

K&LNG Alert

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Bankruptcy

Getting to Know your two Best Friends: The Rights of Setoff and Recoupment

This K&LNG Alert provides commercial lawyers and credit managers with an introduction to the use of setoff and recoupment in order to reduce the amount by which their employers are indebted to an individual or business that has entered bankruptcy. Section I outlines a creditor's right of setoff and describes when the right arises, as well as the process for, and restrictions on, exercising this right. Section II distinguishes the doctrine of recoupment from a creditor's right of setoff, describes how recoupment can be a powerful tool of collection, and outlines the legal requirements are for its use.

SETOFF

Creditors of debtors in or nearing bankruptcy have few tools available to them as powerful as the right of setoff, the right to "net" or cancel mutual debts. This setoff right protects a creditor from having to pay its debt to a debtor in full while standing in line to recover a pro rata share of the debtor's debt to it.¹ Creditors need to recognize when the right to setoff arises, understand how to assert the right, and be aware of the restrictions placed on the right by the Bankruptcy Code.

KEEP RECORDS OF DEBTS WHICH GIVE RISE TO THE RIGHT

A right to setoff usually arises when a debtor owes a debt to a creditor and the creditor owes a debt to the debtor. A creditor should keep track of all mutual debts between it and its business partners or customers, particularly those who are in poor financial condition. In so doing, a creditor will be able to recognize situations that will give rise to the right of setoff.

MAXIMIZE SETOFF OPPORTUNITIES

The Bankruptcy Code allows different sorts of debts to serve as the basis for a setoff. Virtually any right to payment can be a "debt," and the two "debts" underlying a setoff need not be related except that they should ordinarily be between the same two legal entities. Because the Bankruptcy Code allows so many varieties of debts to be offset against one another, creditors need to think carefully about past interactions with a bankrupt debtor. If a creditor can identify any sort of claim for money or damages that the debtor may have against the creditor, that creditor may have identified an opportunity to take a setoff.

PRE-PETITION SETOFFS ARE PREFERABLE TO POST-PETITION SETOFFS

The right of setoff originates in state and non-bankruptcy federal law.² The Bankruptcy Code does not create the right of setoff; rather, it restricts the exercise of this preexisting right. Practically, this means that setoffs taken before the debtor files a bankruptcy petition ("pre-petition") are, with a few exceptions, beyond the reach of the Bankruptcy Code. Hence, creditors should generally take setoffs pre-petition.

How to Take a Pre-petition Setoff

A creditor takes a setoff intentionally by engaging in some action to accomplish and record it.³ These actions need not be formal, but a paper trail should be created at the time of the setoff. A setoff can occur when two parties exchange checks or simply make book entries offsetting the mutual debts.⁴

¹ U.S. v. Brunner (In re Brown), 282 F.2d 535, 537 (10th Cir. 1960).

² All fifty states grant this right.

³ Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 19 (1995).

⁴ Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913).

A creditor's pre-petition setoff will be valid so long as it complies with applicable state or non-bankruptcy federal law that creates the right.⁵ State law may list elements that a setoff transaction must contain, and it will determine whether the debts involved in a setoff are valid or not.

If a purported setoff transaction was not valid under applicable state or non-bankruptcy federal law, then it was never really a "setoff." Hence, the transaction may be avoidable by the trustee of the bankrupt estate during the bankruptcy case as either a fraudulent transfer or a preference.

Disqualifying a Pre-petition Setoff

With three exceptions, all pre-petition setoffs that are valid under applicable state or non-bankruptcy federal law are beyond the reach of the provisions of the Bankruptcy Code. The Bankruptcy Code does, however, reach back to disqualify three types of setoffs. In this context, "disqualify" means one of two things: the Bankruptcy Code makes the setoff either avoidable or directly recoverable by the trustee. Consult counsel if a setoff looks like one of these three varieties disqualified by the Bankruptcy Code.

