

Research on the Efficacy of Set-off in Civil Litigation

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Abstract: Set-off in litigation constitutes a frequent subject of civil disputes. In judicial practice, determinations regarding the validity of set-off defenses are typically articulated within the reasoning section of civil judgments, rendering the recognition of set-off efficacy inherently intertwined with the legal effect ascribed to judicial reasoning. This article undertakes a focused examination of doctrinal theories concerning set-off validity, ultimately affirming the jurisprudential soundness of the Concurrent Effect Doctrine.

1. Introduction

Against the backdrop of an annual increase in the volume of civil cases, enhancing litigation efficiency has become a priority for litigants (at least for one party) and a critical consideration for judges in adjudicating disputes. Consequently, in common debt-related cases, the use of "set-off" by parties has grown increasingly frequent. As a method of debt discharge, set-off offers advantages such as securing debt performance and obviating enforcement, thereby improving procedural efficiency and reducing the waste of judicial resources. It shares functional similarities with counterclaim mechanisms, both serving as tools for parties to pursue comprehensive dispute resolution.

Set-off may be categorized into extrajudicial set-off and judicial set-off. The former refers to situations where, upon meeting statutory requirements for set-off or mutual agreement, one party asserts set-off against the other, resulting in the extinguishment of mutual claims and debts when the set-off notice is delivered. This constitutes a substantive law-based set-off, which takes immediate effect in principle, except under special provisions in bankruptcy proceedings. [1] The latter, judicial set-off, arises during litigation when a party raises a set-off defense against the opposing party. If the court confirms the validity of the set-off upon judicial review, the mutual claims and debts are automatically extinguished within the set-off amount. This hybrid mechanism integrates procedural and substantive law. This paper focuses on judicial set-off due to its frequent contentious nature, primarily for two reasons: 1、Dual Nature: Judicial set-off embodies both substantive and procedural characteristics, which may lead to a disjunction between substantive effects and procedural outcomes in certain scenarios. 2、Contested Validity of Judicial Reasoning: Courts typically address the validity of set-off claims in the reasoning section of judgments. However, the legal effect of such reasoning remains debated. As the adage states, "Where the foundation is undermined, the dependent elements cannot stand"—thus, the validity of set-off determinations becomes inherently entangled with this unresolved doctrinal dispute.

2. Issues Arising from the Exercise of Set-off Rights in Litigation

As a right of formation (Gestaltungsrecht), the exercise of set-off rights in litigation carries unique complexities. A right of formation is defined as "a right vested in a specific individual, exercisable through a unilateral declaratory act of formation, aimed at creating, modifying, confirming, terminating, or extinguishing a legal relationship, thereby effecting changes in legal rights and obligations." When such rights under substantive law are exercised outside of litigation, they directly alter the corresponding legal relationship. However, when a party seeks to exercise a right of formation within the procedural framework of litigation, the same act may generate conflicting effects in substantive and procedural law, leading to doctrinal tension.

Set-off rights are quintessential rights of formation. When asserted in litigation, a party's act of set-off is inherently subject to the dual influence of civil law and procedural law. On one hand, the exercise of set-off constitutes a juridical act under civil law, governed by its substantive rules: the set-off takes immediate effect, extinguishing the opposing claim (Gegenforderung) to the extent of the offset amount. On the other hand, as a procedural act performed during pending litigation, it must comply with the formal requirements and effects prescribed by procedural law. Consequently, a set-off defense raised as a litigation tactic may theoretically be dismissed by the court due to procedural improprieties—e.g., if the court declines to substantively adjudicate the opposing claim, the set-off defense will not acquire res judicata effect. In such cases, the party may reassert the set-off defense in subsequent proceedings. When the effects of these dual acts (substantive and procedural) converge, a paradox arises:

