BIFURCATION OF CLAIMS WHEN SET-OFF LOOMS

Matthew Secomb[*] *& Philip Tan*[†]

Abstract

Bifurcation of international arbitrations offers both opportunities and risks. It may save tremendous time and costs for the parties. However, it also involves risks, such as the tribunal prejudging claims or counterclaims allocated to a subsequent phase. A unique decision taken by a court in Australia in Hui v. Esposito, to set aside an arbitral award, illustrates this risk. This article explores how a tribunal can determine whether to bifurcate proceedings to decide on a claimant's claim, fairly and efficiently, when set-off of the respondent's counterclaim looms. It concludes that a tribunal should bifurcate proceedings when (i) the set-off claim, if granted, would not have already extinguished or reduced the respondent's liability, (ii) the claim can be decided without prejudging the counterclaim, and (iii) the claimant demonstrates that bifurcation is justified in the particular circumstances.

I. Introduction

Bifurcation[1] of international arbitrations offers both opportunities and risks. When bifurcation works well, it saves tremendous time and costs for the parties. However, it also carries risks. For example, bifurcation risks the tribunal prejudging claims or counterclaims allocated to subsequent phases.

This article is about bifurcating claims when set-off[2] of a counterclaim looms. This is an issue for various reasons. Often the claimant has a relatively straight-forward payment claim, and the respondent a less-than-straight-forward counterclaim for damages. When that constellation is combined with procedural games by the respondent, bifurcation may well be justified.

Possible bifurcation in these circumstances is a good example of the often-competing goals of fairness and efficiency that arbitrators face in international arbitration. The decision on whether to bifurcate claims from set-off counterclaims does not lend itself to simple assumptions for or against bifurcation. Rather, this article suggests that it requires a three-step analysis. Namely, a tribunal should bifurcate proceedings when:

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* Matthew Secomb is a partner based in the Singapore office of White & Case LLP. His practice focuses on international arbitration, with a particular emphasis on energy and construction disputes. He also acts regularly as arbitrator, having chaired or sat as sole arbitrator in arbitrations under various rules (principally ICC and SIAC). Matthew is qualified in Australia, Paris, and England & Wales. Matthew spent nearly ten years in White & Case's Paris office before moving to Singapore in 2015. Before joining White & Case in 2006, Matthew worked as counsel to the ICC International Court of Arbitration, where he oversaw hundreds of arbitrations in a wide array of industries and territories. He was listed by Who's Who Legal as one of the most highly regarded "Future Leaders" of international arbitration. Matthew can be contacted at msecomb@whitecase.com or +65 63471325.

† Philip Tan is an associate in the Singapore office of White & Case LLP. He is a member of the firm's International Arbitration practice in Asia. He has experience in advising and representing clients in various energy, construction and commercial disputes. Philip also plays an advisory role in transactional matters. He is qualified in New York, Singapore, and England & Wales. Philip can be contacted at philip.tan@whitecase.com or +65 6347 1362.

1 'Bifurcation' refers to the split of arbitral proceedings into distinct phases. Each phase ends with a decision – typically an award – on the issues addressed in that phase. *See* Benedettelli, *To Bifurcate or Not to Bifurcate? That is the (Ambiguous) Question*, 29 ARB. INT'L., 493 (2013), *available at* https://academic.oup.com/arbitration/article/29/3/493/223488.

2 Set-off is, in essence, a way of satisfying or extinguishing a debt. A party 'sets off' (i.e., pays) its debt owed to another party by using the debt owed to it. *See* section IV. A below.

- the respondent's set-off claim, if granted, would not have already extinguished or reduced its liability;
- the claim can be decided without prejudging the counterclaim; and
- the claimant demonstrates that bifurcation is justified in the particular circumstances.

The first two steps are relatively binary (i.e. susceptible to a yes/no answer based on legal and factual analysis). The third step involves more subjective analysis.

A rare court decision to set aside an arbitral award illustrates the right idea in these circumstances, done wrongly. In the arbitration at issue in *Hui* v. *Esposito Holdings Pty Ltd.* ["**Hui**"],[3] the claimant sought to bifurcate its claims from the respondents' potential set-off defences and counterclaims. The sole arbitrator bifurcated the proceedings, largely because the respondents seemed to be delaying matters. In the first phase, the arbitrator decided not only on the claims, but also on the respondents' right to set-off, even though the respondent did not present submissions on the same. The court vacated the award and removed the arbitrator for pre-judging the respondents' case.

As explained below, *Hui* should not be seen as a cautionary tale against bifurcation of claims from set-off counterclaims. It does not suggest that arbitrators should take the 'safe' decision of not bifurcating, in order to avoid the risk of prejudicing a party's right to present its case, but suggests that efficiency can and should be achieved through bifurcation under appropriate circumstances. Where potential set-off issues loom and a claimant has justifiable reason to seek a partial award on its claims, a tribunal should consider whether it is appropriate to bifurcate.

In this article, the authors describe *Hui*, and the lessons that can be drawn from it. This article also considers the problems that a tribunal may face in deciding whether to bifurcate claims from counterclaims where there are potential set-off issues. Subsequently, this article provides a framework which tribunals may use to decide whether bifurcation is appropriate. Finally, the authors suggest how a tribunal may manage proceedings efficiently, both before and after a decision to bifurcate is made.

II. Hui v. Esposito: the Right Idea, Done Wrongly

Below, the background to *Hui* is set out, along with some thoughts on what can be learnt from it.

