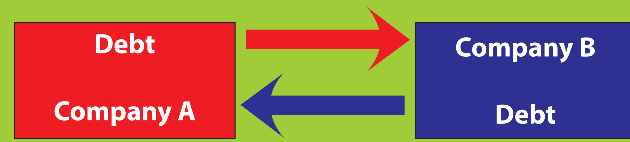
Setoffs –

Cutting Your Losses Both Inside And Outside Bankruptcy



By Joseph Coleman, Esq.

***Editors Note**: The topic of Setoffs was one of the issues discussed at the Open Forum portion of the CRF Forum in Tucson, held from March 23-25, 2015. The Open Forum sessions, held on the final morning of the forums, provide an opportunity to learn from the insight and experience of credit professionals and services providers on important issues of concern among CRF members. The following provides additional information on the topic of Setoffs.*

The Basics

What is a Setoff? The concept of setting off (sometimes called "offsetting") mutual debts is an old one that is pretty simple, at least on the surface. Imagine back when you were a kid. And let's say your dad promised you $10 to mow the lawn -- and you did it. But before you collected your $10, you tossed your football through the front window of your house -- which cost dad $8 to replace (remember, this was a long time ago). Come time for you and dad to settle up, did you pull out a five and three singles and hand it to dad? And did he then pull a ten out of his wallet and hand it over to you? Of course not! Assuming your dad was still of a mind to stand by his lawn-mowing agreement, he just handed you two dollars -- the net amount owed between the two of you. That, in a nutshell, is what setoffs are all about.

In the business world, a setoff opportunity exists when a party is both a creditor and a debtor of another party: your company owes a customer, who also owes your company. The right to offset the parties' respective debts is based on the principle that natural justice and equity require that the demands of mutually indebted parties be "netted" or set off against each other, so that only the balance is recovered. The right of setoff avoids the absurdity of making A pay B, when B still owes money to A (as in our father-son scenario above). A classic setoff example involves a bank and a borrower who has its deposit account at the bank. The borrower owes the bank for its loan; the bank owes the borrower for the amounts on deposit. Should the borrower fail to pay its loan, one of the bank's remedies is to setoff the borrower's deposit account at the bank.

Mutuality. The setoff right is generally recognized as a common-law right, but might also be established by state statute, or by contract. In either case, the basic principles and requirements of a setoff are similar. Key to the concept of setoff is that the parties' debts must be "mutual." Unfortunately, determining just what debts are "mutual" can be a problem.

Debts are said to be "mutual" when the debts and credits are in the same right and are between the same parties, standing in the same capacity. In our lawn mowing example above, if it was your neighbor who agreed to pay you to mow his lawn, there could be no setoff -- you owed your dad for the window, while your neighbor owed you. Similarly, if you owe money to Joe the plumber, individually, you can't setoff against his company, Joe's Plumbing, Inc.

In a business setting, a supplier may not offset a debt owed by a customer against an amount owed by the supplier to an affiliated, but separate subsidiary of the customer. Similarly, a parent corporation cannot ordinarily offset a debt owed to Corporation A against the parent's subsidiary's claims against Corporation A. So-called "triangular setoffs" such as this are generally not permitted under common law because they violate the mutuality component -- parent and subsidiary are not the same parties. However, the mutuality requirement may be broadened contractually, such as by an agreement expressly providing for triangular setoffs. For example, Company A may execute a written agreement that allows Company B and its subsidiaries to offset amounts owed to Company A, by both Company B as well as its subsidiaries. An agreement authorizing a triangular setoff might take many forms, but would most typically be included as part of a loan agreement, promissory note, credit application or credit agreement, or perhaps even on an invoice.

Matured Debts and Claims. An additional, significant requirement of setoffs is that the debt to be offset be "matured" -- generally defined as a debt that is unconditionally due and owing. For example, a bank cannot set off against a customer's deposits prior to the maturity of the customer's debt to the bank (unless there is express authority given the bank to do so). If a setoff occurs prior to maturity, the creditor may face serious consequences, including litigation based on conversion and breach of contract.

Setoffs In Bankruptcy

The right to setoff is explicitly recognized and dealt with under several separate sections of the Bankruptcy Code, although the Bankruptcy Code presents a number of possible obstacles to a creditor's setoff rights that do not exist outside bankruptcy.

