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# **Set-Off in French Insolvency Law**

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## **Introduction**

The principle that two persons who each owe the other a debt may extinguish one of the debts which will leave one or other party in the position of creditor is well known in commerce. The use of this device, called set-off, in insolvency raises particular questions about whether the principle operates so as to prefer one creditor above another. The use of set-off in France, as elsewhere, has occasioned much debate about the nature of set-offs and their utility in insolvency.<sup>1</sup>

## **The General Contract Principle**

The principle that a set-off may be invoked when two parties owe each other a debt is contained in the Civil Code.<sup>2</sup> This rule implies that the parties owe each other obligations which arise out of the same transaction.<sup>3</sup> The rule may also operate to benefit a third party who is subrogated to the rights of one of the original contracting parties. There is no requirement that the parties agree expressly to the set-off, as the law provides that this happens automatically when both debts come into being simultaneously. This results in the extinguishing of one or both of the debts.<sup>4</sup> Set-off may only occur when both debts are expressed in monetary terms or in amounts of bulk goods of the same type. The debts must be capable of being expressed as a liquid sum and must be due at the time set-off operates.<sup>5</sup> The fact that a grace-period has been given for payment is no obstacle to a set-off occurring.<sup>6</sup> If the debts are expressed as being payable in different places, which may occur under contracts for the sale of goods, a set-off may only take place if it takes into account any costs incidental to the transfer of funds.<sup>7</sup>

## **Set-Off and Exceptions**

Set-off may occur as a result of the rules contained in statute, by an order of court or by agreement between the parties. There are exceptions to a set-off being invoked, which occur in three situations, where the goods concerned have been unjustly taken from one of the parties, where the claim is for the return of a deposit or a loan and where the debt is due by reason of payment for foodstuffs.<sup>8</sup> These exceptions do not apply where the set-off results from an order of court.<sup>9</sup>

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<sup>1</sup>See Medjaoui K., L'exception de compensation dans le cadre d'une procedure collective, Les Petites Affiches 1996.10.7.

<sup>2</sup>Arts. 1289-1299, Civil Code.

<sup>3</sup>Cassation commerciale, 23 June 1992, Bull. Civ. IV No. 246.

<sup>4</sup>Art. 1290, Civil Code.

<sup>5</sup>Art. 1291, Civil Code.

<sup>6</sup>Art. 1292, Civil Code.

<sup>7</sup>Art. 1296, Civil Code.

<sup>8</sup>Art. 1293, Civil Code.

<sup>9</sup>Cassation civile, 10 April 1973, JCP 1974.II.17605.

## **Third Parties and Subrogation**

The guarantor of a debt may invoke the set-off for his benefit. The debtor, however, does not benefit from any right of set-off which operates between his creditor and his guarantor. Similarly, a debtor who owes his debt jointly and severally with other parties, may not invoke any set-off which may apply because the creditor owes a sum of money to one of his co-debtors.<sup>10</sup> If a debt has been paid to another, where this debt could have been set-off, any legal rights, such as a mortgage or other legal charge, which attach to the debt may no longer be used against third parties.<sup>11</sup> The debtor may not apply a right of set-off against a third party who has been subrogated in the place of his creditor where he agrees to the subrogation taking place. If the debtor has made his opposition clear, the subrogation has effect only on the set-off of any debts arising after the debtor has been notified of the subrogation taking place.<sup>12</sup>

## **Set-Off in Insolvency**

The basic principle in insolvency is that following the opening judgment no debt which arose prior to this moment may be paid.<sup>13</sup> An exception is made for connected debts which may be set off.<sup>14</sup> Any payment made in contravention of this article is voidable at the request of any interested party, who presents a petition to this effect within three years of the payment being made.<sup>15</sup>

## **Application of Set-Off**

Set-off may not occur where one of the debts arose before the opening judgment and the other only became due following this event.<sup>16</sup> The same rules as ordinary contractual set-offs apply, including the requirement that there be a connection between both debts which entitles the parties to apply a set-off.<sup>17</sup> A set-off may be invoked even if the supervising judge has ordered that an expert carry out an investigation in connection with the debt.<sup>18</sup> A creditor may raise set-off as a defence against an action by the administrator for payment of a debt due to the insolvent firm. The inverse also applies where the creditor may have submitted a proof of debt, which has subsequently been accepted and is in turn sued by the administrator for debts occurring as a result of supply contracts.