A. Background

Hui concerned disputes under a share sale agreement under which Esposito agreed to sell the shares in 5 Star Foods to UDP. Hui acted as guarantor for UDP.[4]

The agreement was signed in December 2013 and the share sale was completed at the end of January 2014. Only part of the purchase price was paid on completion of the share sale. The

[3] Hui v. Esposito Holdings Pty Ltd, [2017] FCA 648 (Austl.) [*hereinafter* "Hui"].
[4] *Id.* ¶ 8.

balance was to be paid over the following year.[5] UDP did not pay the balance amount to Esposito. On October 30, 2014, Esposito filed a notice of arbitration and a statement of claim against UDP, Hui, and 5 Star Foods as respondents under the UNCITRAL Arbitration Rules with Melbourne as the seat of arbitration.[6]

Within two weeks of filing the notice, the UDP Group, which included UDP and 5 Star Foods, went into receivership.[7] The respondents did not file a response to the notice of arbitration. They agreed with Esposito on the appointment of the arbitrator, but did not file their statement of defence within the time limit initially prescribed.[8]

Esposito proposed that its claim for the balance of monies be resolved in a partial award. It argued that:

- the proof of its claims and any defences would be "*relatively straight forward and involve little hearing time*";
- the parties would be ready for a hearing in "*a matter of weeks*" as the evidence would be limited and was "*largely documentary and … uncontroversial*";
- discovery could be deferred until after the partial award was delivered; and
- the nature of its claims were "*essentially debt/property based*", which suggested that any later submissions by the respondents would be unlikely to preclude the tribunal from deciding on Esposito's claims first.[9]

UDP and 5 Star Foods objected to Esposito's proposal. Again, the arbitrator directed the respondents to file a statement of defence, but they failed to do so. UDP and 5 Star Foods explained that there were potential claims which could arise from possible breaches of warranties given by Esposito.[10] However, they needed more time to review certain due diligence material to explore the claims. Meanwhile, Esposito filed a formal bifurcation application.

On March 19, 2015, the arbitrator held a directions hearing to determine Esposito's bifurcation application.[11] The arbitrator saw three options:

1. The preliminary phase could deal with Esposito's claim for the balance of monies only.
2. The preliminary phase could proceed with Esposito's claim, together with limited defences concerning the construction of a clause in the share sale agreement.
3. The matter could proceed with Esposito's claim and a full hearing of any counterclaim.[12]

5 *Id.* ¶¶ 8-10.
6 *Id.* ¶ 12.
7 *Id.* ¶ 13.
8 *Id.* ¶¶ 14, 18.
9 *Id.* ¶ 19.
10 *Id.* ¶ 24.
11 *Id.* ¶ 26.

After hearing the parties' arguments,[13] the arbitrator decided to proceed with the first option. The arbitrator then, for the third time, directed the respondents to file their statement of defence.[14] This time, the respondents complied.[15] Their statement of defence did not plead set-off defences. The reason seemed to be that receivers for UDP and 5 Star Foods were only appointed in April 2015, and investigations to identify potential set-off claims against Esposito were still on-going.[16] It might have also been because the respondents thought that set-off defences were not within the scope of the upcoming preliminary hearing.[17]

The hearing in the preliminary phase was held in June 2015. Only Esposito and Hui appeared for the hearing, while UDP and 5 Star Foods did not attend.[18] At the hearing, Esposito's counsel addressed the availability of set-off defences; despite what the arbitrator had determined would be the scope of the preliminary hearing. Hui's counsel did not engage with the availability of set-off defences. He stated throughout that the arbitrator had made it clear that the availability of Hui's set-off defences was not within the scope of issues to be determined in the partial award.[19] In July 2015, the respondents amended their statements of defence to plead set-off defences against Esposito.[20]

In September 2015, the arbitrator delivered a partial award. He determined Esposito's claims, but also determined issues concerning the availability of set-off defences and Hui's guarantee. Among other issues, he decided that:

- the respondents had no *contractual* right to set-off certain sums;
- 5 Star Foods and Hui had no entitlement under *equity or otherwise* to set-off counterclaims for purchase price adjustments or warranty breaches; and
- Hui could not reduce his liability as a guarantor through *any set-off or counterclaim*, until all money payable to Esposito under the share sale agreement had been paid.[21]

The respondents were evidently disgruntled with the decision, and they requested that the arbitrator set aside his partial award and withdraw himself from office, on the alleged basis of procedural unfairness and perceived bias.[22] The arbitrator declined to withdraw himself from the case, and rejected the application to set aside the award. He stated that the respondents should have foreseen the possibility of him deciding the set-off issues. They were put on notice that the

12 The court in Hui referred to both 'cross claim' and 'counterclaim' interchangeably. In this article, we use the term 'counterclaim'.
13 Hui and 5 Star Foods argued that a partial award could not be made if the proceedings were bifurcated and the arbitrator determined Esposito's claims in the first phase. Esposito disagreed and argued that the arbitrator could make an enforceable partial award at the end of the first phase. Hui*,* [2017] FCA 648 (Austl.)*,* ¶¶ 34-36.
14 *Id.* ¶ 40.
15 *Id.* ¶ 45.
16 *Id.* ¶¶ 47-50.
17 *Id.* ¶ 40.
18 *Id.* ¶ 62.
19 *Id.* ¶ 63.
20 *Id.* ¶¶ 68-69.
21 *Id.* ¶¶ 71-75.
22 *Id.* ¶¶ 77, 80.

arbitrator could make a partial award in favour of the claimant, which would involve considering set-off defences.[23]

The respondents then applied to the Federal Court in Victoria, Australia to set aside the partial award and remove the arbitrator.

The Federal Court found that the partial award should be set aside so far as it dealt with the availability of defences and set-offs. It held that the respondents could not have reasonably foreseen that the award would address the availability of the same. As a result, they had been denied a reasonable opportunity to present their case on the issues.[24] The Federal Court further removed the arbitrator.

The court decided *Hui* based on the respondents' right to be heard having been violated. It did not however, comment on whether the arbitrator made the right decision by bifurcating the claims from the counterclaims in the first place.

