

TUCKER | HESTER, LLC

RECOUPMENT **Creditors Rights v. The Stay and Preference Actions**

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By: Lara B. O'Dell
Attorney at Law
lara@tucker-hester.com

Tucker | Hester, LLC
www.tucker-hester.com

Pennsylvania Center, Suite 100
429 North Pennsylvania Street
Indianapolis, IN 46204-1816

317.833.3030 | 317.833.3031 [fax]

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RECOUPMENT AND THE BANKRUPTCY CODE

The Bankruptcy Code does not specifically address the issue of recoupment. All references to recoupment in the case law are made after distinguishing the concept of “recoupment” from the concept of “set off.” Set off, however, is addressed under section 553 of the Code, which is why the distinction is of importance.

SETOFF AND THE BANKRUPTCY CODE

The setoff section, section 553(a), reads as follows:

“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 (except for a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561); or
- (3) the debt was 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 (except for a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561).

The portions underlined above were added with the enactment of BAPCPA, and create exceptions to the rules governing set offs.

§362(b)(6) relates to set off of a margin payment or settlement payment arising out of commodity or securities contracts under the control of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency.

§362(b)(7) relates to set off of a margin payment or settlement payment by a repo participant or financial participant.

§362(b)(17) relates to set off of by a swap participant or financial participant in connection with a swap agreement.

§362(b)(27) relates to set off by a master netting agreement participant.

§555 relates to the contractual right to liquidate, terminate, or accelerate a securities contract.

§556 relates to the contractual right to liquidate, terminate, or accelerate a commodities contract or forward contract.

§559 relates to the contractual right to liquidate, terminate, or accelerate a repurchase agreement.

§560 relates to the contractual right to liquidate, terminate, or accelerate a swap agreement.

§561 relates to the contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts.

DEFINING "RECOUPMENT"

The case law related to recoupment attempts to define it, usually in relation to set off.

Defendant may be entitled to "recoupment" if two elements are satisfied: first, both claims must arise from single contract or transaction, and second, some type of overpayment must exist, whether overpayment was accidentally or contractually made. *In re Photo Mechanical Services, Inc.*, 179 B.R. 604 (Bkrtcy.D.Minn.1995).

While setoff under this section is limited to instances involving mutuality of obligation, recoupment is subject to no such limitation and only real requirement regarding recoupment is that sum can be reduced only by matters or claims arising out of the same transaction as the original sum. *Waldschmidt v. CBS, Inc.*, 14 B.R. 309 (M.D.Tenn.1981).

In bankruptcy, "setoff" is asserted for purpose of reducing or extinguishing creditor's claim against debtor when mutual debt and claim contemplated are generally those arising from different transactions, while "recoupment" is setting up of demand arising from same transaction as creditor's claim or cause of action, strictly for purpose of abatement or reduction of such claim. *Matter of U.S. Abatement Corp.*, 79 F.3d 393 (5th Cir. 1996).

Determination of whether action will be characterized as setoff or as recoupment under the Bankruptcy Code depends on whether reciprocal obligations arose from same transaction or series of transactions. *Westinghouse Elec. Corp. v. Fidelity and Deposit Co. of Maryland*, 63 B.R. 18 (E.D.Pa.1986).

RECOUPMENT FACT PATTERNS

If the distinction between recoupment and set off is still not clear, perhaps the review of some fact patterns will help to clarify. Most of the cases discussed below deal with payments to a debtor by two separate entities (often an insurance company and the Social Security Administration) for the same thing or arising out of the same incident (often an ongoing disability).

In re Hiler, 99 B.R. 238 (Bankr.D.N.J. 1989).

Debtor was beneficiary under employee benefit plan (the "Plan"), which entitled members to receive sixty percent of their basic monthly income for the duration of qualified periods of disability ("Disability Income"). The Plan was designed to ensure that income from all sources, including Social Security Disability ("SSD") equaled the base amount of the Disability Income. For example, if the debtor's Disability Income was \$1,225.00 (which is 60% of his basic monthly income of \$2,041.67), and SSD only paid the debtor \$625.00 per month, then the Plan would contribute \$600.00 to the debtor.

The Plan usually estimated what SSD would pay (anticipating that the debtor would receive a lump sum back payment in the future) and would then pay the difference to the Plan beneficiary. However, in this case in May, 1982, the debtor requested that the Plan administrator stop factoring in the SSD estimate and pay the debtor his full Disability Income. The Plan administrator agreed to this request, but stipulated that there would be no change with regard to the effect of a favorable decision from SSD on the debtor's application.

