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# Exercising Setoff and Recoupment Rights in Bankruptcy

Mutuality of Obligation; Disputed Transactions; Relief From Automatic Stay

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TUESDAY, NOVEMBER 21, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# Setoff and Recoupment in Bankruptcy

**NOVEMBER 21, 2017**

**Presented by**

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# I. Setoff

## Setoff: Why is Setoff Important

- Section 506(a) of the Bankruptcy Code provides:

“(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, **or that is subject to setoff under section 553 of this title, is a secured claim** to the extent of the value of such creditor’s interest in the estate’s interest in such property, **or to the extent of the amount subject to setoff**, as the case may be . . .”

## Setoff: §553 of the Bankruptcy Code

- Section 553(a) of the Bankruptcy Code provides:

“Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . .”



## Setoff: Sources of the Right to Setoff

“Except as otherwise provided in this section and in sections 362 and 363 of this title, **this title does not affect any right of a creditor to offset** a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . .”

- The right to setoff in bankruptcy is not created under the Bankruptcy Code, but must exist under applicable non-bankruptcy law.
- Possible sources of setoff right:
  - Credit Agreements
  - Cash Management Agreements
  - Statute
  - Regulation

## Setoff: Doctrine of Mutuality

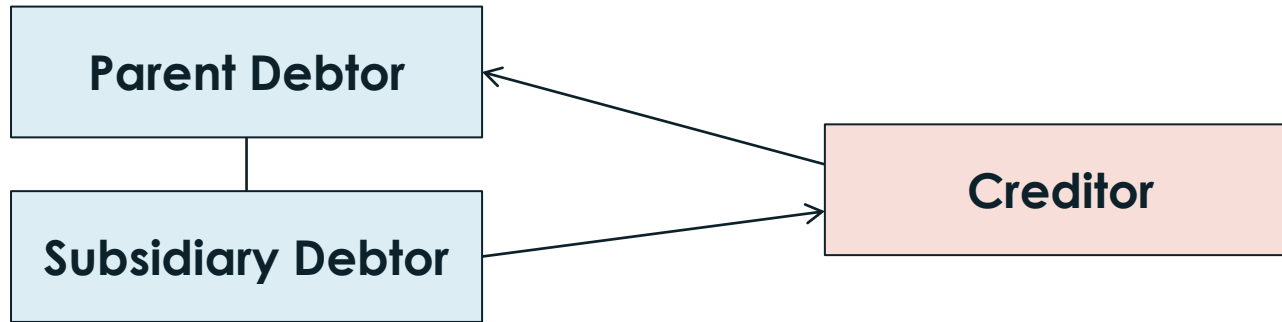
“Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset **a mutual debt owing by such creditor to the debtor** that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . .”

- The doctrine of mutuality requires that the identities of the parties be the same.



## Setoff: Doctrine of Mutuality

- Generally, mutuality is strictly enforced and So-called “triangular” setoffs are not permitted.

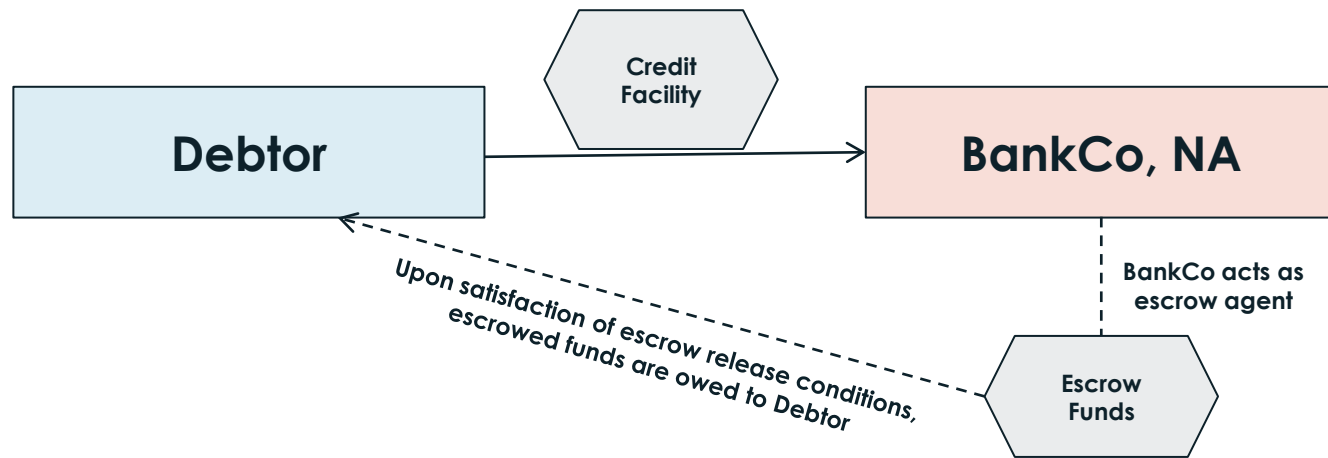


**Triangular Setoff**

- However, there are certain exceptions to this rule:
  - Claims acquired by assignment
  - Subrogation
  - Piercing the corporate veil
  - Contractual rights to setoff among different entities

