, liquid, and enforceable,$^{27}$ if the law or laws controlling the compensation

$^{24}$ Germany: BGB. § 387.
Japan: C. C. art. 505.
Switzerland: C. Obl. art. 120.
$^{25}$ Tosi-Bellucci, supra n. 1, 26-28, often cited.
$^{26}$ See the critical surveys by Arminjon § 155; De Nova 181 ff. An individual theory has also been hinted at by Pontes de Miranda 234.
$^{27}$ E.g., RG. (July 1, 1890) 26 RGZ. 66: French-Rhenish law is consulted for the question whether a legacy claim is exigible. It was wrong that OLG. Frankfurt (April 27, 1923) JW. 1924, 715 applied German bankruptcy law to decide premature compensability of a debt in a Dutch bankruptcy.
require these conditions. We are interested only in what law or laws are in fact controlling.

(a) *Lex fori.* The law of the forum has been postulated, sometimes invoking the common law, by a series of authors. Some have had in view lawsuits exclusively; others have assumed that the connection with procedural rules should prevail, or that the court ought to be able to decide according to equity. These views have repeatedly been criticized and are commonly rejected. Characterization of compensation as a remedy or as procedural is regarded as a grave mistake.

(b) *Laws of both debts cumulatively.* Many French authors, supported by Zitelmann and other writers, have required that when claim and counterclaim are governed by different laws, compensation must be simultaneously authorized and made effective by each law. They argue that discharge of both debts requires consent of both laws. Although the principal claim depends only on its own law, the counterclaim is not extinguished unless the law governing it so provides, and without such extinction not even the principal claim would be discharged. Against the objection that this method gives preference to the law according to which setoff is not effective, it has been replied that favoring the less exacting law would harm the authority of the more severe law; either law has "equal authority."
The precise meaning of this theory seems to vary. In the most consistent variant, however, the entire problem whether compensation by unilateral act is effective in the individual situation, must be decided by both laws. The total facts are tested by both legal systems cumulatively.\(^{36}\) We shall see what this means.

(c) *Law of the principal claim.* A vigorous third theory, at present prevailing in the German and Swiss doctrine, is satisfied with the observance of the provisions which govern the claim against which compensation is declared. If the law governing the principal debt predicates that the debt is discharged, this is all that is needed.\(^{37}\) Or in terms of procedure, the law that governs the debt sought to be enforced and alleged to be discharged by setoff, is competent.

The followers of this theory effectively refute the main argument of the adversaries, viz., that because of the nature of compensation both laws must agree in extinguishing both debts. The party claiming the setoff avails himself of a means of discharge by which a unilateral use of a counterclaim is substituted for payment. This must be permissible under the law determining the modes of discharge. Insofar, however, as this party employs his own claim, he does so not by any forcible method of self-help, but by a voluntary disposition, to which he is entitled under the law governing his claim. It remains merely to ask whether this law frees the debtor; this will always be true, since the creditor has received satisfaction, except when setoff is not known to this law.\(^{38}\)

\(^{36}\) Thus expressly, Dölle, *supra* n. 1, 40; and seemingly, 2 Arminjon 343; De Nova 240; Batiffol 450 § 567.

\(^{37}\) Bar, Lehrbuch 118; 2 Bar 91; Neumeyer, IPR. 29 (in principle); M. Wolff, IPR. 93.

Germany: ROHG. (June 4, 1873) 10 ROHGE. 226; RG. (July 1, 1890) 26 RGZ. 66; OLG. Augsburg (Nov. 6, 1917) 36 ROLG. 105.


\(^{38}\) Lewald 283 f.
3. Rationale

The arguments used for the two antagonistic Continental opinions have not sufficed to convince either party. It would seem that these theories are too much dependent on the municipal doctrines, and moreover that they are framed in all too general terms.

Where the axiom, *ipso iure compensatur*, is the basic concept, as in France and Italy, it might be natural to assume that automatic termination of two debts by "law" presupposes approval by both laws. This idea, however, should have been discarded when it was settled that one of the parties must act to set the mechanism of the double discharge in motion.

The modern German doctrine, on the other hand, may be inclined to consider the claim to be discharged by declaration of the debtor as the main problem. Also some common law writers may think that, if any law other than the law of the forum is considered, it is the law governing the debt sued upon. But the matter is not so simple.

