

**Setoff and Recoupment**  
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**March 2003**

**I. Setoff and Recoupment Generally**

Setoff is an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction. Recoupment differs in that the opposing claims must arise from the same transaction. The Bankruptcy Code is not an independent source of law that authorizes setoff or recoupment; it recognizes and preserves rights that exist under non-bankruptcy law. Therefore, a creditor seeking to set off or recoup a debt must establish a claim and a right to do so under state or federal law.

**II. Setoff**

A. The right to setoff is authorized and restricted by 11 U.S.C. § 553. The provisions of the Bankruptcy Code have no effect on the creditor's right of setoff as long as the criteria set out in § 553 are satisfied. In other words, if § 553 is followed, the estate cannot collect an obligation owed to the debtor if that obligation was satisfied through setoff before bankruptcy. In re Nerland Oil, Inc., 303 F.3d 911 (8th Cir. 2002).

B. Requirements of § 553 protection

i. Requirement of a substantive i.e. non-bankruptcy right of setoff.

1. The requirements for setoff in Minnesota are virtually identical to those in § 553. See Nietzel v. Farmers and Merchants State Bank, 307 Minn. 147, 238 N.W.2d 437 (1976); Firststar Eagan Bank v. Marquette Bank, 466 N.W.2d 8, 12 (Minn. Ct. App. 1991).
2. Minnesota law requires the existing indebtedness be due at the time of setoff and the mutuality of obligations. Firststar Eagan Bank v. Marquette Bank, 466 N.W.2d 8, 12 (Minn. Ct. App. 1991) (requiring the existing indebtedness be due at the time of setoff and the mutuality of obligations); Farrell v. Wurm (In re Donnay), 184 B.R. 767, 787 (D. Minn. 1995).

ii. Requirement of mutuality

1. Mutuality is strictly construed. Id. To be mutual, the debts must be: (1) in the same right; (2) between the same parties; and (3) the parties stand in the same capacity. Id.
2. The Courts have interpreted between the same parties to require both claims to arise on the same side of the line described by the

petition's filing, i.e. both claims must be pre-petition claims or post-petition claims. In re M.W. Ettinger Transfer, Co., 1988 WL 129334 (Bankr. D. Minn. Nov. 29, 1988).

a. This is because after filing petition, Debtor is considered a different party.

b. Further, if such a crossover of the petition date was allowed, a creditor could upset the orderly process of liquidation and equality of distribution amongst creditors and accomplish through setoff a post-petition payment of a pre-petition claim in violation of § 549 of the code. In re M.W. Ettinger Transfer, Co., 1988 WL 129334 (Bankr. D. Minn. Nov. 29, 1988).

c. The courts are split on the question whether setoff of post-petition claim is permitted. In re Dartco, Inc., 197 B.R. 860 (Bankr. D. Minn. 1996) (rejecting attempt to set off post-petition claims).

3. Mutuality does not require that the debts be of the same character or have arisen from the same transaction.

### iii. Code's Exceptions to Setoff

A claim cannot be set off if: (1) it is disallowed, § 553(a)(1); (2) creditor acquired the claim from a third person during the 90 days proceeding the case while the debtor was insolvent or after the commencement of the case, § 553(a)(3); (3) the debt being offset was incurred during the 90-day period while the debtor was insolvent for the purpose of obtaining a right of setoff, *id.*; and (4) the creditor improved her position during the 90-day period. § 553(b).

### C. Setoff and the Automatic Stay

11 U.S.C. § 362 states that the filing of the petition stays the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor.

- i. The stay does not vitiate the right of setoff. Instead it changes the procedure for exercising the right.
  1. Before bankruptcy, creditor can exercise any of its remedies available to setoff.
  2. After a petition is filed, creditor must seek relief from the automatic stay before it exercises its right of setoff..

- ii. Administrative hold and stay violation.
  1. The creditor may “freeze” sums subject to offset but delay consummating setoff while filing a proof of claim indicating the sum is held “subject to” setoff, without requesting relief from stay. Citizen’s Bank v. Strumpf, 516 U.S. 16, 116 S. Ct. 286 (1995); In re Laux, 181 B.R. 60 (Bankr. S.D. Ill. 1995); In re Tillery, 179 B.R. 576 (Bankr. W.D. Ark. 1995) (good discussion).
  2. The issue remaining to be decided is how long the “temporary” freeze may last. In re Killen, 249 B.R. 585 (Bankr. D. Conn. 2000) (9 months delay in filing motion for setoff not too long); Town of Hempstead FCU v. Wicks, 215 B.R. 316 (E.D. N.Y. 1997) (4 month freeze too long).