2.1. The exercise of the right of set-off was judicially determined to be invalid and accordingly disallowed

In litigation, where the defendant asserts the right of set-off as a means of attack or defense, such an assertion may be dismissed by the court. Under Japanese civil procedure theory, Article 157 of the Code of Civil Procedure of Japan is typically invoked. This provision stipulates that if a party seeks to raise the exercise of a formative right (e.g., set-off) as an attack or defense method during proceedings, and such assertion is delayed due to the party's intentional act or gross negligence, thereby risking undue delay in the adjudication of the case, the court may, either upon application or ex officio, issue a ruling to reject such defense method. In such circumstances, the plea of set-off as a defense will not acquire res judicata effect; however, the substantive legal effects of the set-off itself shall nonetheless be deemed to have arisen.

2.2. Failure to establish the requisite elements necessary to maintain an action

If a lawsuit filed by the plaintiff is procedurally dismissed due to a lack of procedural requirements for litigation (e.g., jurisdictional prerequisites), but the defendant has already made a declaration of intent to exercise the right of set-off prior to the court's dismissal order, the procedural law does not formally address the assertion of the set-off defense due to the termination of the proceedings. In such cases, the defendant's assertion of set-off does not produce procedural effects under the law of civil procedure, such as counteracting or extinguishing the plaintiff's claim, as it has not undergone judicial evaluation through the litigation process. However, under substantive law, because the declaration of set-off was validly made, the right of set-off may be deemed exercised and thereby extinguished, regardless of the procedural dismissal.

2.3. The plaintiff filed a notice of voluntary dismissal without prejudice

After the defendant made a declaration of intent to exercise the right of set-off, the plaintiff filed a motion to withdraw the lawsuit.

Consequently, the exercise of the right of set-off in litigation may give rise to a dichotomy between substantive and procedural legal effects, potentially prejudicing the party asserting the right. To resolve issues arising from the exercise of set-off in judicial proceedings, it is imperative to first clarify its legal nature and, based on such characterization, delineate the specific scope within which its effects operate.

3. The legal character of set-off pleaded as a countervailing defense in litigation

Judicial set-off in litigation essentially involves the transposition of the exercise of the right of set-off under civil law into the procedural realm, thus embodying dual characteristics of substantive and procedural law. Regarding the legal nature of judicial set-off, divergent doctrinal views exist, which are generally categorized into four theories: the private act theory, the procedural act theory, the hybrid theory, and the new concurrent theory.

3.1. The private act theory

The private act theory posits that the assertion of set-off in litigation does not alter its civil law nature. Like the exercise of set-off under civil law, the right of set-off takes legal effect immediately upon its invocation. However, since the set-off is asserted in litigation through procedural pleadings, it generates dual legal effects: (1) the extinguishment of obligations under civil law due to the exercise of the right of set-off, and (2) the substantive adjudicative effect of confirming the set-off's validity arising from its assertion in the litigation. These two effects operate independently and do not interfere with each other.

Critics of the private act theory argue that, under this doctrine, if the defendant's procedural act of asserting set-off fails to satisfy procedural requirements, it may unjustly diminish the defendant's claim. This is because, while the procedural act would be deemed invalid, the substantive legal effect of the set-off (i.e., the mutual discharge of debts in equal amounts) would already have taken effect under civil law. Additionally, set-off in litigation is typically asserted subsidiarily (e.g., the defendant contends that if the court recognizes the plaintiff's claim, the defendant's counterclaim will offset it). Under the private act theory, such conditional assertion would conflict with the civil law principle that the exercise of set-off cannot be subject to conditions. The introduction of conditions creates uncertainty as to whether the set-off will take effect, yet the counterparty remains bound by the contingent right of set-off within a specified period, resulting in legal instability for the counterparty.[2] This constitutes a second inconsistency between the private act theory and the practical realities of judicial set-off. To address these flaws, the procedural act theory, hybrid theory, and new concurrent theory propose alternative frameworks to reconcile the procedural and substantive dimensions of set-off.