- The first type of setoff that the Bankruptcy Code will reach back to disqualify is the "acquired claim" setoff.⁶ An "acquired claim" setoff right arises when a creditor obtains a claim against a debtor via a transfer from a third party. An example is when a creditor buys a debtor's debt from someone else. If the transfer of this claim occurs within the period beginning ninety days before the petition's filing and while the debtor is insolvent,⁷ the trustee of the bankrupt estate will be able to avoid any setoff so taken.⁸

- The second type of setoff that the Bankruptcy Code will reach back to disqualify is the "acquired debt" setoff.⁹ An "acquired debt" setoff right arises when a creditor of a debtor incurs a debt to that same debtor while the debtor is insolvent and for the purpose of obtaining a setoff right. If this debt acquisition occurs within the period beginning ninety days before the petition's filing, the trustee will be able to avoid any setoff so taken.¹⁰

- Finally, the Bankruptcy Code makes portions of "improvement in position" setoffs directly recoverable by the trustee.¹¹ This Bankruptcy Code provision compares a creditor's actual pre-petition setoff to a hypothetical setoff the same creditor could have taken at earlier benchmark times (beginning ninety days before the filing of the petition). The Bankruptcy Code authorizes the trustee to recover the difference between the actual setoff and the hypothetical one if the actual was more advantageous to the creditor than the hypothetical would have been.¹²

KNOW THE RULES APPLICABLE TO POST-PETITION SETOFFS¹³ The Automatic Stay Applies to All Post-petition Setoffs¹³

Once a debtor files its bankruptcy petition, a creditor can take a setoff only after being granted relief from the automatic stay by the bankruptcy court. In order to obtain relief from the automatic stay, a creditor must file a motion for relief with the bankruptcy court. A creditor should not take a setoff without first obtaining relief to do so. Any setoff taken without first obtaining relief from the automatic stay will be void as a matter of law, and the creditor may be held in contempt of court and subjected to penalties.

⁵ 11 U.S.C. § 553(a)(1) (2000).

⁶ 11 U.S.C. § 553(a)(2) (2000).

⁷ A debtor is "presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 553(c) (2000).

⁸ The Bankruptcy Code treats "acquired claim" setoffs as either preferences or fraudulent transfers in order to subject them to avoidance by the trustee.

⁹ 11 U.S.C. § 553(a)(3) (2000).

¹⁰ Like "acquired claim" setoffs, the Bankruptcy Code treats "acquired debt" setoffs as either preferences or fraudulent transfers in order to subject them to avoidance by the trustee.

¹¹ 11 U.S.C. § 553(b) (2000).

¹² Example: An individual ("Debtor") obtains a loan from a bank ("Bank") and maintains a checking account at Bank. Bank can offset what it owes to Debtor (checking account balance) against what Debtor owes to it (loan balance). Assume on day one, one month before Debtor files for bankruptcy, Debtor owes Bank \$100 and has \$50 in his or her account. Assume on day twenty, Bank takes a setoff. At this time, Debtor has \$75 in his or her account. By waiting, Bank took a setoff that was \$25 more valuable. The "improvement in position" disqualification provision will allow the trustee to recover Bank's improvement in position, \$25.

¹³ 11 U.S.C. § 362(a)(7) (2000).

A claim that would have been subject to a pre-petition setoff is classified and treated like any other claim against a bankrupt estate. A creditor with an unexercised setoff right is treated as a secured creditor to the extent of the setoff amount and as an unsecured creditor for any amount that exceeds the debtor's claim against the creditor. The Bankruptcy Code entitles this unexercised setoff claim to adequate protection.¹⁴ If the debtor cannot grant such protection, the creditor can move for relief from the automatic stay to exercise its setoff right. Courts will grant a creditor relief from the stay where adequate protection cannot be obtained.¹⁵

All Setoffs Taken Post-petition Must Contain Five Elements¹⁶

Debts and Claims Must be Acquired in the Same Time Frame

A creditor may offset two debts only if those debts came into being before the filing of the petition or if both debts came into being after the filing of the petition.¹⁷ A post-petition debt can never offset a pre-petition debt.