The primary Bankruptcy Code section dealing with setoffs is found in Section 553, which provides that the Bankruptcy Code "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 . . . against a claim of such creditor that arose before the commencement of the case." So clearly, the Bankruptcy Code explicitly recognizes a party's existing prepetition setoff rights, if any.

Automatic Stay. The right to setoff is limited, however, by the automatic stay under Section 362 of the Bankruptcy Code, so that a setoff of mutual prepetition debts may not take place unless and until the automatic stay is modified by order of the bankruptcy court. Section 506(a) further provides that an allowed claim that is subject to setoff under Section 553 is a secured claim to the extent of the amount subject to setoff. Finally, to the extent the holder of a valid right of setoff holds a secured claim, Section 363(e) provides that the holder may be entitled to "adequate protection" of its interest.

Of these provisions, the automatic stay provision of Bankruptcy Code Section 362 is the primary "landmine" for creditors to avoid when contemplating a post-petition setoff involving a debtor. A setoff is not self-executing; to be effective, a creditor must take affirmative steps to establish and memorialize the setoff -- typically by making accounting entries reflecting the netting of respective debt obligations. But by doing so post-petition and without bankruptcy court approval, the creditor directly violates Section 362(a)(7), which specifically prohibits the setoff of prepetition debts. We won't name names here, but we have experienced more than one instance of large, sophisticated companies who exposed themselves to sanctions by unwittingly initiating setoffs after a customer's bankruptcy petition was filed. Rather than being put on the defensive, parties should file for relief from stay and request authorization from the bankruptcy court to setoff mutual, prepetition debts.

Bankruptcy Requirements. Section 553 does not itself create a right of setoff, but merely preserves that right if it otherwise exists under applicable non-bankruptcy law. For that, a bankruptcy court must analyze the law of the state where the operative facts occurred. Therefore, a creditor seeking to setoff a debt under the Bankruptcy Code must first establish its claim and a right to setoff by applying the law of the state where the operative facts occurred. A savvy creditor may know which state's law applies, and whether the applicable law in that state provides a right of setoff. If not, it would be a good idea to do a little research, or seek legal counsel on setoff rights in the applicable jurisdiction.

To exercise a state law right of setoff in a bankruptcy setting, Section 553 requires that the creditor establish (i) a debt owed by the creditor to the debtor which arose prior to the commencement of the bankruptcy case; (ii) a claim of the creditor against the debtor which arose prior to the commencement of the bankruptcy case; (iii) the debt and claim are "mutual" obligations; and (iv) a right to setoff the debts under nonbankruptcy law.

Frequently, just as outside bankruptcy, the mutuality of respective debts is a key issue. To make it more of a challenge, the majority of bankruptcy courts hold that the requirement of mutuality be "strictly construed." In other words, courts are not likely to authorize a setoff unless the party desiring the setoff can rigidly satisfy all the usual requirements -- i.e., matured, mutual prepetition debts between the exact same parties. Unfortunately, while the Bankruptcy Code sets forth any number of defined terms, the Code does not define the term "mutual," making it even more difficult for a creditor to establish its setoff rights. The mutuality requirement of Section 553 also prevents "triangular setoffs," which are generally not permitted in bankruptcy, but which, as previously mentioned, may be available outside bankruptcy by contractual agreement. Unfortunately, because bankruptcy courts construe the definition of mutuality narrowly, the general consensus is that mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff. So while Section 553 appears to preserve any non-bankruptcy setoff rights, the Bankruptcy Code's mutuality requirement clearly limits those rights in bankruptcy.

Under the Bankruptcy Code then, two entities, even if related, may not aggregate their debts and claims for setoff purposes. A subsidiary may not offset a debt to the debtor against a debt the debtor owes to another related subsidiary. Nor can a parent corporation offset a debt owed to the debtor against its subsidiary's claim against the debtor.

In the end, the allowance or disallowance of a setoff of prepetition claims is a decision that ultimately rests in the sound discretion of the Bankruptcy Court, but a court will generally not disturb an otherwise valid setoff unless compelling circumstances require it. In general, the statutory remedy of setoff will be enforced unless the court finds that allowance would not be consistent with the provisions and purposes of the Bankruptcy Code as a whole.