#### D. Right to Setoff is Secured Claim

- i. The creditor’s right to setoff is a secured claim in any monies owed to the debtor. 11 U.S.C. §506(a); In re Patterson, 967 F.2d 505 (11<sup>th</sup> Cir. 1992); In re Allen, 135 B.R. 856 (Bankr. N.D. Iowa 1992).
- ii. A debtor may use the amount of subject to setoff provided it obtains court approval (unless the creditor consents) and furnishes adequate protection to the creditor. 11 U.S.C. § 363(c)(2)(B); In re Lough, 163 B.R. 586 (Bankr. D. Idaho 1994).
- iii. Funds subject to setoff are expressly excepted from any right of the debtor to demand turn over under § 542(b). If the creditor turns the money over to the debtor, it is entitled to adequate protection. In re Empire For Him, Inc., 1 F.3d 1156 (11<sup>th</sup> Cir. 1993). This may take the form of treating the claim in a plan as a secured claim. In re Mohar, 140 B.R. 273 (Bankr. D. Mont. 1992).

#### E. Setoff and Government Agencies

- i. The United States is one party for mutuality purposes and can set off claims held by different agencies. In re HAL, Inc., 122 F.3d 851 (9th Cir. 1997) aff’g 196 B.R. 159 (B.A.P 9th Cir. 1996). The issue is now considered settled law. In re Killen, 249 B.R. 585 (Bankr. D. Conn. 2000).
- ii. The only exception is when the government agency is acting in a distinctly private capacity. In re HAL, Inc., 122 F.3d 851 (9th Cir. 1997) aff’g 196 B.R. 159 (B.A.P 9th Cir. 1996).
- iii. Whether state agencies are one entity for purposes of setoff is less clear and may depend on how the state agencies act outside of bankruptcy. Compare In re Lakeside Community Hosp., 139 B.R. 886 (Bankr. N.D. Ill.

1992) (finding state agencies not one entity for setoff purposes) with Wallich v. New York (In re Bison Heating & Equipment, Inc.), 177 B.R. 785 (Bankr. W.D. N.Y. 1995) finding state agencies are a single entity in part by distinguishing In re Lakeside based on New York statute).

#### F. Debtor's Right to Setoff

- i. Courts have held that Debtor can exercise setoff across the time line described by the petition. In re PSA, Inc., 277 B.R. 51 (Bankr. D. Del. 2002); In re M.W. Ettinger Transfer, Co., 1988 WL 129334 (Bankr. D. Minn. Nov. 29, 1988).
  1. Section 558 preserves any pre-petition defenses a debtor may have. In re PSA, Inc., 277 B.R. 51, 53 (Bankr. D. Del. 2002).
  2. Mutuality is satisfied because the debts are between the same parties; no requirement in present context for the exchanges to be contemporaneous. Id.; but see In re Braniff Airways, Inc., 42 B.R. 443 (Bankr. N.D. Tex. 1984) (holding that doctrine of mutuality bars debtor as well as creditor from offsetting pre-petition claims against post-petition debt).
  3. Courts find holding to the contrary would be wholly unjust, improper and foolish to require debtor to pay the post-petition debt and force debtor to sue on pre-petition claim. Id. at 54; see also In re M.W. Ettinger, Transfer Co., 1998 WL 129334 at \*4.
- ii. Thus, a Debtor is allowed to setoff pre-petition claim against the creditor's post-petition administrative expense claim. In re PSA, Inc., 277 B.R. 51 (Bankr. D. Del. 2002); In re Papercraft Corp., 127 B.R. 346 (Bankr. W.D. Pa. 1991); In re M.W. Ettinger Transfer Co., 1998 WL 129334 (Bankr. D. Minn. 1988).