## Setoff: Doctrine of Mutuality

- In addition to requiring mutuality with respect to the identity of the parties, the doctrine of mutuality requires that the parties owe each other in the same capacity.
- If one party is acting not in its own name but as a fiduciary or trustee, mutuality will be defeated.



## Setoff: Limitations on Purchased Claims

“Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case , **except to the extent that—**

- (1) the claim of such creditor against the debtor is disallowed;
- (2) **such claim was transferred, by an entity other than the debtor, to such creditor—**
  - (A) after the commencement of the case; or
  - (B)(i) after 90 days before the date of the filing of the petition; and**
  - (ii) while the debtor was insolvent . . .**
- (3) the debt owed to the debtor by such creditor was incurred by such creditor—
  - (A) after 90 days before the date of the filing of the petition;
  - (B) while the debtor was insolvent; and
  - (C) for the purpose of obtaining a right of setoff against the debtor . . .”

## Setoff: Prepetition Claim and Debt

“Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose **before the commencement of the case** under this title against a claim of such creditor against the debtor that arose **before the commencement of the case** . . .”

- Both the claim owed to the creditor and the debt owed to the debtor must have arisen before the petition date.
- Determining when a claim or debt arose can be difficult and a source of litigation.
- Different courts have adopted various tests to determine when a claim or a debt arose:
  - » Accrual
  - » Conduct
  - » Relationship
  - » Foreseeability

## Setoff: Prepetition Claim and Debt

- Accrual Test
  - Did liability for the claim accrue prior to the petition date under relevant non-bankruptcy law?
- Conduct Test
  - Did the claim arise from conduct that occurred prior to the petition date?
- Relationship Test
  - Did the claim arise from the parties' prepetition relationship?
- Foreseeability Test
  - Was the claim in the parties' fair contemplation prior to the petition date?

## Setoff: Exercising the Right of Setoff

- The Automatic Stay specifically prohibits the exercise of setoff.
  - Section 362 of the Bankruptcy Code provides:
    - (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title. . . operates as a stay, applicable to all entities, of—
      - (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor
- A creditor seeking to effect a setoff must file a motion and has the burden of proving the elements of a setoff.
- Even if the creditor establishes all elements of the setoff, the court may still deny the motion on equitable grounds.
- The debtor may also show that the interest is adequately protected.



## Setoff: Case Studies and Other Considerations

- In re Lehman Bros. Holdings Inc., 404 B.R. 752, 759 (Bankr. S.D.N.Y. 2009)
- In re Grossman's, Inc., 607 F.3d 114 (3d Cir. 2010)
- United States v. Continental Airlines (In re Continental Airlines), 134 F.3d 536 (3d Cir. 1998)

## II. Recoupment

## Recoupment: Sources of the Right to Recoupment

- Recoupment is a common law doctrine and is not found in the Bankruptcy Code.
- Rather than focus on the right to setoff a claim and a debt arising from different transactions among the same parties, recoupment focuses on netting credits and debts arising out of the same transaction.

## Recoupment: Single Integrated Transaction

- Under the “single integrated transaction test,” courts examine whether the debt and the credit arise out of a “single integrated transaction,” such that it would be inequitable to allow one party to enjoy the benefits of that transaction without complying with its own obligations under the contract.

## Recoupment: Logical Relationship Test

- Under the “logical relationship test,” courts take a looser approach to defining a transaction, but still require that the obligations being netted have a relationship such that it would be unfair to allow one party to leave its obligations unfulfilled.

## Recoupment: Key Differences from Setoff

- Mutuality not necessarily required.
- Debt and claim do not necessarily need to be on the same side of the petition date.
- Application of the automatic stay.
- Lack of a secured claim under section 506(a).

## Recoupment: Case Study

- Moore v. New York Cotton Exchange, 270 U.S. (1926)
- Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138 (2d Cir. 2002)

## III. Discussion and Q&A