The debtor received a favorable determination from SSD that became effective in December, 1986 in the amount of \$636.00 per month, and was retroactive to March, 1983. The debtor failed to notify the Plan administrator of his SSD award. The Plan became aware of the award in September, 1987, and requested that the debtor repay \$34,980.00. When the debtor failed to repay, the Plan stopped sending the debtor checks in an effort to recoup the overpayment.

The debtor filed his bankruptcy petition on April 28, 1988. The Plan continued to recoup payments, contending that the recoupment was not subject to the automatic stay provisions of the Code.

The Court found that the recoupment herein was just, and that if the debtor were permitted to have the overpayments made to him discharged in bankruptcy, he would be retaining property that was never his, thereby giving him a "head start," as opposed to a "fresh start," after bankruptcy.

In re LaPierre, 180 B.R. 95 (Bankr.D.S.C. 1994).

Debtor was covered by a Group Long Term Disability Insurance Policy (the "LTD Policy") of her employer. The LTD Policy set out benefits to be received by the employee in the event of disability, and allowing for the reduction of benefits if the employee became eligible for Social Security benefits.

Debtor began receiving benefits of LTD Policy in June, 1982. Debtor was notified by the Social Security Administration ("SSA") that she was eligible for SSD retroactive to December, 1981. The case does not say when the debtor was notified of this. The insurance company became aware of the SSA award in September, 1991. The insurance company sent the debtor six letters over eighteen months after learning of the SSA award requesting additional information.

In the interim, the debtor filed a joint bankruptcy petition with her husband on April 20, 1990 and received a discharge on June 30, 1990. The bankruptcy was reopened in May, 1992, and the insurance company was added as a creditor.

On February 17, 2003, the insurance company demanded \$66,815.76 for alleged overpayment of benefits to the debtor. On October 1, 1993, the insurance company stopped making payments to the debtor in order to recoup the overpayments.

The Court found that the insurance company was not an agent of the former employer (who did have notice of the SSA award), and therefore, did not have constructive knowledge of the award. The Court also held that the insurance company had a right of recoupment not subject to the automatic stay provisions of the bankruptcy code and that the insurance company did not have to factor in any SSA overpayment to the amount it was entitled to recoup.

In re Bram 179 B.R. 824 (Bankr.E.D.Tex. 1995).

Debtor was beneficiary of Long Term Disability Plan, which had has one of its provisions that the insurance provider's liability for monthly benefits would be adjusted downward proportionately to any Social Security Disability Income Benefits received. Debtor became eligible under the LTD Plan and began receiving benefits in September, 1992. Debtor also became eligible under SSA guidelines and began receiving SSD in September, 1992.

The Plan administrator became aware of the overpayment in March, 1993, at which time the debtor had been overpaid by \$6,246.91. The Plan administrator suspended benefits in April, 1993 to recoup the overpayment. The debtor filed a Chapter 7 bankruptcy on October 13, 2003.

The Court held that the creditor had a valid right of recoupment, not subject to the automatic stay provision. The Court also held that the right of recoupment did not constitute a "debt" that could be discharged in bankruptcy.

In re Harmon 188 B.R. 421 (9th Cir BAP 1995)

Debtor made a claim under state's worker's compensation law due to a work-related injury in February, 1985. State law allows the SAIF to credit overpayments against a permanent disability award. Debtor filed Chapter 13 bankruptcy in August, 1992.

Two different awards were made herein. First, a time-loss award was made to replace income lost from work interruption due to work-related injury. Second, a permanent disability award was made to replace future income earning capacity based on permanent disability.

The Court found that allow the awards were made in two separate transactions, both awards stem from the common work-related injury. The Court also found that the court should view the claims of the parties through the single state statute, which created the rights and remedies herein. The Court found in this case that the debtor's entitlement to both of the awards arose pre-petition, and therefore, held that either setoff or recoupment should have been permitted.

In re Boyd 223 B.R. 536 (Bankr.E.D.Ark. 1998).

Debtor separated from active duty in the military. As a result, he was awarded readjustment pay. Later, and prior to the filing of the bankruptcy case, the debtor applied for and received disability compensation related to his service in the Persian Gulf War. The readjustment pay and the disability award were for the same period of service.

The United States Code provides that the government must recoup readjustment pay from any disability benefits. A separated service member may have either readjustment pay or disability benefits, but not both.

The Court held that the statutory directive to recoup the readjustment pay is not a debt or a claim, and therefore, there is no entitlement to discharge under the Bankruptcy Code.