A set-off will operate although the debt has not been ascertained, for example where the remainder of the debt has yet to be calculated or a court has not made a definite order setting out the sum that is due, as long as the invoices were notified to the debtor before the opening of insolvency proceedings.<sup>19</sup> This is also the case where there is a claim relating to breaches of a contract of supply which

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<sup>10</sup> Art. 1294, Civil Code.

<sup>11</sup> Art. 1299, Civil Code.

<sup>12</sup> Art. 1295, Civil Code.

<sup>13</sup> L. Art. 33 al. 1. (References to articles of a law ('L.Art') are to Law no. 85-98 of 25 January 1985.)

<sup>14</sup> Cassation commerciale, 2 March 1993, BRDA 93-10 p14.

<sup>15</sup> L. Art. 33 al. 4.

<sup>16</sup> CA Paris, 30 September 1991, JCP 1992 éd E.I.136.9.

<sup>17</sup> Cassation commerciale, 5 April 1994, JCP 1994 éd E.pan.802.

<sup>18</sup> Cassation commerciale, 27 April 1993, Sommaires de Jurisprudence 1993.52.2.

<sup>19</sup> Cassation commerciale, 7 July 1992, RJDA 8-9/92 No. 867.

are still the subject of litigation. The fact that the creditor is himself in insolvency is no obstacle to the debtor applying a set-off.<sup>20</sup>

### **Obstacles to Set-Off**

In general, a set-off may not occur if the creditor has failed to declare his debt in the insolvency.<sup>21</sup> This does not apply where the set-off occurs in time before the date of the opening judgment. Where two companies jointly established a contra account in which transactions between the companies were registered, a claim by the administrator to recover sums due under an invoice following the insolvency of one of these companies was rejected by the Supreme Court, which held that a legal set-off could be raised where transactions occurred which would in the ordinary course of events be treated as giving rise to a right of set-off without it being necessary for a supposed creditor to declare the set-off in the insolvency.<sup>22</sup>

Nevertheless, the nature of the debt may be important to determine whether it may be properly the subject of a set-off. Thus, the transfer of a debt held on the Treasury to a bank, where the insolvent company held an account, was held not to authorise the bank to apply this sum towards extinguishing the company's liabilities to the bank. The administrator in this case was allowed to pursue his action for the recovery of the debt and the case was remitted for further hearing.<sup>23</sup> Banks are, however, in a different position to other creditors and some care needs to be taken in cases involving set-offs being asserted by banks. The rights of banks as holders of subrogated rights or debt transfers is also quite complex, the case-law not being entirely clear. Thus, in the situation of a bill of exchange discounted by a bank in favour of suppliers of its clients, where the suppliers subsequently became insolvent, was held not to entitle the clients to raise a right of set-off on debts owed by the suppliers so as to avoid an action for payment of the bill.<sup>24</sup>

Set-offs may not occur where the debt results from action taken against a creditor pursued for having contravened one of the rules in insolvency or for having contributed to the insolvency. For example, a judgment which declares a creditor liable for the unwarranted breach of a supply contract, which led in the court's opinion to the insolvency of the company, may not be set off against any debt this company owes in turn to the creditor or against any guarantor of the debt.<sup>25</sup>

A set-off may not occur even if there are mutual debts existing between the debtor and creditor, where these debts occurred as a result of transactions under separate contracts. What constitutes a series of separate contracts as opposed to a series of transactions giving a right of set-off is a matter of interpretation for the relevant court. Where the transactions are for the sale and delivery of individual apartment blocks, defined in individual sale of land agreements, a court has held that the transactions between the parties were not part of an overall agreement but had to be taken individually.<sup>26</sup>

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<sup>20</sup>Cassation commerciale, 25 May 1993, BRDA 93-14 p20.

<sup>21</sup>Cassation commerciale, 15 October 1991, Bull. Civ. IV No. 290.