In fact, the subject is so involved as to suggest future special investigation. Only some of the problems may be illustrated here.

Although we surmise that the mode of operation by procedural defense or extrajudicial declaration is immaterial, and disregard the variety existing in the effects of compensation, the conditions to be fulfilled are still not all susceptible of the same treatment.

(a) The innumerable provisions by which compensation is excluded because of the nature of a debt may be divided into two classes: prohibitions to discharge a certain debt by compensation and prohibitions to use a certain debt as a means of compensation—thus concerning compensation *against* a debt and *through* a debt. But both groups defy the double-law theory.
On one side, certain claims are privileged so that they cannot be extinguished without consent of the creditor except by actual payment or equivalent satisfaction. Thus, according to the various systems, a debtor may not be discharged by setoff, for instance, from a debt grounded on tort (or intentional wrong, or unlawful possession); from a judgment debt; from restitution of a deposit (or a bank deposit); from an unattachable debt such as an obligation to pay wages may be, etc. The debtor may not set off against such a claim. It is not true, however, that the obligation in these cases is not "susceptible of compensation." The creditor of such an obligation based on tort, deposit, or wages is not prohibited, in principle, from extinguishing it by using a debt of his own; this is permitted by the law governing his privilege, and a fortiori by a law without such prohibition.

An exception confirms the rule. Although the provisions concerning compensation merely state that there can be no unilateral compensation against an unattachable debt or a debt of certain wages, it has been inferred from other sources of law in Switzerland that a wage earner cannot dispose of his wages insofar as they represent his minimum living standard. 39

Even so, it is exclusively the law governing the employment which prevents the employer, and by exception the employee, from disposing of the claim for wages.

Illustrations. (i) A, an employee of B, owes B repayment of a loan. Under the law governing the employment, B is not entitled to satisfy his claim by withholding wages. A, under the law governing the loan, is entitled to compensate it by setting off his wage claim, usually even including future claims. But, by exception, the law governing the employment also precludes A from resorting to this right of compensation.

(ii) A has deposited a sum of money with B. Under the French Civil Code, article 1293 n. 2, a depositary is not allowed to set off any claim of his own. French law, however, permits the depositor to set off his own claim. German law has no such prohibition. It has been deduced from the double-law theory that B cannot set off, even though the deposit be governed by German law, if B’s counterclaim against A is under French law. This result has been advocated, although in this case either law would permit the compensation. 40

It seems logically and practically sufficient, however, that a prohibition by a law should apply to the case for which it is meant.

On the other side, claims of a certain origin or affected by certain occurrences, are considered too weak to discharge a normal claim. Thus, a debtor may not compensate for his debt through a claim barred by limitation of action, or by an exception of fraud or informal release. Again, it appears that the law of the claim to be discharged, here the blameless claim, is alone material.

Illustration. Jackson sued his employer for back salary and commissions; the defendant moved for setoff by cross-action on a claim for conversion; this claim was not yet barred by limitation at the time of the action, but the period lapsed during the trial. Under such circumstances, two Texas decisions have held setoff accomplished by operation of law; two are of the contrary opinion. 41 If there were equally different solutions in two civil law jurisdictions, the law under which the suit is brought alone could decide the time when limitation will bar counterclaim.

Hence, prohibitions on compensation, either against or through a claim of a certain nature, are determined in principle by the law of the principal claim.

40 Dölle, supra n. 1, 40.
(b) This principle is not adequate for the requirement of reciprocity, that is, the condition that claim and counterclaim should exist between the same parties or persons equivalent to them.

Illustrations. (i) Suppose the principal debt is governed by New York law, whereas the surety has bound himself under the law of Cuba. The former law prohibits, the latter allows, the surety to use a counterclaim of the debtor against the suing creditor. We have found earlier that the relationship between the principal and the surety should be consulted, in addition to the law of the suretyship.

(ii) Under German law, a debtor may compensate against a subassignee such counterclaims as he acquired against the assignee before notice of the subassignment, even though he did not know of the assignment until he heard of the subassignment. He cannot do so if his debt is governed by English law and the subassignee was without notice of the counterclaim.

Should he be permitted to discharge his German-governed debt by an English-governed counterclaim against the assignee? It is repugnant to the common law that a creditor should free a debtor against his will.

In all such cases where three parties are involved, mere observance of the law governing the principal debt is insufficient.