B. What can be Learnt from Hui?

Hui is not, for the most part, a case about the necessary conditions for bifurcation. As described above, the court did not set the award aside or remove the arbitrator because of the decision to bifurcate in the first place. Rather, it was because of the arbitrator's subsequent step in the partial award to decide on the respondents' set-off claims.

Thus, *Hui* is less a case about when to bifurcate, and more about what not to do once you have bifurcated.

III. To Split or Not to Split – that is the Question

Bifurcation is a tricky issue for arbitrators, largely because it involves balancing two admirable and necessary goals – efficiency and fairness.

An arbitrator must make the arbitration as efficient as possible. This responsibility is not only a general principle, but also set out expressly in many arbitral rules. For example, the London Court of International Arbitration Rules, ["**LCIA Rules**"] empower arbitral tribunals with procedural discretion to avoid unnecessary delay or expense for the sake of a "*fair, efficient and expeditious means for the final resolution of the dispute*."[25] The International Chamber of Commerce Rules of Arbitration, ["**ICC Rules**"] also states that the arbitral tribunal (and parties) shall "*make every effort to conduct the arbitration in an expeditious and cost-effective manner.*".[26]

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23 *Id.* ¶¶ 83-98.

24 *Id.* ¶ 227.

25 Administered Arbitration Rules of the London Centre for International Arbitration (2014) [*hereinafter* "LCIA Rules"], art. 14.4(ii) ("a duty to adopt procedures suitable to the circumstances of the arbitration, avoiding unnecessary delay and expense, so as to provide a fair, efficient and expeditious means for the final resolution of the parties' dispute.").

26 Administered Arbitration Rules of the International Chamber of Commerce (2017) [*hereinafter* "ICC Rules"], art. 22(1) ("The arbitral tribunal and the parties shall make every effort to conduct the arbitration in an expeditious and cost-effective manner, having regard to the complexity and value of the dispute.").

When done properly, bifurcation can be incredibly efficient. Take the classic example of bifurcating jurisdictional objections. If bifurcated jurisdictional objections are accepted, it can save both the sides significant time and expenses by never dealing with the matter's merits.[27]

But avoiding costs is not the only way that bifurcation can achieve efficiency: it can also be achieved in deciding *when* claims are determined. A frequent criticism of arbitration is that it is slow. One way that this can be partially addressed is by allowing some claims to be determined before others.

Early determination of payment claims is a good example of this. Timely payment is of key commercial importance to parties. If the claimant succeeds on its claim on a bifurcated basis, and a partial award is rendered, it would expedite its recovery from a cash flow perspective. This may prove important in cases where either the claimant or the respondent is facing financial difficulties.[28]

The importance of set-off from a cash flow perspective has been recognised for a long time. As the English courts have noted, where a defendant succeeds in its set-off claim, an award is given simultaneously on the claim and counterclaim, thereby "*relieving the defendant from having to find the cash to satisfy a judgment in favour of the plaintiff (or, in the 18th century, go to a debtor's prison) before his cross-claim has been determined.*".[29]

The problem of delay was especially pertinent in *Hui*. By the time the directions hearing took place on March 19, 2015 (when the arbitrator decided to bifurcate the proceedings), the arbitrator had twice directed the respondents to file their statements of defence, but the respondents still failed to do so. This took place almost five months after Esposito filed its statement of claim. The long delay seemed to be one of the reasons why the arbitrator decided to bifurcate the claims from the set-off claims.[30]

However, the drive for efficiency through bifurcation must not jeopardize fairness. The right to be heard is well established. The UNCITRAL Model Law provides that "*each party shall be given a full opportunity of presenting his case.*".[31] This right has been enshrined in various jurisdictions.[32] The International Arbitration Act, 1974 in Australia, on which the court in *Hui* based its analysis, provides for at least a "*reasonable opportunity*" for a party to present its case.[33] If the right to be heard is violated, the award may not be enforceable under the New York Convention.[34]

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27 JEFFREY WAINCYMER, PROCEDURE AND EVIDENCE IN INTERNATIONAL ARBITRATION 613 (2002).
28 Benedettelli, *supra* note 1.
29 Stein v. Blake, [1995] UKHL 11, [1996] AC 243, 251(UK).
30 Hui, [2017] FCA 648 (Austl.), ¶ 160 (Esposito's counsel quoted the arbitrator saying, at the directions hearing, "Enough delay has occurred, enough obfuscation has occurred. We are going to proceed on these claims, and the set-off claims will be dealt with at another time.").
31 United Nations Commission on International Trade Law [*hereinafter* "UNCITRAL"], Model Law on International Commercial Arbitration, 1985 U.N.G.A. Res 40/72 (Dec. 11, 1985), as amended by U.N.G.A. Res 61/33 (Dec. 18, 2006) UN Doc A/RES/61/33, art. 18.
32 *See* the Arbitration Act, 1996, § 33 (UK); Art. 1039 4 Rv (Neth.) (Netherlands Arbitration Law); Federal Act on Private International Law Act, 1987, art.182 (Switz.); Swedish Arbitration Act, § 24 (SFS 1999:116) (Swed.).
33 International Arbitration Act, 1974, art. 18C (Austl.) ("For the purposes of Article 18 of the Model Law, a party to arbitral proceedings is taken to have been given a full opportunity to present the party's case if the party is given a

It may be difficult for tribunals to strike the appropriate balance between efficiency and fairness. In exercising their procedural discretion, tribunals may be tempted to err on the side of providing parties with more time and opportunity to make submissions, at the expense of efficiency. Similarly, to avoid prejudicing the respondent's right to be heard, a tribunal may decline to bifurcate claims from counterclaims. An undue assumption against bifurcation would be an example of "*due process paranoia*". That paranoia is the perceived reluctance by tribunals to act decisively in certain situations for fear of the award being challenged based on a party not having had the chance to present its case in full.[35]

Due process paranoia needs to be addressed. Users are increasingly concerned that tribunals are too reluctant to act decisively. Interestingly, fairness, or the lack thereof, is not a characteristic which users of arbitration have complained about. Rather, users complain most often about cost and lack of speed in arbitration.[36]

Thus, arbitrators should carefully balance competing considerations of fairness and efficiency in deciding on whether to bifurcate. Below, we propose some guidelines to assist arbitrators in this duty.

