

## CREDITOR'S RIGHTS TOOLKIT

# Can I Net Amounts Owed to the Debtor Against Amounts Owed to Me?

There are two mechanisms through which a creditor may net amounts owed to the debtor against amounts owed by the debtor — **setoff and recoupment**. These mechanisms are distinct and are treated very differently in a bankruptcy setting.

## Key Issues

- **SETOFF**

Setoff is a right based in state law that allows parties to apply their mutual debts against each other. These rights are preserved in bankruptcy through Section 553(a) of the Bankruptcy Code, which does not create any federal right of setoff, but leaves such state law rights undisturbed.

While the finer points of the elements of setoff differ by jurisdiction, in general, to have setoff rights, a creditor must show:

- **Mutuality:** The same parties must be involved in both the debt owed by the debtor to the creditor and the debt owed by the creditor to the debtor. The debts owed to each party need not arise from the same transaction, but the parties involved must be the exact same two parties — affiliates, subsidiaries, or parent companies are not sufficient for the purposes of mutuality.
- **Both Debts are Pre-Petition or Post-Petition:** The debt owed from the creditor to the debtor and the debt owed from the debtor to the creditor must both arise prior to the filing of the bankruptcy case, or both arise after the bankruptcy filing.

Importantly, a creditor cannot effect its rights of setoff without relief from the automatic stay imposed by Section 362 of the Bankruptcy Code — Section 362(a)(7) explicitly stays creditors from exercising rights of setoff against a debtor.

When filing a proof of claim against a debtor, a creditor can assert a claim as “secured” by its right of setoff up to the amount it owes the debtor. While a right of setoff is not actually a security interest in the debtor’s property, it allows a claim to be treated as secured insofar as the claim can be used to reduce the amount the creditor owes the debtor on a dollar-for-dollar basis. Filing a proof of claim secured by a right of setoff may be done without stay relief, though stay relief is required to actually effect the setoff.

Because setoff is treated as a secured claim in bankruptcy, it may be lost when a debtor sells its claims against the creditor (for example, in a sale of accounts receivable free and clear of liens, claims and interests) if the creditor does not timely object or take other steps to preserve its setoff rights.

- **TRIANGULAR SETOFF**

As noted above, mutuality is required for a creditor to have setoff rights. For this reason, certain jurisdictions, notably the Third Circuit, have prohibited “triangular” setoff arrangements. For example, consider a scenario where company A owes a debt to company B, and company C — an affiliate of company B — owes a debt to company A. The parties cannot offset the debt owed from company A to company B with the debt owed by company C to company A. Even though company B and company C are affiliates, the involvement of more than two parties in the transaction violates the strict mutuality required for setoff. Importantly, the Third Circuit Court of Appeals has held that parties cannot simply contract around this requirement by explicitly agreeing to triangular setoff in governing contracts.

- **RECOUPMENT**

Like setoff, recoupment can be used to net amounts owed between a creditor and a debtor. However, unlike setoff, recoupment is not covered by the automatic stay and may be exercised at any time during the bankruptcy case (though parties may wish to seek court authority to avoid running afoul of the automatic stay in the event that a court holds that a creditor’s recoupment rights were, in fact, setoff rights covered by the stay).

The defining feature of recoupment is that the amounts owed among the debtor and the creditor must arise from the same transaction, making recoupment a narrower concept than setoff. Different jurisdictions have different views of what it means for claims to arise from a single transaction, but the Second Circuit has a notably strict view of the concept called the “single integrated transaction test.” Under this test, the debts among the debtor and creditor must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations. Even if obligations arise from the same contract, they may not be considered to be part of a single integrated transaction if that contract handles those obligations as business being transacted in discrete, independent units.

- **THE IMPACT OF PLAN CONFIRMATION AND ASSET SALES**

Some bankruptcy plans or asset sale orders proposed by debtors will seek to cut off creditors’ rights to setoff and recoupment upon confirmation of the plan or the sale of assets. Depending on the jurisdiction, there may be established case law permitting the debtors to do so or requiring a creditor to seek to effect its rights of setoff or recoupment prior to plan confirmation or entry of a sale order to avoid waiver of those rights. In those cases, a creditor’s rights of setoff and recoupment may be lost if the creditor does not timely object or take other steps to preserve its rights.

## Takeaway

Setoff and recoupment can be powerful tools that can help a creditor maximize recovery on its claim or reduce the amount it owes a debtor. However, setoff and recoupment are complex and distinct concepts that are treated very differently in bankruptcy. Setoff and recoupment rights must be carefully exercised and preserved. It is important to have experienced bankruptcy counsel who can help guide you through these concepts to preserve and maximize your rights.