Setoff and Recoupment in Bankruptcy: A Primer for Credit Managers

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Abstract

Today's credit manager is under more pressure than ever. Accounting wants to know why bad debt expense is so high, while sales is calling to find out why their largest prospective customer in years was turned down for financing. Sometimes it feels like no one is happy with the news coming out of your department.

Add to a credit manager's woes a customer's bankruptcy filing and it may seem time to rethink your career choice. Unfortunately, in today's economic climate, bankruptcies are a part of doing business. And although a customer's bankruptcy filing generally means a credit grantor will suffer some loss, often there are ways to mitigate those losses, both prior and subsequent to the filing of a bankruptcy petition.

In this article we explore two tools that can assist with minimizing losses, the legal doctrine of setoff and the equitable remedy of recoupment. Our goal in this article is to provide you with the tools and legal framework to minimize your company's losses by strategically evaluating a customer's bankruptcy filing and identifying potential sources of recovery using setoff and recoupment.

What Are Setoff and Recoupment and What Is The Difference?

Setoff and recoupment are intimidating legal terms, but are really quite simple. In practice, we have found credit managers are already familiar with both concepts and the underlying mechanics -- all that remains is explaining the practice of how each may be utilized in the bankruptcy context.

Setoff

Although lawyers and courts often dress up setoff with fancy terminology, it is important to understand what setoff is fundamentally. At its core, setoff is nothing more than your right to cancel mutual debts with one of your customers. Think of it this way: let's go back to our childhood game playing days (assuming you were a child before video games). If you owed your friend eight marbles from the current round, and your friend owed you four marbles from a prior

round several days earlier, how would you best resolve the outstanding debts -- while still remaining friends?

While friends might resolve this childhood dilemma in two separate exchanges, we highly recommend against such a practice when dealing with a debtor in bankruptcy. The first principal of setoff (and for that matter, dealing with any customer in bankruptcy) is to hold onto all of your marbles unless instructed otherwise by your lawyer or a bankruptcy judge.

Your initial thought might be (and some overly aggressive debtor's lawyers have argued) that your company must give back to the debtor what is owed and file a proof of claim for what the debtor owes you. Of course, that would result in your company paying real dollars, but only getting back "bankruptcy dollars." Without the doctrine of setoff, such an unfortunate situation might indeed be the case.

Setoff allows your company to "net" these reciprocal obligations. Using our marbles example, you would net the eight marbles you owe your friend with the four marbles he owes you. The result would be that you would only owe your friend four marbles – the payment of which would fully satisfy both obligations.

Without setoff, your company would be required to return the eight marbles to your friend and file a claim for the four marbles you are owed. Assuming a twenty-five percent distribution in the bankruptcy case (which, as you know, is often wishful thinking in bankruptcy cases), your company would get one marble back, leaving you seven marbles in the red (and leaving both your sales and finance colleagues very upset). Setoff is nothing more than a mechanism which allows you to keep more of your company's marbles.

Let's continue with our marble example to get a flavor of what might happen in a typical bankruptcy case. Let's assume the childhood friends in the above example will eventually get into a dispute during the course of playing their game. This "marble dispute" is akin to the filing of a bankruptcy petition. A bankruptcy petition is nothing more than a debtor's way of saying "I'm not able to work out my problems with my creditors, so I'll try to force them to take less than they are owed." By filing for bankruptcy, a debtor draws a line in the sand, i.e., there are transactions prior to the petition (pre-petition debts which are general unsecured obligations) and transactions subsequent to the petition (post-petition obligations, often referred to as administrative expenses).

Setting off mutual obligations can only be used in cases where both transactions occurred pre-petition. So if, for example, you owed your friend eight marbles prior to the petition date, and your friend owed you four marbles from a post-petition transaction, setoff is not available (however, because post-petition claims generally are required to be paid in full, all may not be lost).

On the other hand, let's assume both debts occurred pre-petition. Practically speaking, how do you mechanically go about setting off these mutual debts? First, it is important to recognize the answer depends on whether the customer has filed for bankruptcy. Assuming a petition has not yet been filed, and the underlying contract allows for setoff, a creditor is generally permitted to

setoff the mutual debts without a formal legal proceeding. The mechanical act of setting off requires nothing more than making the appropriate accounting entry on your company's books and providing notice to the other party.

Although pre-petition setoff is legally permissible, Congress has fashioned a remedy to allow debtors to test (and potentially avoid) some pre-petition setoffs using what is termed the "improvement in position test." This test essentially measures whether the creditor received more than it should have under the bankruptcy laws. We discuss this test in the following section.

Let's now assume the setoff is not effectuated prior to the filing of a bankruptcy petition -- how then does a creditor use setoff? The answer, quite simply, is very, very carefully and with involvement and approval of the bankruptcy court.

Post-petition setoff, without exception, requires relief from the automatic stay imposed by Bankruptcy Code Section 362.[4] Failing to obtain relief from the automatic stay has severe consequences and should never be considered. In cases where you want to setoff mutual debts after the filing of a bankruptcy, we highly recommend you contact your bankruptcy counsel to advise you, as the particular facts of each case will be important to consider.

The most straightforward way to setoff is to obtain the consent of the debtor. In our experience, we have found that setoff can often be accomplished consensually and by a negotiated stipulation with the debtor. After the filing of a petition, we often negotiate consensual setoffs on behalf of our clients. The good news is that debtors often wish to continue doing business with creditors – providing incentive for a consensual resolution of the pre-petition obligations.