IV. When to Bifurcate Claims from Set-Off Counterclaims?

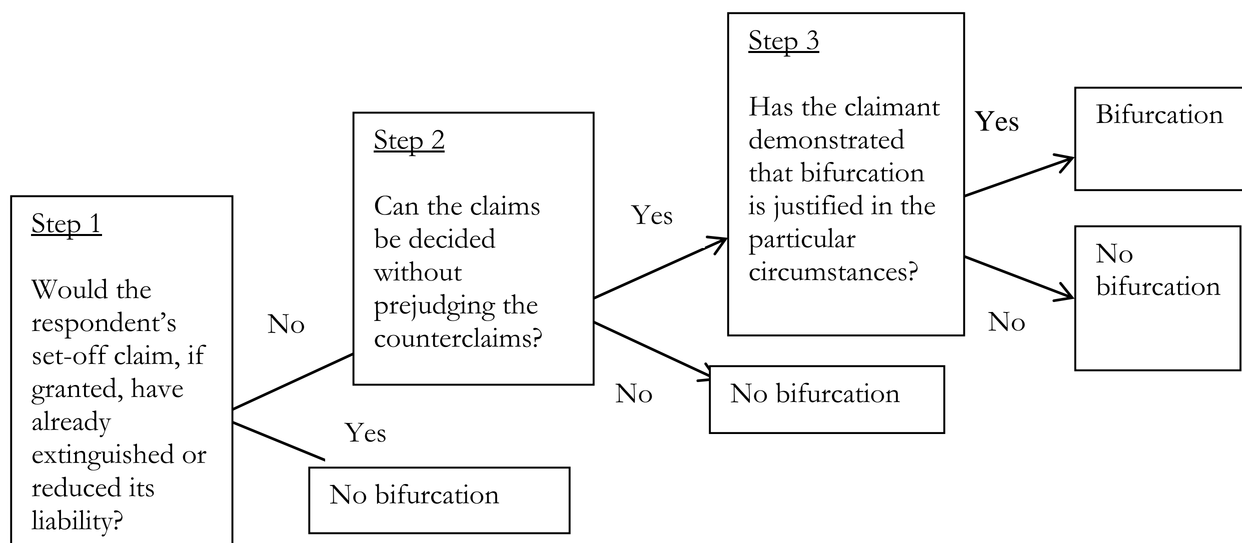
We suggest a three-step test, for arbitrators to decide whether to bifurcate claims from set-off counterclaims. The flowchart below demonstrates how this would be done:

reasonable opportunity to present the party's case"); The Arbitration Act, 1996, § 33 (UK) (England similarly provides for a "*reasonable opportunity*" to present one's case).

34 Enforcement of the award may be refused under Article V(1)(b) of the New York Convention if "[t]he party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to *present his case*" (emphasis added).

35 *See 2015 International Arbitration Survey: Improvements and Innovations in International Arbitrations*, QUEEN MARY UNIVERSITY OF LONDON (2015), *available at* http://www.arbitration.qmul.ac.uk/media/arbitration/docs/2015_International_Arbitration_Survey.pdf; *See 2018 International Arbitration Survey: Improvements and Innovations in International Arbitrations*, QUEEN MARY UNIVERSITY OF LONDON (2018), *available at* http://www.arbitration.qmul.ac.uk/media/arbitration/docs/2018-International-Arbitration-Survey-report.pdf. (In the 2018 International Arbitration Survey, due process paranoia "continues to be one of the main issues that users believe is preventing arbitral proceedings from being more efficient.").

36 In both the 2015 and 2018 International Arbitration Surveys, 'cost' was by far the most complained of characteristic. 'Lack of speed' was the fourth most selected option in identifying the worst characteristics of international arbitration.



Below, we consider the steps in this process.

A. Step 1: Would the Respondent's Set-Off Claim, if Granted, have Already Extinguished or Reduced its Liability?

First, the hurdle question is whether the claimant's claims might have already been extinguished by way of the set-off counterclaim. If that is the case, generally set-off would not be appropriate.

At this point, it is helpful to step back and consider what a set-off is. Set-off is, in essence, a way of satisfying or extinguishing a debt.[37] The party seeking set-off says that it wishes to pay any debt it may owe to the other side by using the debt owed to it. In the adversarial arbitral context, that is the subject of this article, this means that the respondent says that it wishes to satisfy (i.e. pay) all or part of any debt it owes to the claimant with the amount that it is owed, by way of its counterclaim.[38]

Set-off claims have several elements to them. The first element is to ask whether the claim is justified at all,[39] much like the analysis of any other claim. The arbitrator must consider the law and the facts in light of the parties' argument and make that determination. Only once a claim has been determined, does the possibility of set-off arise.

The second is that there must be some legal basis for set-off. Absent a legal or contractual basis, claims cannot be set-off. Legal set-off takes place due to the operation of the applicable law. Contractual set-off operates, as the name suggests, by virtue of the parties' agreement. If a claim and counterclaim are both granted and:

- set-off is not granted, the award should contain two separate decisions (e.g. that respondent should pay claimant X, and that claimant should pay respondent Y);

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37 Hanak v. Green [1958] 2 QB 9 at 16 (Eng.).