3.2. The procedural act theory

The procedural act theory asserts that the legal effects of judicial set-off must be governed by procedural law. Under this theory, a declaration of set-off in litigation only takes effect upon the court's final judgment, thereby extinguishing the relevant claims. Specifically, the requirements, manner of exercise, and effects of judicial set-off must be determined exclusively under procedural law. By introducing the court's substantive adjudication as a prerequisite, judicial set-off acquires

a public law character, operating independently of party autonomy and constituting a purely procedural act.

While the procedural act theory avoids the flaws of the private act theory, it is criticized as overly narrow. Opponents argue that judicial set-off cannot be evaluated solely through a procedural lens while disregarding substantive law requirements. This is because judicial set-off inherently originates from substantive law: a party asserts set-off in litigation precisely because the unilateral declaration of set-off under substantive law, as a formative right, produces immediate legal effects. The party invokes this right procedurally to counteract the opposing party's claim. As noted by Shin'ichi Kōji, treating judicial set-off as a purely procedural act risks oversimplification.[3] Thus, the view that judicial set-off should be detached from substantive law requirements and classified as a mere procedural act is fundamentally untenable.

3.3. The eclectic theory

The eclectic theory posits that set-off asserted in judicial proceedings constitutes a *tertium quid* distinct from both private law acts and procedural acts, embodying dual characteristics of substantive law and procedural law. This theory adopts an intermediate position between the doctrine of private law acts and the doctrine of procedural acts, seeking to reconcile the deficiencies inherent in both approaches through a harmonizing mechanism. Its divergence from the private law act doctrine lies in the requirement of consistency between the accrual of substantive/procedural legal effects and the ultimate juridical consequences of set-off in litigation. Under the eclectic theory, mere satisfaction of substantive law requirements without fulfillment of procedural law prerequisites will not effectuate mutual discharge of debts.

Conversely, its distinction from the procedural act doctrine resides in the indispensable presence of substantive law elements for set-off, thereby acknowledging the substantive legal foundation underlying judicial set-off as derived from codified private law.

While the eclectic theory purports to unify substantive and procedural law by creating a hybrid category amalgamating private law and procedural acts—ostensibly overcoming the shortcomings of both predecessor doctrines—it suffers from fundamental theoretical infirmities. The principal critique centers on its jurisprudential untenability: the mere desire to resolve inconsistencies in the alignment of substantive/procedural legal effects under the private law act doctrine does not justify the artificial creation of a novel juridical category lacking normative underpinnings.

3.4. The novel doctrine of concurrent acts

The novel doctrine of concurrent acts, grounded in a dual procedural perspective, posits that the juridical nature of set-off in civil litigation must be comprehended through the connective nexus between substantive law and procedural law. This theory conceptualizes judicial set-off as comprising two constituent elements: (1) the debtor's manifestation of set-off intent to the creditor (substantive act), and (2) the litigant's formal assertion of set-off before the court (procedural act). Certain procedural acts, while capable of generating substantive legal effects, retain their essential character as procedural legal acts.[4] Although a successful set-off defense adjudicated by the court produces debt-extinguishing effects equivalent to substantive set-off, such consequences constitute merely one facet of its substantive legal outcomes—representing the procedural act's absorption of substantive law content.

While maintaining the private law act doctrine's framework, the concurrent acts theory innovates by imposing suspensive conditions (*aufschiebende Bedingung*) on the accrual of substantive legal effects. It postulates that judicial set-off embodies the unification of substantive and procedural declarations of intent, necessitating synchronized activation of their respective legal consequences.

Consequently, the court must exceptionally deny civil law effects to the defendant's set-off declaration when procedurally invalid, thereby resolving scenarios where procedural defects (e.g., dismissal of action, overruling of claims, or preclusion due to untimely assertion) would otherwise engender substantively meaningless debt reductions under pure private law doctrine. This rectifies lacunae in traditional theories through dual protection of the right of formation (*Gestaltungsrecht*) and the right of disposition (*Dispositionsbefugnis*).