#### G. Setoff and avoidable preference under § 547

- i. Section 547 allows the trustee to avoid preferential transfers. However, setoff is governed exclusively by § 553 and is not avoidable as a preference under § 547. In re Holyoke Nursing Home, Inc., 273 B.R. 305 (Bankr. D. Mass. 2002); In re O'Neill, 1997 WL 615661 (Bankr. D. Minn. Oct. 2 1997).
- ii. Courts have reached this conclusion by two lines of reasoning. In re Wild Bills, Inc., 206 B.R. 8, 12-13 (Bankr. D. Conn. 1997).
  1. Setoff is excluded from the definition of transfers in the Bankruptcy Code. In re Ralar Dist., Inc., 4 F.3d 62 (1<sup>st</sup> Cir. 1993); In re Murphy, 203 B.R. 972, 975 (Bankr. S.D. Ill. 1997); In re O'Neill, 1997 WL 615661 (Bankr. D. Minn. Oct. 2 1997) or

2. Section 553(a) lists the sections that affect a creditor's right to setoff and does not list § 547. In re Wild Bills, Inc., 206 B.R. 8, 12-13 (Bankr. D. Conn. 1997); see also In re Kalenze, 175 B.R. 35 (Bankr. D. N.D. 1994) ("Only if the court finds that setoff invalid and additionally concludes that no right to setoff exists, is section 547 applied.").

### III. Recoupment

#### A. Equity-based Defense

Unlike setoff, recoupment does not appear in the Bankruptcy Code. Recoupment is an equitable principle permitting the creditor to show that it is not liable for the full amount of the debtor's claim because of matters that arise out of the same transaction. United States v. Dewey Freight Sys., Inc., 31 F.3d 620 (8th Cir. 1994); In re Pho to Mech. Servs., Inc., 179 B.R. 604 (Bankr. D. Minn. 1995).

#### B. "Same Transaction"

Courts have avoided setting out a precise definition of same transaction, preferring instead to focus on the particular facts of each case. United States v. Dewey Freight Sys., Inc., 31 F.3d 620 (8th Cir. 1994).

- i. The parameters of recoupment are derived from the common law pleading rules concerning counterclaims. Coplay Cement Co. v. Willis & Paul Group, 983 F.2d 1435, 1440 (7th Cir. 1993). In that context it has been said transaction is a word of flexible meaning including: a series of occurrences, depending not so much on the immediateness of their connection as upon their logical relationship. Moore v. New York Cotton Exch., 270 U.S. 593, 610 (1926); Tullos v. Parks, 915 F.2d 1192 (8th Cir. 1990).
- ii. In the Eighth Circuit, the determination of whether competing claims arise out of the same transaction or occurrence is made considering one or more of the following factors. In re Koehler, 204 B.R. 210, 221 (Bankr. D. Minn. 1997).
  1. Are the issues of fact and law raised by the claim and counterclaim largely the same?
  2. Would res judicata bar a subsequent suit on defendant's claim absent the compulsory counterclaim rule?
  3. Will substantially the same evidence support or refute plaintiff's claim as well as defendant's counterclaim?
  4. Is there any logical relation between the claim and counter claims.

- a. Whether the logical relationship standard is appropriately used in bankruptcy proceedings to decide whether a creditor has a right of recoupment is controversial.
  - b. One court has permitted the use of that standard. Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392 (9th Cir. 1996).
  - c. Most courts, however, take a more restrictive view of transaction; usually requiring a single contract or even a single transaction under a contract. In re University Medical Ctr., 973 F.2d 1065 (3rd Cir. 1992). But see Dewey Freight Systems, 31 F.3d 620 (8<sup>th</sup> Cir. 1994), where all shipments under a freight contract were considered one transaction for recoupment.
- iii. A second court within the Eighth Circuit stated that two elements must be satisfied before a creditor is entitled to recoupment. In re Photo Mech. Servs., Inc., 179 B.R. 604, 613 (Bankr. D. Minn. 1995).
  - 1. Both the claims arise from a single contract or transaction.
  - 2. Some type of overpayment must exist, whether the overpayment was accidentally or contractually made. See also Matter of Kosadnar, 157 F.3d 1011, 1015 (5th Cir. 1998)

