

# Common Law Setoff, Recoupment, and Bankruptcy

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## Setoff

“The right of setoff (also called ‘offset’) 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.’” *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995) (quoting *Studley v. Boylston Nat’l Bank*, 229 U.S. 523, 528 (1913)).

## Mutuality

“To be mutual, the debts must be in the same right and between the same parties, standing in the same capacity.” *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990).

The United States is one party for purposes of mutuality, so one agency can setoff its claim against a debt owed by another agency. *In re HAL, Inc.*, 122 F.3d 851 (9th Cir. 1997); *In re Turner*, 84 F.3d 1294 (10th Cir. 1996) (en banc); *In Chateaugay Corp.*, 94 F.3d 772 (2d Cir. 1996).

But, the same party requirement is strictly construed as to debtors. Be aware of separate legal entities with common ownership, parent-subsidary relationships, and, especially as to individuals, state-law issues such as community property rules.

Contracts may define or limit right of setoff and may place parties in different capacities for purposes of setoff. E.g., parties in a fiduciary relationship do not stand in the same capacity, so a debt arising from a debtor-creditor relationship lacks mutuality with a debt arising from a fiduciary relationship.

The debts need not arise from the same transaction, but they must be of the same character. E.g., a tort claim can be setoff against a contract claim, but a liquidated claim cannot be setoff against an unliquidated claim. (Although a creditor may withhold funds until the unliquidated claim is liquidated.)

### Timing

In general, a setoff requires three steps: (1) a decision to effect the setoff, (2) an affirmative action to accomplish the setoff, and (3) a recording of the setoff in the creditor's records.

Although a statute of limitations bars a creditor's right to sue to collect a debt, it generally does not prevent a creditor from defensively asserting setoff against other claims by a debtor. *See* 28 U.S.C. § 2415(f).

Due process may require notice to the debtor before the United States can effectuate the setoff.

## Recoupment

Recoupment is an equitable doctrine, defensive in nature, used to determine amounts owed on a given transaction. It is the ancestor of the compulsory counterclaim set forth in Federal Rule of Civil Procedure 13(a). *Coplay Cement Co. v. Willis & Paul Group*, 983 F.2d 1435 (7th Cir. 1993). The United States has a long recognized right to money erroneously paid.

### Same transaction

Unlike setoff, recoupment is only available where the mutual debts arise out of the same transaction or occurrence.

Whether two claims arise out of the same transaction or occurrence is often fact-based. Also, the test for determining whether claims arise out of the same transaction varies depending on jurisdiction.

In the Ninth Circuit (AK, AZ, CA, HI, ID, MT, NV, OR, WA, and Pacific territories), whether two claims arise out of the same transaction depends upon their “logical relationship.” *In re TLC Hospitals, Inc.*, 224 F.3d 1008 (9th Cir. 2000) (holding that Medicare overpayments and underpayments from different years arise out of the same transaction, the Medicare Provider Agreement, because the Agreement contemplated year-to-year adjustments and an “exchange of funds . . . over an extended period of time”).

Other courts, such as the Third Circuit (DE, NJ, PA, and USVI), require the claims to arise out of a “single integrated transaction.” *University Med. Ctr. v. Sullivan (In re University Med. Ctr.)*, 973 F.2d 1065 (3d Cir. 1992). In these jurisdictions, a single contract may give rise to multiple transactions for purposes of recoupment.

Where the government has only a statutory relationship with the debtor, such as an entitlement program, some courts have not permitted recoupment. *Compare, e.g., In re Vance*, 298 B.R. 262, 267 (Bankr. E.D. Va. 2003) *with In re Keisler*, 176 B.R. 605, 607 (Bankr. M.D. Fla. 1994).

Recoupment is generally unaffected by a statute of limitations. 28 U.S.C. § 2415(f)

### **Setoff and Recoupment in Bankruptcy**

#### Automatic Stay

The filing of a bankruptcy petition operates as stay of “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case” and of “the setoff of any debt owing to the debtor that arose before the commencement of the case . . . against any claim against the debtor.” 11 U.S.C. § 362(a)(6) & (a)(7). (The automatic stay covers many other things, too; see 11 U.S.C. § 362(a) for the full list.)

Mere refusal to pay money does not necessarily violate the stay. A creditor may temporarily impose an administrative freeze on payments to the debtor if the creditor has a right of setoff. *See Strumpf*, 516 U.S. at 19-21. *See also* 11 U.S.C. § 542(b) (requiring payment of debts to the trustee “except to the extent that such debt may be offset under [11 U.S.C. § 553]”).

**When an agency learns of a bankruptcy case, it should not pay the debtor any amount until the agency has determined that neither it nor any other agencies have any claims appropriate for setoff.**

#### Setoff in Bankruptcy

To exercise a right of setoff, the United States must obtain relief from stay under 11 U.S.C. § 362(d). Federal agencies should coordinate with the Department of Justice to request relief.

If the debtor has filed for bankruptcy, generally prepetition claims can only be setoff against prepetition debts.

Under the bankruptcy code, a claim that is subject to setoff is a secured claim to the extent of the amount subject to setoff. 11 U.S.C. § 506.

Nothing in the bankruptcy code requires that a right of setoff be asserted in a proof of claim. But under some circumstances, courts have held that a creditor can waive its right of setoff by failing to timely assert it or by taking action inconsistent with the assertion of a right of setoff. Some agencies routinely state in their proof of claim that the claim may be subject to setoff.

In general, setoff rights survive discharge, but some courts have denied setoff where the creditor failed to adequately protect its right. *E.g.*, *United States v. Continental Airlines*, 134 F.3d 536 (3d Cir. 1998). In general, a right of setoff should be asserted before discharge or confirmation. A chapter 11 plan should provide that confirmation does not alter or affect the United States' setoff rights.

### Recoupment in Bankruptcy

In bankruptcy, recoupment differs from setoff in two ways:

First, the automatic stay does not apply to recoupment. *See, e.g.*, *Matter of Holford*, 896 F.2d 176, 179 (5th Cir. 1990)

Second, prepetition claims can be recouped from postpetition debts. *In re TLC Hospitals, Inc.*, 224 F.3d at 1011.

But remember that recoupment is available only for claims arising out of the same transaction, and whether claims arise out of the same transaction varies by jurisdiction.