Under formation right theory, judicial set-off operates as a unilateral act exercisable *ex parte* by the defendant upon meeting statutory prerequisites, independent of plaintiff consent. Disposition right theory characterizes set-off as the defendant's autonomous management of creditor rights through reciprocal debt cancellation. The concurrent acts doctrine synthesizes these paradigms, affirming that judicial set-off inherently embodies both formative and dispositive attributes.

4. The Author's Position

This article expresses a doctrinal preference for the concurrent acts theory, maintaining that a set-off defense raised in judicial proceedings can only produce substantive legal effects of debt discharge upon obtaining judicial recognition through the court's adjudicative process. While the right of set-off originates from civil law provisions, its assertion within the litigation context necessarily circumscribes party autonomy, requiring judicial scrutiny to validate the defense's legal sufficiency. Absent this procedural safeguard, extrajudicial set-off remains governed by the principle of private ordering under civil law, where parties may freely effectuate debt cancellation through mutual consent. The analytical rationale unfolds as follows:

4.1. The right of set-off originates in procedural entitlements.

The basis for a party's assertion of set-off in litigation derives from procedural rights, as such set-off is not autonomously determined by mutual agreement between the parties but is ultimately adjudicated by the court upon one party's claim. Consequently, the foundation of judicial set-off originates from procedural law requirements rather than substantive legal provisions. Even if a party possesses a substantive right of set-off under applicable law, the exercise of such defensive pleading remains impermissible absent judicial recognition through litigation procedures. Generally, a set-off defense lacks inherent connection to the principal claims in the pending action, and parties would otherwise be precluded from raising extraneous set-off matters. However, by virtue of procedural law mandates and the conferral of litigation rights upon litigants, parties are legally empowered to advance set-off defenses. It therefore follows that the nature of set-off in this context should be characterized as a procedural act.

4.2. Judicial set-off may be characterized as a "conditional set-off" under procedural law.

In litigation, a prerequisite for the defendant's assertion of a set-off defense is the court's prior recognition of the validity of the plaintiff's underlying claim. Typically, the defendant initially challenges the existence of the plaintiff's claim through denial-based defenses—such as alleging discharge of debt through payment or release—before resorting to a set-off defense if such preliminary defenses prove ineffective. Consequently, the defendant's assertion of a set-off defense operates conditionally, which appears contradictory to the substantive law principle that "set-off shall not be subject to conditions or time limitations." The only coherent resolution to this paradox lies in characterizing the set-off defense as a strictly procedural act within the litigation framework.

5. Conclusion

Judicial set-off, distinct from extrajudicial set-off, encompasses both substantive and procedural legal dimensions, with its legal efficacy remaining subject to scholarly debate. The Concurrent Effect Doctrine provides a more contemporaneous analysis of set-off's jurisprudential nature, positing that validity arises only upon concurrent satisfaction of substantive and procedural prerequisites. This dual requirement aligns with substantive law governing the formation of set-off while fulfilling the litigant's procedural objectives in asserting such defense.

References

- [1] *The Enterprise Bankruptcy Law of the People's Republic of China* (Articles 40, 41, 42, 43, 96, and 97) imposes specific restrictions on set-off, such as stringent limitations on bankruptcy set-off rights, prohibitions against individual repayments, enumerated scenarios prohibiting set-off, and non-offsettable circumstances.
- [2] Shi Shangkuan, *General Principles of Obligations*, China University of Political Science and Law Press, 2000, p. 816.
- [3] Shin'ichi Kōji (Japan), *New Civil Procedure Law*, trans. Lin Jianfeng, Law Press, 2008, p. 303.
- [4] Shao Ming, *Essential Analysis of Civil Procedural Acts*, *Journal of Renmin University of China*, No. 2 (2002), p. 102.