If a consensual arrangement cannot be reached, a creditor wishing to setoff mutual debts must file a motion with the bankruptcy court seeking relief from the automatic stay. Assuming the underlying elements of the proposed setoff are permissible under state law (and not prohibited by the parties' contract), the bankruptcy court, after notice and a hearing, often may permit a setoff. In our experience, this process generally moves fairly quickly and may be concluded in a month.

Setoff and the Improvement in Position Test

Although a creditor generally may setoff mutual debts prior to the filing of a bankruptcy petition (be sure to first check the contract to see if there is specific language setting forth or limiting the terms of setoff), Congress has fashioned a test to limit the effect of such transactions. Before exploring the mechanics of the test, we must emphasize one very important point. Often, it is advisable to setoff a debt even if it appears the improvement in position test may later apply in a bankruptcy case rendering the setoff avoidable. Such a statement might at first be counterintuitive – why would you want to effectuate a setoff if the transaction might later be unwound?

The answer is actually quite simple. Any time you are dealing with an entity with a going concern issue, it is almost always better to have the money in your pocket. Just like in life, a bird in the hand is worth two in the bush. Effectuating a setoff is akin to accepting a preference

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[4] All section references are to the Bankruptcy Code unless otherwise noted.

payment. While it is true that a preference payment may be subject to avoidance by a debtor after the filing of a petition, it is better to have the money in your company's pocket. Perhaps, more importantly, it is rare that everything occurs as planned or expected. Thus, even if an entire industry expects a company to file for bankruptcy, it may not happen, or it may be delayed for some time, adding to the likelihood that the setoff or preference will be outside the avoidability period.

Although the statute governing improvement in position is dense and difficult to parse, its application is relatively straightforward. Let's go back to our marble example. Let's assume that the letter "A" equals the marbles the debtor owes you. The letter "B" represents the marbles you owe the debtor. Both A and B are calculated ninety days before the petition is filed. Now, let's make that same calculation on the date of the setoff. We'll assume letter "C" equals what the debtor owes your company immediately after the setoff and the letter "D" equals what you owe the debtor immediately after the setoff.

The improvement in position test can then be broken down into a mathematical formula. If (A-B) < (C-D), your position as a creditor was not improved by effectuating a setoff and the debtor has no claim for avoidance in the bankruptcy case. If on the other hand, (A-B) > (C-D), there has been an improvement in the creditor's position and the extent of the improvement is subject to avoidance by the debtor.[5] If this is the case, we recommend contacting your bankruptcy lawyer to examine strategies to best evaluate and minimize further losses. Further, although the above formula may make the analysis seem black and white, there are additional strategies that can be employed to minimize liability – all of which may allow you and your company keep more of your marbles.

Recoupment

Recoupment shares many similarities with setoff. However, there are several subtle differences. As you will recall, setoff is employed when each party owes a debt to the other arising from separate and distinct transactions. In our first marble example above, setoff is the appropriate remedy because the debts arise from two independent games of marbles on different days. Recoupment, on the other hand, applies in cases where the reciprocal obligations arise solely from one single integrated transaction.

To better understand recoupment, let's consider a slightly different set of facts. Let's presume there is only one game of marbles. In this game, let's assume in the first round you as the creditor lose and owe your friend (the debtor) eight marbles. In the second round, you are more successful, with your friend owing you four marbles. Although the numbers are the same as the previous example, these are two very different fact patterns. Both examples may allow a netting of the obligations, however, the procedure and potential bankruptcy consequences are quite different. Here, the more powerful equitable remedy of recoupment applies, rather than setoff.

The benefits of recoupment are more favorable to a creditor. Unlike setoff, where a court would employ the improvement in position test which may result in avoidability of part or all of the recovery, the doctrine of recoupment is immune from the improvement in position test. In fact,

[5] This example is adopted from and further explained in the bankruptcy case of In re Matter of Frederick, 58 B.R. 56 (Bankr. N.D. Ala. 1986).

unlike setoff, which is governed by Section 553, the doctrine of recoupment is a common law doctrine not restricted by statute. Accordingly, it is unlikely a debtor will be able to avoid any benefit a creditor may receive from recoupment.

Another important distinction between setoff and recoupment is the applicability of the automatic stay pursuant to Section 362. As discussed previously, the right of a creditor to setoff mutual obligations under Section 553 is restricted by the automatic stay. While courts often lift the automatic stay to allow setoff, a court may decline to do so for a variety of reasons. Even if the court does lift the stay, it is still a procedural impediment creditors must resolve prior to enforcing the setoff right. Recoupment, on the other hand, is not restricted by the filing of a bankruptcy petition and not prohibited by the automatic stay. Accordingly, a creditor is entitled to net mutual obligations without court approval.

Although court approval is not required to effectuate a recoupment, we have found in our practice that it makes sense to discuss recoupment with our client prior to their taking any steps to net reciprocal obligations. In cases where the transaction is not carefully examined prior to effectuating the recoupment, we often find debtors attempt to drag creditors into court arguing that the creditor acted improperly. First, a debtor will allege that if any right to net existed, it was only the right to setoff (rather than recoupment). Debtors then take the position the creditor violated the automatic stay by failing to first seek automatic stay relief. We have found it is better to fully examine the transaction and to properly document the steps involved before taking action to avoid such a situation from occurring in the first place and to ensure the paper trail is intact to protect the creditor from any attack by the debtor.

Conclusion

A bankruptcy filing is often the frustrating end of a troubled relationship with a customer. Although the temptation is to simply write off the debt and move on, it is often worth examining the underlying relationship to determine if any lemonade can be made from the lemons.

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