Where there is doubt about the timing of a debt, bankruptcy courts use one of four tests to fix the moment at which a debt comes into being. The accrual test, conduct test, relationship test, and foreseeability test are the four tests courts may turn to when in doubt as to when a debt arose. The accrual test is disfavored and seldom used.¹⁸ The conduct test focuses on the acts giving rise to the claim. The relationship test asks whether the debt arose out of a pre-petition relationship. The foreseeability test asks whether the liability giving rise to a debt was foreseeable pre-petition. Counsel can assist with determining which test applies.

Creditor Must Have A Claim against Debtor

A creditor seeking to take a setoff must hold a "claim" against the debtor. A "claim" is a "(A) right to payment, whether or not such right is reduced to

judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured."¹⁹

A tremendous number of "claims" will fit this definition. However, there are some exceptions, and a few of these exceptions are quite notable. A contingent claim qualifies, but taking a setoff based on such a claim means estimating the dollar amount involved or delaying the setoff until the contingent claim becomes a fixed one. Further, claims that settle during the bankruptcy case raise a difficult issue because courts give different answers to the question, "Does settlement after the petition 'convert' what was a pre-petition claim into a post-petition claim?"²⁰ Since post-petition debts can never offset pre-petition ones, the answer to this question will determine whether a setoff can be taken following the settlement of one of the claims involved.

Creditor Must Owe Debt to Debtor

A creditor seeking to take a setoff must owe a "debt" to the debtor. "Debt" is defined as "liability on a claim."²¹ In practice though, the term is synonymous with "claim."²² Therefore, many claims qualify as a debt.

The Claim and Debt Must Be Mutual

The debt and claim involved in a setoff must be "mutual." Mutual debts are owed in the same right. This means that a debt held by one individual cannot offset a debt held jointly by two individuals.²³ Further, mutual debts are owed in the same capacity. This means that a creditor and debtor must owe each other in their own names, not as fiduciaries. Finally, mutual debts are generally debts between two, and only two, parties. Although three-way debts are not

¹⁴ The concept of adequate protection is defined in 11 U.S.C. § 361 (2000). It roughly means that the trustee must establish a way to compensate a creditor for or protect a creditor against any loss in value to the creditor's claim that occurs during the bankruptcy case.

¹⁵ 11 U.S.C. § 362(d) (2000).

¹⁶ 11 U.S.C. § 553(a) (2000).

¹⁷ *Se. Bank, N.A. v. Grant (In re Apex Int'l Mgmt. Servs., Inc.)*, 155 B.R. 591, 594-95 (Bankr. M.D. Fla. 1993).

¹⁸ However, the test was adopted by the Third Circuit in *M. Frenville Co. v. Avellino & Bienes (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1985).

¹⁹ 11 U.S.C. § 101(5) (2000).

²⁰ Compare *Cooper-Jarrett, Inc. v. Cent. Transp., Inc.*, 726 F.2d 93 (3d Cir. 1984) (post-petition settlement agreement converted a pre-petition debt into a post-petition debt and debts could not be offset), with *Archer v. Warner*, 538 U.S. 314 (2003) (post-petition settlement agreement did not convert a pre-petition fraud claim into a post-petition contract claim; the claim remained a fraud claim). Note, *Archer* did not overrule *Cooper-Jarrett*. While the principle of law regarding the re-characterization of a liability following a settlement of that liability applied in *Archer* appears to directly conflict with the principle applied in *Cooper-Jarrett*, *Archer* dealt with the question of a debt's dischargeability, so its holding is not directly applicable to setoff law.

²¹ 11 U.S.C. § 101(12) (2000).

²² *Pa. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 558 (1990).

²³ However, there is a narrow equitable exception to this rule. See *Gray v. Rollo*, 85 U.S. 629 (1873).

normally eligible for setoff, three parties can take a “triangular setoff” if they formally agree to this arrangement pre-petition in a written contract.²⁴ Mutual debts, importantly, need not be of the same character. For instance, tort and contract claims may be offset against each other in certain circumstances.²⁵

THE CLAIM AND DEBT MUST BE VALID AND ENFORCEABLE

The debt and claim involved in a setoff must be “valid and enforceable” obligations.²⁶ This is easy to establish for pre-petition claims. Here, the claim and debt underlying the setoff only need be valid under applicable state law.