Other Limitations to Setoff in Bankruptcy. The right to setoff in bankruptcy is not without other restrictions. For one, the right of setoff is limited to the extent the creditor's claim is disallowed. Clearly, if the creditor's own claim in the bankruptcy case is subject to challenge (as to amount, validity, avoidability, etc.), the creditor will have no right to offset his claim against the debtor's obligations.

The ability to setoff also requires a significant degree of "clean hands" on the creditor's part. So a "bad guy" might not be allowed to set off his claims against the debtor. By way of example, if the creditor's liability to the debtor is based upon the creditor's willful conversion of the debtor's property, a court will almost certainly deny any setoff. Similarly, if the debtor gratuitously transfers property to a creditor, the transfer would most likely be avoidable, and recoverable in bankruptcy as a preference or fraudulent transfer. The creditor should not then be able to set off his debt to the debtor against the value of the property recovered by the debtor.

The creditor is also prohibited from setting off claims acquired (other than from the debtor) during the 90 days preceding the case, and at a time the debtor was "insolvent" -- typically a balance sheet test. And under Section 553, the debtor is presumed to have been insolvent during the 90 days before the case. In plain English, a "clever" creditor cannot buy or otherwise obtain a claim against the debtor, simply in an effort to manufacture a setoff and minimize his own obligations to the debtor in the event the debtor ends up in bankruptcy.

The Improvement of Position Test. One of the more complicated restrictions on a creditor's ability to retain the benefits of a prepetition setoff is the so-called "improvement of position" test described in Section 553(b). At issue is whether the creditor improved his position *vis-a-vis* the debtor in the 90-day period prior to the debtor's bankruptcy (similar to the improvement in position test found in the preference section of the Bankruptcy Code (Section 547 (c)(5)). If so, the creditor can be compelled to give back the amount of the improvement.

As with other provisions of the Bankruptcy Code, Section 553(b) is not exactly written in simple, "See Spot run" language. But the gist of Section 553(b) is as follows. First, a creditor must determine its "insufficiency" on the 90th day before the debtor's bankruptcy filing (or the first date during the 90 days on which there is an insufficiency). "Insufficiency" is defined as the amount, if any, by which a claim against the debtor exceeds a mutual debt owed to the debtor by the holder of the claim. So basically, the initial question is how far in the hole is the creditor's claim if there is a hypothetical setoff?

Next, the creditor must determine the amount of its insufficiency (if any) at the time of the actual prepetition setoff. If the insufficiency at the time of the actual setoff is less than the earlier, hypothetical insufficiency, the creditor will be found to have improved his position, and the creditor may be required to return the difference to the debtor, or to a bankruptcy trustee.

So does this mean a creditor shouldn't even consider exercising setoff rights against a financially-troubled customer, just in the event the customer files bankruptcy? Absolutely not! As with potential preferential payments, it's always better to have money in your own pocket instead of the debtor's pocket. Never let the preference "tail" wag the collection "dog."

Conclusion

Where your company owes a customer, who also owes your company -- you have an additional right and remedy — namely setoff. The key is that the respective debts be both matured and "mutual" — owed by and to the exact same entities. Effectuating a setoff of mutual debts before your customer files bankruptcy is generally better, as it enables you to avoid some, but not all, of the setoff limitations imposed by the Bankruptcy Code.

About the Author:

Mr. Coleman is a founding director of Kane Russell Coleman and Logan PC, where he chairs the Insolvency, Bankruptcy and Creditor Rights practice group. His team has represented 38 Creditor Committees in 16 states together with every other facet of credit rights and bankruptcy representation. His firm was recently named among the top 20 mid-sized law firms in the nation by The National Law Journal."

Please Make Note **- of the following upcoming CRF User Group Meetings**
For more information or to register, please click on the appropriate links.

Oracle User Group Meeting – June 17 – Chicago, IL. See details and register here.

SAP User Group Meeting – June 18 – Chicago, IL. See details and register here.

Also, don't forget to participate in CRF's 1st Qtr. 2015 DSO Survey by April 30th - CLICK HERE