#### C. Other Rules Specific to Recoupment

- i. Recoupment may be allowed when the parties have made no contractual arrangement for it. Holford v. Powers (In re Holford), 896 F.2d 176, 178 (5th Cir. 1990).
- ii. The majority rule is that the automatic stay does not apply to recoupment. Matter of Kosadnar, 157 F.23d 1011, 1014 (5th Cir. 1998), In re Holyoke Nursing Home, Inc., 273 B.R. 305 (Bankr. D. Mass. 2002); In re Pruett, 220 B.R. 625, 628 (Bankr. E.D. Ark. 1997), Mercy Hosp. Of Water Town v. New York St. Dept of Social Services, 171 B.R. 490,494 (Bankr. N.D.N.Y. 1994). But a court within the Eighth Circuit has held the stay does apply. In re Scharff, 143 B.R. 541 (Bankr. S.D. Iowa 1992).
- iii. Pre-petition claims can be withheld from post-petition debts. In re Midwest Serv. and Supply Co., 44 B.R. 262 (Bankr. D. Utah 1983). The petition date is not the "bright line" that it is in setoff.
- iv. Recoupment is unaffected by discharge in bankruptcy. In re Flagstaff Realty Assocs, 60 F.3d 1031, 135-36 (3rd Cir. 1995).

- v. As an affirmative defense, recoupment is not extinguished by a § 363 sale, because it is not an “interest” in the property sold (including accounts receivable). Folger Adam Security, Inc. v. Dematteis/MacGregor, JV, 209 F.3d 252,261 (3<sup>rd</sup> Cir. 2000); MBNA American Bank, NA v. TWA Airlines, LLC, 275 B.R. 712, 720-21 (Bankr. Del. 2002).
- vi. When recoupment is used as a defense to plaintiff’s action, it is not barred by a statute of limitations as long as the main action itself is timely. United States v. Dalm, 494 U.S. 596 (1990).
- vii. Although recoupment is a defensive doctrine a creditor may take the offensive and seek an adjudication that it may recoup without waiting for the debtor to bring suit. In re Flagstaff Realty Assocs, 60 F.3d 1031, 135 (3rd Cir. 1995).

#### D. Application of Recoupment

- i. The Eighth Circuit has held a creditor’s claim for damages from the debtor’s post-petition rejection of an executory contract did not arise from the same transaction as the debtor’s claim for compensation arising from post-petition services, although the same contract was the center of each claim. The court reasoned the same contract is not equated with the same transaction because the debtor’s failure to perform an executory contract is a “failure that is inextricably tied to its status as a Chapter 11 debtor.” Dewey Freight, 31 F.3d at 623.
- ii. Because recoupment is an equitable defense, most courts recognize that application of the defense of recoupment in a contractual context is especially appropriate. Where the parties’ mutual debts arise out of the contract recoupment is allowed because there is but one recovery due on a contract, and that recovery must be determined by taking into account the mutual benefits and obligations of the contract. Lee v. Schweiker, 739 F.2d 870 (3rd Cir. 1984); see also FSLIC v. Smith, 721 F. Supp. 1039, 1042 (E.D. Ark. 1989); In re Wiener, 228 B.R. 647 (Bankr. N.D. Ohio 1998).
  - 1. A number of courts have rejected the argument that because the obligations arise from the same contract they necessarily arise from the same transaction. See, e.g., In re Peterson Distributing, Inc., 82 F.3d 956 (10th Cir. 1996).
- iii. A bankruptcy court in the District of Minnesota denied exercise of recoupment when the right to payment arose from a series of contracts and not the same contract. Thus, the court held that manufacturer’s claim against debtor for failing to pay distributor for certain products, the claim for which had been assigned by distributor to manufacturer, did not arise from same transaction as did manufacturer’s obligation to pay rebate to

debtor. In re Photo Mechanical Servs., 179 B.R. 604 (Bankr. D. Minn. 1995).

- iv. A conservatee's pre-petition claim would not be recouped against the trustee's avoidance recovery. The earlier claim arose out of two distinct advances of conservatorship funds to the debtor, evidenced by notes and subject to fixed repayment terms. Trustee's claim arose out of revolving line of credit, whose terms were never reduced to writing and were much more ad hoc. In re Dartco, Inc., 197 B.R. 860 (Bankr. D. Minn. 1996).
- v. Where the relationship between the government and the debtor is statutory rather than contractual, such as social security benefits or VA overpayments, the application of the doctrine of recoupment is questionable. Compare In re Ross, 104 B.R. 171 (Bankr. E.D. Mo. 1989) (allowing recoupment of unemployment compensation benefits) with Lee v. Schweiker, 739 F.2d 870 (3rd Cir. 1984) (disallowing recoupment).