38 Alexis Mourre, *The Set-off Paradox in International Arbitration*, 24 ARB. INT'L. 387, 387-388 (2008).

39 Vladimir Pavić, *Counterclaim and Set-off in International Commercial Arbitration*, ANNALS INT. ED. at 104, http://anali.ius.bg.ac.rs/Annals%202006/Annals%202006%20101-116.pdf.

- set-off is granted, the award should contain only one decision (e.g. either that respondent should pay claimant X, or that claimant should pay respondent Y).

Finally, set-off can take place at different times, subject to different conditions. In some instances, set-off can happen merely because one party claims it.[40] That is, a party can declare that it will satisfy a debt it owes to a party by way of a debt that party owes to it. In that case, the debt is immediately extinguished. Of course, the party may object to the set-off. If it does, and the matter is referred to arbitration, the arbitrators will ultimately resolve the issue. When doing so, they will decide whether the set-off was valid in the past (i.e. when declared).

In other instances, a party can claim set-off during the proceedings.[41] However, they do so knowing that it will only be effective once the claims are decided (i.e. set-off will take place when the second claims are actually determined).

The timing of set-off is critical to bifurcation. This, specifically, is the distinction between set off which would:

- if granted, have already extinguished or reduced a respondent's liability; and
- only extinguish or reduce a respondent's liability at some later point, typically when the claims are decided.

Generally, claims cannot be bifurcated if they fall into the first category. That is because they may have already been extinguished by way of the set-off. In contrast, if the respondent's set-off claim falls in the second category, the tribunal can move on to Step 2 of the decision-making framework.

Below, we explain these two categories of set-offs and their implications on bifurcation.

i. Set-offs which extinguish or reduce a respondent's liability before an award

Some types of set-offs have the effect of extinguishing or reducing a respondent's liability even before an award is rendered. Examples are set-offs:

- under many civil laws, where certain forms of set-off take effect from the time when the conditions for set-off were met;[42]
- under the UNIDROIT Principles of International Commercial Contracts, where mutual obligations are discharged at the time one party gives notice of its exercise of set-off and the conditions of set-off are satisfied (e.g. the debts are mutual and due);[43] and

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[40] This typically applies in civil law jurisdictions where the concept of set-off is seen as 'substantive', such that debts can be set-off against each other out of court or arbitration. Scherer, *Set-Off in International Arbitration*, *in* AUSTRIAN YEARBOOK ON INTERNATIONAL ARBITRATION (Jan. 2015), Chapt. III at 3-4.

[41] This typically applies in common law jurisdictions where the concept of set-off is seen as 'procedural'. Set-off here takes effect only through a judgment or an award. *Id.*, at 4. For a discussion of the historical differences in set-off in civil and common law jurisdictions, *see generally* Klaus Peter Berger*, Set-Off in International Economic Arbitration,* 15 ARB. INT'L. 64 55-58 (1999).

[42] *See* CODE CIVIL [C. CIV.] [CIVIL CODE] art. 1290 (Fr.) (stating that set-off is brought about ipso facto by the operation of the law, and the debts are reciprocally extinguished from the moment they exist to the extent of their respective amounts).

- by agreement, where parties agree for certain debts to be netted off against each other (also known as contractual set-off).[44]

If the set-off sought is of this nature, and the claims are found to be valid, the set-off would extinguish or reduce the respondent's liability from the time the respondent had such right (rather than only when the award is rendered). It follows that the tribunal necessarily has to account for the respondent's possible pre-existing right to set-off in deciding on the claimant's claim. As such, it generally cannot decide that those claims are valid in a partial award before it decides on the respondent's claims.

Hui provides a useful lesson on what not to do. One of the respondents, UDP, claimed a right to contractual set-off. This would have had the effect of adjusting or reducing the amount payable to Esposito from the time the relevant contractual conditions were satisfied. Under such circumstances, the arbitrator would have had to decide that UDP did not have such a right, before he could have decided that Esposito's claims were valid and payable.

The arbitrator in fact determined that UDP did not have such a right. However, he did so in the preliminary phase of the arbitration, without hearing UDP's submissions on contractual set-off.[45] As such, the arbitrator made a partial award that deprived UDP of its contractual set-off defence.[46]

The arbitrator in *Hui* should have done things differently. For example, he could have invited the parties to make submissions on set-off before or during the preliminary phase. After which:

- If the arbitrator found that any of the respondents had a contractual right to set-off, bifurcation would not be permissible. Rather, the arbitrator would have had to hear Esposito's claim and the respondents' set-off claims together.

- If the arbitrator found that the respondents had had no contractual right to set-off (e.g. the particular clause did not allow for set-off), he could have then proceeded to decide whether Esposito's claim could be decided without prejudging any counterclaim (Step 2) and whether bifurcation was procedurally justified (Step 3). If these conditions were satisfied, the arbitrator could have then bifurcated proceedings and dealt only with Esposito's claim in the first phase.

Of course, this does not mean that merely because a respondent claims the right to this type of set-off, that bifurcation is not possible. The claimant may argue that the respondent's counterclaim is purely tactical, designed to delay the matter. Requiring full submissions on set-off may unduly prolong the time taken to bifurcate proceedings and may in effect render a

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[43] INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW [UNIDROIT], Principles of International Commercial Contracts, art. 8.1.

[44] ZIMMERMANN, COMPARATIVE FOUNDATIONS OF A EUROPEAN LAW OF SET-OFF AND PRESCRIPTION, 20 (2002) (noting that "[a]ll legal systems allow set-off by agreement").

[45] Hui, [2017] FCA 648 (Austl.), ¶¶ 71, 172.

