

THE CREDIT MEMO

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The Power and Limitations of the Recoupment Doctrine

This issue of *The Credit Memo* discusses the “recoupment” doctrine — a powerful creditor remedy that is often overlooked and underappreciated — and compares “recoupment” with the more familiar remedy known as “setoff.”

What is Recoupment?

If applicable, the doctrine of recoupment may allow a creditor to avoid paying amounts owed to a company or individual that has filed for bankruptcy (a “Debtor”), provided the amount owed to the Debtor arises from the same transaction as the creditor’s own claim against the Debtor. Thus, it is the recoupment doctrine which enabled an employer in one case to recover disability overpayments by reducing future benefits to a former employee, even though the overpayment was made pre-bankruptcy and the future benefits were payable after bankruptcy. Similarly, it is the recoupment doctrine which enabled an employer in another case to recover the amount owed by a former employee for personal charges appearing on the corporate credit card, by reducing future severance payments, even though the credit card charges accrued pre-bankruptcy and the severance was owed post-bankruptcy.

The recoupment doctrine stems from the premise that where the creditor’s claim against the Debtor arises from the *same transaction* as the Debtor’s claim against the creditor, it is essentially a defense to the Debtor’s claim against the creditor. The creditor is thus relieved of some or all of its obligation to pay the Debtor. Recoupment is considered a close-cousin of the doctrine of setoff and, in fact, a great deal of effort has been expended by courts and commentators alike to define the boundaries of each remedy.

Setoff vs. Recoupment

Understanding the distinction between a “setoff” and a “recoupment” usefully underscores the benefits and limitations of each remedy and why recoupment is a more limited, albeit more powerful remedy. Historically, setoff was a common law right of a creditor to apply the “unappropriated” moneys of its debtor, in its hands, in extinguishment of the debts due to it. The right of setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding “the absurdity of making A pay B when B owes A.” For setoff to apply, the mutual debts can be unrelated and arise from different transactions; whereas recoupment only applies if there is a close nexus between the debts — i.e., they arise from the same transaction.

Section 553 of the Bankruptcy Code recognizes the right of setoff in bankruptcy cases, although it does not create the right. Assuming a valid right of setoff under non-bankruptcy law, a creditor may invoke setoff rights in bankruptcy only if the creditor and Debtor owe each other mutual debts and each of those debts arose pre-bankruptcy. The mutuality requirement generally is satisfied when the offsetting obligations are held by the same parties in the same capacity. Mutuality may be lacking, however, in what is known as a “tri-partite” relationship. This arises when there is a parent/subsidiary or similar connection between two companies that do business with a common Debtor.

There also are several additional considerations that bear upon the right of setoff in a bankruptcy case. First, a creditor holding a valid right of setoff is considered a secured creditor to the extent of the amount it owes to the Debtor and thus obtains the benefits accorded to secured creditors (and oversecured creditors) under Sections 361 and 506 of the Bankruptcy Code, including the right to earn post-bankruptcy interest. Second, the right to setoff is limited by the Bankruptcy Code’s automatic stay provisions, which prevent a creditor from effecting a setoff without prior court approval. While there is a presumption in favor of allowing setoff, and it generally will be the rare occasion for a court to disallow the right assuming all elements have been satisfied, a court does have the discretion in some cases to deny the remedy.

The Power and Limitations of Recoupment

In contrast to the right of setoff, there is no specific provision in the Bankruptcy Code recognizing or allowing a creditor to exercise a right of recoupment. Likewise, there generally is not a “mutuality” requirement, nor is there a requirement for prior court approval or relief from the stay. Furthermore, when applicable, a creditor may be able to recoup a pre-petition claim against the Debtor with a post-petition obligation owed to the Debtor.

For recoupment to apply, however, a claim held by a creditor against a Debtor (i.e., a receivable) and a debt owed by a creditor against the Debtor (i.e., a payable) must arise from the *same transaction*. As discussed above, setoff is not so limited and the debt and the claim can be entirely unrelated. Thus, for example, the government was able to setoff a tax refund owed to a taxpayer against the taxpayer’s debt for a student loan that the government had guaranteed. Clearly, a tax debt does not arise from the same transaction as a student loan.

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The “Same Transaction” Requirement

Courts have struggled with defining when a debt and a claim arise from the same transaction and have considered the requirement almost a term of art for which no reliable set standards are recognized. Some courts, applying a very narrow definition, hold that recoupment should be limited to cases in which the claim and the debt each arise out of a *single integrated transaction* and have allowed recoupment only after concluding it would be inequitable for the Debtor to enjoy the benefits of that transaction without also meeting its obligations. Some courts also have reasoned that a mere logical relationship between the debt and the claim is not enough for recoupment to apply, nor is the fact that the same two parties are involved, or that a similar subject matter gave rise to both claims. Some courts also have applied the recoupment doctrine only in situations involving an overpayment by a creditor.

When available, the right of recoupment can be useful to creditors and can be a powerful weapon in helping avoid unjust outcomes. This is particularly true in an employment context. For example, and as foreshadowed above, courts have recognized an employer’s right to recoup past disability overpayments from future disability payments, even when the future payments become due after a bankruptcy filing. To understand this scenario better and how the recoupment doctrine applies, assume an initial overpayment of \$2,000 to a disabled employee, and an employer’s ongoing obligation to pay the former employee \$1,000 per month in disability for the remainder of her/his life. If the employee filed for bankruptcy still owing the entire overpayment, the employer would hold a \$2,000 claim against the employee. Notwithstanding the bankruptcy, the employer could deduct (or recoup) the overpayment from future disability payments, even payments owed to the employee subsequent to the bankruptcy filing. (Setoff would not apply in this context, because the overpayment is a pre-petition claim and the future benefits are post-petition obligations.) In this scenario, some courts have accepted the recoupment doctrine after finding that it would be inequitable to require the employer to continue to honor its obligation to pay benefits, without also requiring the employee to repay the initial overpayment. Conversely, one court did not permit an employer to recoup a disability overpayment by withholding future wages; reasoning that the duty to pay future wages was not part of the same transaction as a past disability overpayment.

Also, in another employment-related case, an employer was allowed to recoup amounts owed by a former employee that had filed for bankruptcy against severance payments owed to the employee. There, the employee used a corporate credit card to pay personal expenses, which the employer ultimately paid and then charged back to the employee. Subsequent to the employee’s bankruptcy, the employer was allowed to recoup the credit card debt against the severance obligation. The key fact for the court was that the employer’s severance obligation was memorialized in the same agreement in which the former employee agreed to pay the employer any amounts he owed the employer for personal charges. The court reasoned that the predominate consideration is whether it would be fair for the former employee/debtor to enjoy the benefits of the severance agreement without also meeting its obligations.

Counsel Should be Consulted to Ascertain the Existence of Recoupment Rights

Before exercising a right of recoupment, creditors would be well-advised to consult with experienced bankruptcy counsel to ascertain if they do, indeed, hold a right of recoupment, as opposed to a right of setoff. As noted above, creditors are prohibited by the automatic stay from exercising the right of setoff absent court approval, whereas there generally is no such limitation with respect to recoupment, and guessing wrong could, in certain circumstances, subject a creditor to sanctions for violating the stay.

A synthesis of reported decisions suggests creditors also would be well-advised to try to incorporate language in relevant contracts authorizing them to recoup amounts they owe under the contract to the Debtor against amounts the Debtor owes to them. Such language generally does not cause any prejudice and it may bolster a later recoupment argument.

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