Post-petition setoffs, however, must involve two debts that are valid under both applicable state law and the Bankruptcy Code. The Bankruptcy Code will occasionally make unenforceable a debt that would be enforceable under state law. For example: assume a landlord holds a security deposit of \$100 against a lessee who owes the landlord \$1,000 in unpaid rent. Pre-petition, the landlord can offset the deposit against the unpaid rent and try to obtain the other \$900. However, post-petition, the Bankruptcy Code may cap²⁷ what the landlord can recover at a lesser amount and not allow recovery of the full \$1,000 owed. Assuming the lesser amount is set at \$700 and the landlord did not take his or her setoff pre-petition, then the landlord can no longer take his or her setoff against the whole \$1,000 and still file a claim for \$700. Three hundred dollars of the old debt is unenforceable under the Bankruptcy Code, and the landlord cannot take a setoff against it. The landlord must take the setoff against the \$700.²⁸ Thus, if the landlord had acted pre-petition, he would have \$100 plus a state law claim for \$900, which would be capped at \$700. By waiting to act post-petition, the landlord’s \$1,000 state law claim is first capped at \$700, and then the offset is allowed, resulting in the landlord’s having \$100 and a claim for \$600.

Disqualification of Setoffs Post-petition

The provisions that disqualify “acquired claim” setoffs and “acquired debt” setoffs taken 90 days prior to the filing of the petition will also disallow setoffs taken post-petition which meet the other requirements of those specific disqualifications. On the other hand, the disqualification provision that authorizes the trustee to recover a portion of an “improvement in position” setoff generally only applies to setoffs taken pre-petition.²⁹

BE AWARE OF THE NARROW EXCEPTIONS TO SETOFF DISQUALIFICATION

The Bankruptcy Code’s three disqualification provisions (acquired claim, acquired debt, improvement in position) have a narrow set of exceptions which apply to financial participants and other parties to complex financial transactions.³⁰

SETOFF RIGHTS CAN BE WAIVED

A creditor may waive setoff rights both expressly and implicitly. Implicit waiver will, however, only be found with reference to a number of factors, such as length of delay, diligence of the creditor, and detrimental reliance and prejudice. Note that waiver for some purposes may not be waiver for all purposes and that there are defenses to a claim of waiver.

For instance, typically, a creditor asserts its setoff rights by filing a proof of claim that specifically invokes such rights. If a creditor fails to file a proof of claim, however, it does not necessarily lose its setoff rights for all purposes. The rights can normally be asserted in a defensive manner. Further, a creditor may defend against a claim of waiver on a number of grounds. Three examples where the creditor has a valid defense to waiver are: (1) inadvertence, particularly where error gave rise to no detrimental reliance; (2) mistake of facts; and (3) lack of intent to waive.

²⁴ A triangular setoff involves a triangle of debts – A owes B, B owes C, C owes A. Note that an industry custom of three-party debt cancellation is not enough to constitute a formal agreement to take a triangular setoff. See *In re Elcona Homes Corp.*, 863 F.2d 483, 487 (7th Cir. 1988).

²⁵ *Camelback Hosp., Inc. v. Buckenmaier (In re Buckenmaier)*, 127 B.R. 233, 238 (B.A.P. 9th Cir. 1991).

²⁶ 11 U.S.C. § 553(a) (2000).

²⁷ 11 U.S.C. § 502(b)(6) (2000).

²⁸ This example recreates, with simplified numbers, the scenario in *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944).

²⁹ This fact gives rise to the primary situation in which it may be better to take a setoff post-petition rather than pre-petition – when a debtor maintains an account with the creditor. Refer back to the example in footnote 14. Now, assume that the Bank takes a setoff involving the same amounts, a \$100 loan and a \$75 deposit, but after the petition’s filing. Most courts hold that the “improvement in position” disqualification provision only applies to setoffs taken pre-petition. It will not disqualify the \$25 improvement in position represented by this post-petition setoff.