[46] *Id.* ¶ 199.

subsequent decision to bifurcate meaningless. To avoid this, a summary determination procedure on set-off may be appropriate.[47]

In sum, where the respondent claims a right to set-off, which, if granted, would have already reduced or extinguished its liability, the tribunal can only bifurcate proceedings if it finds that the respondent does not have such a right. If, however, the tribunal finds, based on the submissions before it, that the respondent has or may likely have such a right, it should not order bifurcation.

ii. Set-offs which do not extinguish or reduce a respondent's liability before an award

Set-offs under the common law tradition generally fall within this category. Under English law, for example, absent parties' agreement or a judgment or award, mutual debts or claims cannot be netted off against each other.[48] This applies to both legal,[49] and equitable set-offs.[50]

If the respondent's counterclaim falls within this category, the tribunal can move on to Step 2 of the decision-making framework. This is because set-offs in this category only take effect because the tribunal decides to net off the counterclaim against the claim in an award. There is no pre-existing right, before the award, for the respondent to have its liability extinguished or reduced to the extent of its counterclaim.

For example, in an arbitration initiated to collect the balance of the price in a sale of goods contract under English law, if the respondent buyer claims that the goods are defective, the tribunal will have to decide if the claimant seller is liable to the respondent for damages and for how much.[51] However, the debt owed by the buyer to the seller is not reduced by the seller's liability until an award is rendered. Where such a counterclaim is asserted, the tribunal is thus not precluded from making a partial award on the seller's claim first, before deciding on the respondent's counterclaim.

B. Step 2: Can the claim be decided without prejudging the counterclaim?

Step 2 involves deciding whether the claim can be decided without prejudging the counterclaim.

The effect of bifurcating the claim from the counterclaim is that all the submissions, witnesses, and evidence relating to the claim would be heard first. The arbitrator would render a partial award solely on that claim.

The important thing at this point is that the arbitrator must be able to decide all legal and factual issues necessary to decide on the claim, without inappropriately prejudging issues that will properly be part of the second phase.

A claim cannot be decided without prejudging the counterclaim where, for example:

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47 This is explained in section V, below.

48 Fearns (trading as Autopaint International) v. Anglo-Dutch Paint & Chemical Co. Ltd. and others, [2011] 1 WLR 366 ¶¶ 15, 24-35 (Eng. & Wales) [*hereinafter* "Fearns"].

49 Legal set-off applies to sums which are due and are either liquidated or capable of ascertainment without valuation or estimation at the time of pleading. *See* Stein v. Blake [1995] UKHL 11, [1996] AC 243, 251(UK).

50 Equitable set-off applies where a counterclaim is "so closely connected" with the claim that it would be "manifestly unjust" to allow the claimant to enforce payment without taking into account the counterclaim. Fearns, [2011] 1 WLR 366 ¶ 20 (Eng. & Wales). It may not be appropriate to order bifurcation in the context of equitable set-off. We explore this under section IV.iii.b , below.

51 This is an example of legal set-off under English law.

- the claim and counterclaim are based on the parties having opposing positions on the same legal issue (e.g. differing legal interpretations of the same contractual provision(s));[52] or

- the counterclaim also goes to the merits of the claim (e.g. where the respondent counterclaims for breach of condition which would not only entitle the respondent to damages under the contract, but would also invalidate the claimant's claim).

C. Step 3: Has the Claimant Justified that Bifurcation is Procedurally Justified in the Circumstances?

Step 3 requires the tribunal to consider whether bifurcation is procedurally justified.

The tribunal generally has broad discretion on how to manage the arbitration, including in deciding whether to bifurcate proceedings. It has a duty to achieve both fairness and efficiency in doing so.[53]

In the context of bifurcating claims from counterclaims, the justification for bifurcation lies in fairness as an end goal rather than efficiency *per se*. That said, the tribunal would also have to consider potential unfairness and inefficiencies arising from bifurcation, to decide on balance if bifurcation is appropriate.

i. Would bifurcating promote fairness?

Bifurcation is commonly seen as a tool to promote efficiency.[54] Bifurcating claims from counterclaims may promote efficiency where claims stand independent from counterclaims and are relatively simple. The arbitrator can thus render a partial award quickly on the claims without getting into the weeds of the counterclaims. This is what the claimant argued in *Hui*.[55]

However, bifurcating claims from counterclaims seems to benefit *only the claimant*. In arguing for bifurcation, the claimant hopes that the tribunal would take a shorter time to decide solely on the claims rather than to decide on both the claims and the counterclaims. This would mean that, assuming the claim is successful, the claimant may get its money more quickly.

This is unlike other forms of bifurcation that may save time and costs for both parties. For example, in bifurcating an arbitration to decide issues on jurisdiction before merits or liability before damages, it is possible that the first phase would eliminate the need for the second phase. This may happen if the tribunal in the first phase finds that it has no jurisdiction,[56] or that the

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52 This was the situation in Hui. The parties differed on the contract's interpretation. The respondents' position was that the contract gave them a right to set-off, while Esposito seemed to argue otherwise. Hui, [2017] FCA 648 (Austl.), ¶¶ 30, 64.

53 *International Arbitration Practice Guideline: Managing Arbitrations and Procedural Orders*, CHARTERED INSTITUTE OF ARBITRATORS (2015), *available at* http://www.ciarb.org/docs/default-source/ciarbdocuments/guidance-and-ethics/practice-guidelines-protocols-and-rules/international-arbitration-guidelines-2015/managing-arbitrations-and-procedural-orders.pdf?sfvrsn=2.

54 *See* Greenwood, *Does Bifurcation Really Promote Efficiency?*, 28(2) J. INT. ARB. 105, 106 (2011) (noting that the "accepted view is that bifurcating a dispute can (and often does) promote efficiency").

55 *See* section A, above.