(c) Exclusion of unliquidated debts from setoff, as provided in the Latin systems, under the influence of the Corpus Juris, has led to the following problem:

Illustration. A has a German-governed claim against B who opposes an Italian-governed unliquidated counterclaim.

43 Cuba: C. C. art. 1197.
44 Supra Ch. 47 ns. 48-51.
45 Commentaries to BGB. § 406.
46 In re Milan Tramways Co. (1884) 25 Ch. D. 587.
See also Wyman v. Robbins (1894) 51 Ohio St. 98, 37 N. E. 264.
The latter is available for compensation under German law, though possibly needing special procedural treatment until verification; this would suffice under the theory invoking only the law of the debt to be discharged.\textsuperscript{47} Compensation has been declared excluded, however, under the two-laws theory, because Italian law is supposed to require "liquidity" in the interest of both parties.\textsuperscript{48}

Historically, the requirement of liquidity served the purpose that plaintiffs should be protected from being exposed to vexatious delay of the suit by fictitious or unsubstantiated allegation of exceptions. More emphasis has been attributed in modern times in France to the idea that compensation is a means of abbreviated double payment—"paiement abrégé." This theory excludes debts of uncertain existence or amount from the function of paying as well as being paid. But such an idea does not necessarily affect compensation against a debt governed by a law admitting illiquid debts.

Since liquidity is generally regarded also in Latin laws as a substantive requirement for legal compensation, the one-law theory seems to suffice.

A different aspect is presented by the Anglo-American requirement of liquidity excluding from setoff debts which must be assessed by a jury. As a matter of procedure, the common law requirement pertains to the law of the forum. And so does the French judicial compensation, which may intervene after the defendant's counterclaim has been ascertained in the proceedings.

\textit{Conclusion.} In most respects, it would seem that the law of the principal debt should exclusively permit or prohibit the use of compensation against the principal debt and determine the availability of the specific opposite claim for compensation. This theory is, however, not correct in all respects. More research is necessary to clarify this subject.

\textsuperscript{47} \textit{Raape}, D. IPR. 290.
\textsuperscript{48} \textit{De Nova} 167 n. 2.
SETOFF AND COUNTERCLAIM

III. CONTRACT OF COMPENSATION

Nothing in the above-discussed doctrines affects voluntary agreements providing for the compensation of either existing or future debts. They have not always been held licit, but are now everywhere permitted, and subject to their own law or that of the main contract to which they are ancillary.

The Continental writers are almost unanimous in following the intention of the parties. In England, the right of setoff has been recognized when based on an express term of the original contract but it is not settled whether it may subsequently be agreed.

The most prominent example is afforded by running accounts. The working of book accounts with periodical balances and acknowledgments is extremely controversial in theoretical construction, and certainly shows fundamental differences between common law and Continental practices.

It would seem that these multiple differences ought not to affect the formation of a conflicts rule. But this is an unsolved problem, except for one important case. When a private individual keeps a running account with a bank, his relationship is covered as a whole by the law of the place where the bank office or branch involved is situated.

The Swiss Federal Tribunal has clearly stated this solution with regard to the relation flowing from a current account.

49 Crews v. Williams (1810) 2 Bibb (Ky.) 262 and other old decisions.
50 DIENA, 2 Dir. Int. Com. 152 § 124; id., 2 Principi 263; DESPAGNET 921 § 316; Tosi-Bellucci, supra n. 1, 73 n. 2; 2 MEILI 36 speaks of the contractual exclusion of compensation.
51 FOOTE 556; HIBBERT 189.
52 See the excellent article by ULMER, "Kontokorrent," 5 Rechtsvergl. Handwörterbuch 194, 216.
53 2 BEALE § 322.1 argues exclusively from the viewpoint of lex loci contractus.
54 Cf. supra Ch. 34 ns. 56 ff. and Ficker, 4 Rechtsvergl. Handwörterbuch 473 No. 4.
55 BG. (Nov. 22, 1918) 44 BGE. II 489, 492; (Oct. 26, 1937) 63 id. II 383, 385.
It was embarrassed, however, when both parties to the account were professionally engaged in banking; in the particular case, the court clung to the law of the forum invoked by both attorneys. 56

56 BG. (Oct. 26, 1937) 63 BGE. II 383, 386.