³⁰ 11 U.S.C.A. § 553 (West 2005).

FINAL THOUGHTS ON SETOFF

The Bankruptcy Code makes exercising the right of setoff complicated whether that right is exercised pre-petition or post-petition. A creditor should consider the timing of the setoff, the possibility of disqualification of claims, and the elements of the setoff transaction under the Bankruptcy Code if the setoff is to be taken post-petition. In order to reduce the risk of violating the automatic stay, a creditor should consult counsel before exercising its setoff rights.

RECOUPMENT

When a possibility of taking a setoff arises, the prudent creditor should also consider the potential utilization of the doctrine of recoupment. While similar to setoff, there are several subtle yet important differences between these two mechanisms for dealing with a debtor. As will be shown below, recoupment is both a narrower and potentially a more powerful doctrine.

RECOUPMENT DISTINGUISHED FROM SETOFF

Recoupment is not addressed explicitly by the Bankruptcy Code, but rather it is an equitable doctrine developed by the courts. Nevertheless, recoupment has long applied in the bankruptcy context.

Recoupment, like setoff, always involves mutual debts. Like setoff, it permits a creditor to “net” mutual debts between itself and a debtor. Although debts to be netted in a setoff can be from totally unrelated transactions, recoupment is available only where the two debts arise out of the “same transaction” or occurrence.³¹ For example, in one often-cited case, a court held that rental payments due under a lease could be recouped against losses caused by fraud in the inducement of the same lease after the lessor went into bankruptcy because both debts arose out of the “same transaction” -- the lease.³² Because of the “same transaction” requirement, the universe of debts eligible to be recouped is much smaller and narrower in scope than the range of debts eligible to be offset.

RECOUPMENT HAS CERTAIN KEY ADVANTAGES OVER SETOFF

Notwithstanding its limited applicability, recoupment can be a very valuable tool for credit managers and commercial lawyers alike. There are many distinguishing characteristics that make recoupment more advantageous in bankruptcy than setoff.

Pre-petition Recoupment

Recoupment and setoff have a similar effect in the period preceding the filing of a petition in bankruptcy; both are treated as forms of counterclaims. However, in addition to the definitional distinction that recoupment must arise out of the “same transaction,” two other advantages between pre-petition recoupment and pre-petition setoff should be mentioned. First, the statute of limitations generally does not apply to bar a recoupment defense, whereas a setoff may be time barred by the limitations period absent statutory authority holding otherwise.³³ This serves as a potential advantage, of course, both in bankruptcy and prior thereto. Second, the disqualification provisions discussed above that reach back to disqualify certain pre-petition setoffs do not affect a true recoupment.

Post-petition Recoupment

Many of the requirements and limitations of the Bankruptcy Code that are germane to setoff, including the requirement that relief be sought from the automatic stay and the prohibition of offsetting pre-petition debts with post-petition debts, do not apply to recoupments.

Because post-petition setoff is subject to the Bankruptcy Code’s automatic stay, a creditor must make a claim for the amount it is owed and then obtain court approval before it can offset the debts, all while still paying the debtor fully. If the court refuses to grant relief from the stay, a creditor is forced to accept a secured claim for possible later recovery from the debtor’s estate. As a holder of a secured claim, a creditor faces significant risks and burdens prior to being able to recover anything on its claim. It must await confirmation of the plan of

³¹ *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155, 157 (10th Cir. 1986).

³² *Holford v. Powers (In re Holford)*, 896 F.2d 176 (5th Cir. 1990).