56 *See Partial Award in ICC Case No. 4402*, IX Y.B. Comm. Arb. 138 (1984) (tribunal dismissing proceedings against a particular party over which the tribunal has no jurisdiction); *Interim Award in ICC Case No. 6648*, XXIII Y.B. Comm.

claim should be wholly denied.[57] Even if the tribunal finds otherwise, the parties may well reach a settlement upon completion of the first phase. This saves time and costs. In contrast, there are no such potential efficiencies for both parties in bifurcating claims from counterclaims. No matter what the decision on the claim may be, the tribunal would still have to go on to decide on the counterclaim. It is also unlikely that the respondent would be amenable to settlement after completion of the first phase, when its counterclaim has not been heard.

Under such circumstances, the question arises: Why should a tribunal grant bifurcation if it would only potentially benefit one party, and not the overall proceedings?

The answer here must be based in fairness, rather than mere efficiencies. For example, the tribunal may see that the counterclaims are demonstrably tactical or that the respondent is delaying proceedings, such that it would be unfair for the claimant to have its claims resolved together with the respondent's counterclaims. The goal of bifurcation here would not be to promote efficiency for efficiency's sake, but rather, to safeguard the fairness of the proceeding and ensure that no party is unduly benefited.

ii. Would bifurcation lead to unfairness?

Following Steps 1 and 2 of the decision-making framework would have avoided the risk of prejudicing a respondent's right to be heard in many situations when set-off looms. However, there may still be circumstances where a tribunal may decide to deny bifurcation because it thinks that it is fairer to do so.

For example, a tribunal may decide to deny bifurcation in the particular context of equitable set-off claims under English law.[58] Imagine a scenario where a seller seeks the balance for the sale of machinery, but the buyer has legitimate grounds under the doctrine of equitable set-off for setting off damages caused by poor installation of the machinery under a separate installation contract.[59] Under English law, the buyer's liability can only be reduced by the extent of the counterclaim when the tribunal makes an award declaring as such. Thus, bifurcating the claim from the counterclaim here will not necessarily prejudge the counterclaim. The tribunal can still fully determine the merits of the claim without having to decide on the respondent's counterclaim.

However, a partial award on the claim will render any subsequent finding of equitable set-off practically meaningless. Even though the tribunal is free to find in favour of the respondent's counterclaim in the next phase of arbitration, the counterclaim would not operate as a set-off if

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Arb. 30 (1998) (tribunal dismissing proceedings against a particular party over which the tribunal has no jurisdiction).

57 *See* Apotex Holdings v. United States of America, ICSID Case No. ARB(AF)/12/1. The tribunal, in its Procedural Order Deciding Bifurcation and Non-Bifurcation, separated the issue of damages from jurisdictional and liability issues (it declined to bifurcate jurisdictional from liability issues). In its Award, the tribunal dismissed some claims against the respondent on jurisdictional grounds, and dismissed the remaining claims on their merits. The tribunal thus did not need to hear submissions from the parties on damages.

58 PHILIP R. WOOD, ENGLISH AND INTERNATIONAL SET-OFF 1154-56 (1989).

59 This was the situation in Geldof Metaalconstructie NV v. Simon Carves Ltd., [2010] EWCA (Civ.) 667 (Eng.) where the court found that the defendant had an equitable right to set-off damages caused by the claimant's unlawful repudiation of the installation contract. We assume a similar hypothetical in the international arbitration context, where the tribunal has jurisdiction over both the sale and purchase contract and the installation contract.

the respondent has made the payment on the partial award before the final award is rendered. Causing the respondent to lose this opportunity to set-off the past payment with its counterclaimed amount seems unfair if the tribunal ultimately finds that equitable set-off applies (it would have been 'manifestly unjust' to allow the claimant to enforce the claim without taking into account the counterclaim).[60]

Thus, where the respondent demonstrates reasonable grounds for equitable set-off, it may be more appropriate to deny bifurcation.[61] This can be addressed, as with other forms of set-off, in a summary procedure.[62]

iii. *Would bifurcation lead to significant inefficiencies?*

Any gains in efficiency from bifurcation would have to be balanced against any resulting inefficiencies. For example, overlapping issues of fact or law relating to the claims and counterclaims would weigh against bifurcation, as it may be more efficient to hear all the issues collectively. Indeed, viewing issues in isolation in the first bifurcated phase may cause the tribunal to miss 'important links' between different elements, and consequently, render an unjust award in the first phase.[63] It may also be more convenient to witnesses, the parties, and the tribunal, to have both the claims and counterclaims heard and decided in a single proceeding.

In sum, bifurcating claims from counterclaims is appropriate only in specific circumstances, where it would be fairer for the claimant to have its claims resolved before the respondent's counterclaims. Even then, the tribunal would have to weigh this against any potential inefficiencies and unfairness to the respondent that may result from such bifurcation.

V. How to bifurcate?

It is important for tribunals to not only understand the conditions under which bifurcation is appropriate, but also to understand how to bifurcate efficiently.

One tool that may assist in bifurcating claims from set-off counterclaims is summary determination procedures. This may be appropriate when the request for bifurcation is made at an early stage in the arbitration, and the tribunal has limited information about the case.[64]

Early or summary determinations have traditionally been uncommon in international arbitration. However, in recent years, institutional rules have started to provide mechanisms for early disposition of issues. The Singapore International Arbitration Centre Rules ["**SIAC Rules**"] give

60 *See* Benedettelli, *supra* note 1; Leon Corporation v. Atlantic Lines and Navigation Co. Inc., [1985] 2 Lloyd's Rep. 470. (Granting equitable set-off is not a matter of discretion for the tribunal – once this test is satisfied, equitable set-off has to be granted.).

61 Similarly, a tribunal would prevent a respondent from making deductions from payments to a claimant under an equitable right to set-off in an interim award only if the respondent fails to show that it exercised its right in good faith and upon reasonable grounds. *See* SL Sethia Liners Ltd. v. Naviagro Maritime Corporation [1981] 1 Lloyd's Rep. 18. After an interim award is made, although the respondent is free to pursue and prove its counterclaim thereafter, it would have in effect lost the opportunity to reduce the amount of past payments with the amount it is subsequently awarded on its counterclaim.