### **III. Can an unpaid administrative expense claim be setoff against a preference claim?**

A. An apparent majority of courts hold that a creditor is not entitled to setoff its administrative expense claim against preferential transfers recoverable by the trustee. In re Microage, Inc., (9th Cir. B.A.P. 2002); In re Georgia Steele, 38 B.R. 829 (Bankr. M.D. Ga. 1984).

- i. Section 550(a) allows a trustee to recover avoidable payments, and § 502(h) treats the claim arising from such recovery as a pre-petition claim.
- ii. Section 502(d) provides that a creditor asserting a claim may not have a claim allowed unless that creditor has paid the amount of the transferred property or turned over the property itself.

57g of the Bankruptcy Act was the precursor to § 502(d). Under 57g, courts held that even if a claim was for a priority administrative expense, Section 57g precluded allowance of the claim until the repayment of preferential transfers. See, e.g., Weber v. Mickelson (In re Colonial Servs. Co.), 480 F.2d 747 (8th Cir. 1973).

- iii. Section 502(d) is not designed to punish creditors but to give them the option to keep their transfers or to surrender their transfers and their advantages and share equally with all other creditors. [This seems to be the functional equivalent of recouping: the creditor does not pay back the avoided claim and gives up its right to affirmative recovery from the estate.]
- iv. Similarly, goods or services that form the basis for an administrative expense claim do not qualify as "new value" in defense of a preference action. In re Century Brass Prod., Inc., 71 B.R. 77 (Bankr. D. Conn. 1987); In re Bellanca Aircraft Corp., 56 B.R. 339 (Bankr. D. Minn. 1985).



- B. A minority of courts hold that preferential transfer claims against the creditor can be offset against unpaid administrative claims held by the creditor. In re Lids Corp., 260 B.R. 680 (Bankr. D. Del. 2001); In re CM Holdings, Inc., 264 B.R. 141 (Bankr. D. Del. 2000); In re Keydata Corp., 37 B.R. 324 (Bankr. D. Mass. 1983); In re Garland, Inc., 28 B.R. 87 (Bankr. E.D. Mo. 1983).
- i. Section 502(d) is not applicable to setoff of administrative claims, because administrative expense claims are generally excepted from § 502.
    1. The express reference to and treatment of other types of post-petition claims within the purview of § 502(d) suggests by negative implication that the drafters did not intend that administrative expense claims be subject to the setoff provisions of § 502(d).
    2. Further, 11 U.S.C. § 101(10) defines creditor as one with a claim arising pre-petition.
    3. Administrative expense claims under § 503(b) are expressly exempted from conversion under 11 U.S.C. § 348. See, § 348(d).
    4. Section 501 explicitly refers to post-petition claims other than administrative expenses.
  - ii. Applying § 502(d) to administrative expense claims does nothing to advance § 547's goal of equitable distribution to similarly situated creditors by preventing any one creditor from receiving preferential treatment from a troubled debtor on its way to the bankruptcy court.
  - iii. Attempts to apply the coercive effect of § 502(d) in an effort to dislodge preference payments by disallowing otherwise legitimate administrative expense payments under § 503 subverts the priority scheme in bankruptcy to no practical effect.
- C. Although § 502(d) contemplates the return of an avoidable transfer in its entirety, rather than merely an offset of a portion of an avoidable transfer against amounts that would otherwise be due, when the section is applied to an administrative claim against a (rare) solvent estate, the difference between the traditional setoff and the application of § 502(d) may have little practical significance because the amounts due in both directions are likely to be paid at the rate of 100 cents on the dollar. Thus, the parties are likely to voluntarily agree to net out the amount of the preference claim against the administrative claim. In re Microage, Inc., (9th Cir. B.A.P. 2002); In re Bob Grissett Golf Shoppes, Inc., 50 B.R. 598 (Bankr. E.D. Va. 1985). If the estate is paying less than 100%, the parties often net out the returned preference payment to reflect what the creditor would otherwise recover from the estate.