<sup>22</sup>Cassation commerciale, 5 December 1995, Sommaires de Jurisprudence 1996.9.6.

<sup>23</sup>Cassation commerciale, 17 October 1995, RJDA 1/96 No. 119.

<sup>24</sup>Cassation commerciale, 22 February 1994, Les Petites Affiches 1994.116.23.

<sup>25</sup>Cassation commerciale, 28 March 1995, Les Petites Affiches 1995.86.15.

<sup>26</sup>Cassation civile, 18 July 1995, Les Petites Affiches 1996.14.20.

Nevertheless, a right to set-off may be permitted where although there are separate transactions between the parties, they occur under the auspices of a master agreement defining the relationship between the parties.<sup>27</sup> Difficulties arise where a right of set-off is invoked in a multi-party transaction, where one of the companies is a creditor or debtor of the insolvent company and seeks to set off the debt owed to or credit held by the third company. In such situations, a court would be keen to see whether or not there existed links between the companies so as to lead one to assume that the contracts were part of the same overall scheme. Thus, the delivery of goods by one company to a second, in turn redelivered to a third, which taken into account with other contracts involving the first and third companies, would entitle the first company to apply a set-off. A court hearing the case should not immediately assume that because there are a number of parties and contracts, set-off should be limited to commercial dealings between only two parties.<sup>28</sup>

### **Set-Off and Conflict of Laws**

With the adoption of a convention governing the mutual recognition and enforcement of insolvency proceedings, the position of set-offs in private international law, as far as member-states of the European Union are concerned, will be quite clear. Under the convention, the rules governing the invoking of set-offs are governed by the substantive law of the main jurisdiction, which is defined as the place where proceedings are opened involving the main business interests of the debtor.<sup>29</sup>

The position hitherto in French private international law has not entirely been without problems of definition and interpretation. In a case involving the application of the Franco-Italian Convention of 1930, the Supreme Court concluded that, because Article 24 of the Convention provided that the proving of debts was to be subject to the law governing the insolvency proceedings, in this case the law of Italy, it was logical to assume that any right of set-off fell to be governed by the same law, despite the argument of the creditor that this would in effect avoid any examination of the legal basis to the agreement between the parties, including any provisions governing set-off, by surrendering control to a foreign system, which would also have the effect of negating the duty of a French judge to apply the exorbitant jurisdiction rules of the Civil Code.<sup>30</sup>

This may lead to the situation, as was the case, where a right of set-off was denied the creditor by Italian law, due to failure to observe the relevant procedural rules, where it would be recognised by French rules, which would in turn be used to apply the judgment requiring payment by the creditor of any sums owed the insolvent company.<sup>31</sup> This may lead to the difficulties faced by a creditor taking valid procedural moves in the domestic jurisdiction, only to find that recognition of a foreign judgment deprives these moves of validity, as for example the registration of a charge on a building owned by a foreign debtor following the

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<sup>27</sup>Cassation commerciale, 12 December 1995, BRDA 96-2 p8.

<sup>28</sup>Cassation commerciale, 9 May 1995, JCP ed G 25.22448.

<sup>29</sup>Article 4(1), European Insolvency Convention.

<sup>30</sup>Articles 14-15, Civil Code.

<sup>31</sup>Cassation civile, 6 June 1990, D.1991.11.137.

exequatur (formal recognition procedure) being applied to a judgment placing the company in insolvency in its home jurisdiction.<sup>32</sup>

### **Summary**

The rules governing set-off in French insolvency may appear to be complex. This is in part a reflection of the gradual evolution of principles by the Supreme Court to deal with commercial reality and the protection of particular creditors' rights within the broader framework of the proper conduct of insolvency proceedings and the protection of the interests of all parties concerned. This has led in the past to conflict between general contractual rules applied in civil courts and the more specialist treatment of insolvency situations which obtains in commercial courts. In summary, set-off in France is probably more subject to the exception than the rule, although the position is becoming more settled as the Supreme Court lays down authoritative guidance and clear directions.

**17th December 1996**

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<sup>32</sup>Cassation civile, 25 February 1986, Bull. Civ. I No. 138.