62 *See* section V, below.

63 Benedettelli, *supra* note 1 at 499.

64 In contrast, if the tribunal only makes the decision on bifurcation after both parties' main submissions have been filed (e.g. the Statement of Claim and Statement of Defence), and the respondent has made full submissions on set-off in its Statement of Defence, there would be no need for summary determination.

parties the opportunity to apply for early dismissal of claims and defences on the ground that it is "*manifestly without legal merit*".[65] The Stockholm Chamber of Commerce Rules ["**SCC Rules**"] allow the tribunal to determine an issue by way of summary procedure where, for example, no award could be rendered in favour of a party "*even if the facts alleged by [that] party are assumed to be true"*.[66] The ICC has also issued a Practice Note in October 2017 providing guidance on the expedited determination of "*manifestly unmeritorious*" claims or defences.[67] This growing recognition of summary procedures in international arbitration today, shows that these can be adopted without prejudicing the parties' right to be heard.[68]

In practice, this is how deciding on set-off issues in a summary procedure might proceed:

- The tribunal may invite parties' submissions specifically on a claim for set-off in a summary determination. The tribunal may find that the set-off claim can be rejected under the applicable standard (e.g. it is manifestly without merit or would not succeed even if the facts alleged by the respondent are assumed to be true). Equally, it might find that the set-off, as pleaded, cannot extinguish or reduce the respondent's liability before an award is rendered. If so, the tribunal would then proceed to Steps 2 and 3 of the decision-making process.

- If, however, on the face of it, there is some merit to the respondent's claim for set-off to apply before an award is rendered, the tribunal would probably have to deny bifurcation. The tribunal would remain free to ultimately decide, upon a full hearing, whether the respondent's claim for set-off is valid or not.

As stated, there is always a tension between efficiency and fairness. Proceedings may be delayed if the tribunal waits for the respondent to provide its full submissions on set-off before it decides on bifurcation. It may also be counterproductive to conduct an extensive discovery on the right of set-off in order to determine whether to bifurcate. Summary determination may thus be a potential solution. However, the challenge remains for a tribunal to ensure that the summary procedure adopted remains consistent with the parties' right to be heard.

Besides summary determination, other case management techniques may also be employed when bifurcating claims from counterclaims. These include:

- Setting and enforcing time limits for the respondent to assert set-off claims. If there is no reasonable cause for delay in the respondent's submissions on set-off, the tribunal may

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65 Arbitration Rules of the Singapore International Arbitration Centre (2016), art. 29.

66 Arbitration Rules of the Stockholm Chamber of Commerce (2017), art. 39.

67 ICC Practice Note, art. 6(3), Oct. 30 2017. The broad scope of Article 22 of the ICC Rules, which provides for the conduct of an arbitration in an "expeditious and cost-effective manner", gives the tribunal the power to make summary determinations.

68 *See also*, Benedettelli, *supra* note 1, at 502. (suggesting the possibility of bifurcation where "the arbitral tribunal does not consider the relevant risk [of deprivation of set-off defences] substantive enough to counter the claimant's request to bifurcate").

decide on bifurcation based on the evidence presented before it.[69] This is something that the arbitrator in *Hui* could have done expressly.

- Imposing sanctions by way of costs orders.[70] The possibility of cost sanctions may incentivise parties to adhere to submission deadlines. Tribunals may be reluctant to impose sanctions for fear of having their award set aside or not enforced.[71] This reluctance is unfounded, as national courts would generally respect the case management powers of the tribunal.[72]

- Being clear on what issues are bifurcated and sticking to them. *Hui* serves as a reminder to tribunals to *not* decide on issues which were excluded from the first phase of a bifurcated arbitration.

VI. Conclusion

A tribunal can, and indeed should, decide on bifurcation fairly and efficiently when set-off looms. Tribunals should bifurcate proceedings when:

- the respondent's set-off claim, if granted, would not have already extinguished or reduced its liability;

- the claim can be decided without prejudging the counterclaim; and

- the claimant has demonstrated that bifurcation is procedurally justified.

Tribunals should also embrace the use of case management techniques, including the use of summary determination procedures.

The issue of bifurcation may arise under a myriad of circumstances, and may result in different implications for different parties. This is why tribunals have broad discretion to manage arbitration proceedings. Nonetheless, a tribunal has the duty to always use any tool available to it to achieve fairness and efficiency. Rather than simply erring on the side of caution, tribunals should be confident to bifurcate proceedings when the conditions are right.

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[69] The 2016 UNCITRAL Notes on Organizing Arbitral Proceedings at ¶ 75, states that "if a party is requested to submit evidence to support its case but fails to do so within the time limit without showing sufficient cause for such failure, the arbitral tribunal may make the award solely on the evidence before it."

[70] Various institutional rules provide the tribunal with the power to do so. *See* ICC Rules, *supra* note 26, art. 38(5) (2017) ("In making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner."); LCIA Rules, *supra* note 25, art. 28.4. (The tribunal may consider any "non-co-operation resulting in undue delay and unnecessary expense" in its decision on costs).

[71] The lack of effective sanctions was the second most complained about feature of international arbitration in both the 2015 and 2018 International Arbitration Surveys. This seems to stem, not from the lack of availability of sanctions, but rather, the reluctance of tribunals to impose them.

[72] *See generally* Berger and Jensen, *Due Process Paranoia and the Procedural Judgment Rule: A Safe Harbour for Procedural Management Decisions by International Arbitrators*, 32(3) ARB. INT'L. 415, 428 (2016) (arguing that "a court will not second-guess an arbitrator's exercise of his procedural judgment, if his decision is grounded in a bona fide assessment of the case and is reasonable under the circumstances.").