³³ *Beach v. Ocwen Fed. Bank*, 523 U.S. 410, 415 (1998) (stating “defendant’s right to plead ‘recoupment’ . . . survives the expiration of the period provided by a statute of limitation that would otherwise bar the recoupment claim as an independent cause of action.”); *Harmer v. Hulsey*, 321 Pa. Super. 11, 14 (Pa. Super. Ct. 1983) (“[R]ecoupments have traditionally been permitted, even if raised after the limitations period has run, whereas set-offs will not be permitted if late”).

reorganization or liquidation. The creditor is also subject to the possibility of waiver by the debtor and to the threat that the “adequate protection” of its secured claim could turn out to be less than adequate.

In contrast, many courts agree that recoupment is not subject to the automatic stay.³⁴ Therefore, in certain circumstances, creditors may exercise their right to recoup by reducing, dollar for dollar, any amount owing to a debtor by the amount that they are owed from the “same transaction” without petitioning the bankruptcy court for approval or relief from the stay. Additionally, a creditor holding a right of recoupment should not be forced to accept a secured claim in the estate and, as such, the creditor is subject to fewer risks than a creditor holding a post-petition right of setoff. Significantly, however, not all courts are in accord that the automatic stay is inapplicable to recoupment; therefore, the prudent course of action is to check with counsel before trying to recoup any amounts post-petition.

Another advantage to recoupment in most jurisdictions is that the debts to be applied against one another need not be both pre-petition or post-petition in order to be eligible to be recouped. With setoff, both the creditor’s obligation to the debtor and the debtor’s obligation to the creditor must have arisen prior to or after the commencement of the case in bankruptcy. In other words, with setoff a creditor cannot net pre-petition debts against post-petition debts. In contrast, the majority of courts hold that recoupment is not so limited and that a creditor may apply debts arising pre-petition, post-petition, or both, against each other so long as they arise from the “same transaction.”

WHEN CAN RECOUPMENT APPLY

Because of the advantages of using recoupment rather than setoff, the issue becomes whether the particular debts at issue arise out of the “same transaction.” There is no bright line test to resolve this issue; rather, it is a fact-intensive inquiry. Moreover, as with many equitable doctrines, the courts have been less than consistent in their interpretations.

Defining the “Same Transaction” Requirement

The most liberal test used to determine whether the “same transaction” element is satisfied is the “logical relationship test,” under which recoupment is permissible so long as the debts are “sufficiently interconnected so that it would be unjust to insist that one party fulfill its obligation without requiring the same of the other party.”³⁵ Another test is the “integrated transaction test,” under which the mutual debts must “arise out of a single integrated transaction” for recoupment to be applicable.³⁶ The main difference between the two tests is the nexus required between the obligations to be netted.

Other courts have permitted recoupment only in an overpayment context. For example, where a creditor has overpaid a debtor who then files for bankruptcy, the creditor may recoup the amount by which it overpaid from its post-petition obligation to the debtor arising under the same contract.

Finally, in addition to the above tests, a court may consider other factors, including whether there are similar legal and factual issues to be decided and whether to a large extent the same evidence can be used in support of both the debtor’s claim and the creditor’s defense.

WHY IS RECOUPMENT TREATED DIFFERENTLY FROM SETOFF?

While the reasons for the advantageous treatment of recoupment vis-à-vis setoff are often obscure, the consensus is that recoupment is not subject to the automatic stay or the limitations on netting only pre-petition debts because it is more in the nature of a defense to a debtor’s or trustee’s demand for payment from a creditor, rather than an independent claim for money from the estate asserted by a creditor.³⁷ Recoupment allows the creditor to reduce the amount it owes a debtor by asserting against the debtor a claim arising out of the “same transaction” in order to arrive at the proper amount for which the creditor is liable.

In other words, when sued by a bankrupt’s estate, a creditor can show that because of circumstances arising out of a transaction, it is not liable for all or

³⁴ *Shugrue v. Chem. Bank, Inc. (In re Ionosphere Clubs, Inc.)*, 177 B.R. 198, 205 (Bankr. S.D.N.Y. 1995) (noting that “courts have a split on whether exercising recoupment rights violates the automatic stay”). Compare *Burley v. Am. Gas & Oil Investors (In re Heafitz)*, 85 B.R. 274, 280 (Bankr. S.D.N.Y. 1988) (“a party seeking to exercise a proper recoupment must first seek relief from the automatic stay”) with *In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990) (holding that recoupment is not subject to the automatic stay).