In re Graves 234 B.R. 149 (Bankr.M.D.FI. 1999)

Debtor was city employee. City and county subsequently merged, and as a result, the debtor became a county employee. The debtor chose to remain a participant in the city's retirement system. The county covered employees under a group long-term disability policy.

The debtor became medically disabled. She retired and began receiving long term disability payments under the county's plan. Debtor also began receiving disability retirement from the city, which included a lump sum retroactive payment.

The county received notice of debtor's retirement pay from the city and attempted to collect the overpayment from the debtor. When it received notice of the debtor's bankruptcy filing, the county began deducting the overpayment from her remaining monthly payments.

The Court found that as a result of the city's retroactive payment, the debtor received double compensation for the same disability for approximately two years. The Court held that the county was entitled to recoupment, not subject to the automatic stay; and therefore, the Court declined to impose sanctions against the county.

SETOFF, RECOUPMENT, AND THE AUTOMATIC STAY

Section 553 specifically states that setoffs are subject to section 362 and the automatic stay provisions of the bankruptcy code. Section 362(a)(7) prohibits "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim of the debtor." There are exceptions to the rule, as described hereinabove.

Courts have found that unlike set off and because the Code is silent as to the issue, recoupment is not subject to the automatic stay provisions of the Bankruptcy Code.

The primary difference between recoupment and setoff is that the limits placed on setoff under the Bankruptcy Code generally do not apply to recoupment claims. *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392 (9th Cir. 1996).

Setoff is limited to the terms of setoff provision of the Bankruptcy Code. It is, therefore, subject to automatic stay provisions, while recoupment is not. *In re LaPierre*, 180 B.R. 95 (Bkrcty.D.S.C.1994).

Recoupment has some of the characteristics of setoff. Setoff and recoupment have common origin and are equitable in nature, but the two doctrines are distinguishable and are treated differently in the bankruptcy context. *In re Izaguirre*, 166 B.R. 484 (Bkrcty.N.D.Ga.1994).

Recoupment is not subject to limitations on setoff set forth in Bankruptcy Code. *In re American Cent. Airlines, Inc.*, 60 B.R. 587 (Bkrcty.N.D.Iowa 1986).

SETOFF, RECOUPMENT, AND PREFERENCE ACTIONS

Section 553(b) specifically addresses preference actions and the relationship to setoffs.

- (1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, 561, 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of –
 - (A) 90 days before the date of the filing of the petition; and
 - (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
- (2) In this subsection, “insufficiency” means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

The portions underlined above were added with the enactment of BAPCPA.

Therefore, the Code gives a trustee the right to avoid a setoff as a preference if it occurred on or within ninety days of the petition date.

Again the Code is silent as to recoupment in the context of preference law. The Court in *In re Hiler* 99 B.R. at 243 states the following: “...the invocation of the recoupment doctrine promotes no preference problem. It is applied when there are countervailing claims arising from the same transaction “strictly for the purpose of abatement or reduction....” American Central 60 B.R. 587, 590 (1986) (citing 4 Collier on Bankruptcy, §553.03 (15th Edition 1984)). In effect, the application of recoupment goes to the equity of the claim. It provides for the adjudication of the just apportionment of liability relative to a dispute regarding a singular transaction.”

See also the following discussion, quoted from *Newbery Corp. v. Fireman's Fund Ins. Co.* 95 F.3d 1392, 1400 (9th Cir, 1996):

“In any suit or action between the estate and another, the defendant should be entitled to show that because of matters arising out of the transaction sued on, he or she is not liable in full for the plaintiff's claim. There is no element of preference here or of an independent claim to be set off, but merely an arrival at a just and proper liability on the main issue, and this would seem permissible without any reference to ... section 553(a). *Collier* ¶ 553.03, at 553-17 (citing *Quittner*, 202 F.2d 814, 816 n. 3). The Tenth Circuit has offered a similar rationale for treating setoff and recoupment differently in bankruptcy cases: In bankruptcy, both recoupment and setoff are sometimes invoked as exceptions to the rule that all unsecured creditors of a bankrupt stand on equal footing for satisfaction. Recoupment or setoff sometimes allows particular creditors preference over others. Setoff is allowed in only very narrow circumstances in bankruptcy. But a creditor properly invoking the recoupment doctrine can receive preferred treatment even though setoff would not be permitted. A stated justification

for this is that when the creditor's claim arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable. *In re B & L Oil Co.*, 782 F.2d 155, 157 (10th Cir. 1986)."

TOPICS FOR DISCUSSION

Is retention of a security deposit by a utility company recoupment or set off?

Is retention of a tax refund by a taxing authority recoupment or set off?

In what other bankruptcy contexts would the doctrine of recoupment apply?