³⁵ *Aetna U.S. Healthcare, Inc. v. Madigan (In re Madigan)*, 270 B.R. 749, 755 (B.A.P. 9th Cir. 2001).

³⁶ *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1081 (3d Cir. 1992).

³⁷ *In re B & L Oil Co.*, 782 F.2d at 157.

part of the claim. Stated simply, recoupment is a defensive remedy that only serves to determine the amount properly owed to a debtor, while setoff is an attempt to establish and enforce a separate claim against the debtor -- by definition an offensive act.

The parallel justification for bankruptcy's treatment of recoupment is that the Bankruptcy Code only governs the bankruptcy estate, and debts subject to a right of recoupment are not considered to be a part thereof. In other words, a trustee of a bankruptcy estate takes the property subject to the rights of recoupment.

HELPFUL TIPS IN APPLYING THE DOCTRINE OF RECOUPMENT

While there is no way to assure that a bankruptcy court will permit a debt to be recouped in any given situation, there are several practical steps a creditor can take to increase its probability of obtaining a right to recoupment.

Structuring Obligations to Arise from the "Same Transaction"

It is helpful for the offsetting obligations to arise out of the same contract. Therefore, even if a business relationship has several distinct elements, it may be advisable to memorialize all of these elements in a single comprehensive contract outlining the total agreement. For example, one court found that a company could recoup amounts owed by a former employee for personal charges on a corporate credit card against severance payments owed to the employee because both the employee's agreement to pay for personal expenses and the severance agreement were memorialized in a single contract.³⁸

However, the outlining of all obligations within the same contract may not be sufficient in and of itself. To achieve the requisite nexus for recoupment, creditors also should link the activities within the contract in some logical fashion. Furthermore, the contract could provide a recoupment provision, i.e., an express contractual right to withhold payments for the transaction with regard to each party's debts.

Finally, if trade credit is being granted, both parties should properly characterize their book entries. In granting trade credit, a trade creditor should specifically designate contra entries as recoupments, as opposed to using language that could be construed as a setoff.

While these efforts do not guarantee that a creditor will be permitted to recoup its claim, relevant case law suggests that courts are more likely to find a right to recoupment where there is a single contract with a recoupment provision and where the obligations to be recouped are linked in some logical fashion.

Precautions Prior to Exercising a Right to Recoup

Creditors should consult with counsel regarding the specific factors or tests employed by the court hearing a debtor's bankruptcy case to determine whether certain debts arise from the "same transaction." In addition, while it is not normally necessary to file a claim or to file a motion for relief from the automatic stay, the most prudent course for any creditor would be to file a motion for a determination of whether recoupment is applicable. A creditor may also file a proof of claim and identify the amount included in the claim that is subject to recoupment. These actions will reduce the risk that the creditor will become the subject of a contempt motion for violating the automatic stay should the court later determine recoupment was inappropriate.

FINAL THOUGHTS ON RECOUPMENT

Whenever setoff applies, examine whether the doctrine of recoupment might also apply. Where applicable, recoupment can give a creditor a significant advantage over others attempting to recover from the debtor. However, as an exception to the Bankruptcy Code's automatic stay and ratable distribution principle, the right to recoupment is often narrowly construed. Therefore, it is prudent to take some steps, such as memorializing agreements in a single contract that incorporates a recoupment provision, in order to bring obligations within the ambit of the doctrine.

³⁸ *Reeves v. Columbia Gas of Ohio (In re Reeves)*, 265 B.R. 766, 770 (Bankr. N.D. Ohio 2001).

While these concepts may appear simplistic, the line between setoff and recoupment is easily blurred. Therefore, before attempting to recoup funds from a debtor who has filed a petition in bankruptcy, consult an attorney to ascertain whether recoupment is applicable and to avoid violating the automatic stay.

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