

Bankruptcy Law News

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Shumaker, Loop & Kendrick, LLP

July 2015



Recoupment or Setoff? - A Distinction with a Difference

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Setoff is commonly encountered in bankruptcy and non-bankruptcy situations. If there are mutual debts between two entities, either may generally offset the debts. These debts frequently arise where one entity is a vendor to a customer and selling on credit, and at the same time is also making occasional purchases on credit from the customer. If one entity owes \$100 to a second entity but is owed \$300 by this second entity, these mutual debts may be offset, leaving just the \$200 owed by the second entity.

Recoupment is a subset of setoffs. It has been defined as “the setting up of a demand *arising from the same transaction* as the plaintiff’s claim or cause of action, strictly for the purpose of abatement or reduction of such claim.”¹ In addition to mutuality, an element necessary for recoupment is that the two sets of claims must have been part of a single integrated business transaction between the two entities.

A factual situation involving recoupment and setoff.

Associated Wholesalers Inc., a large cooperative food distributor serving supermarkets and convenience stores, filed for Chapter 11 under the name ADI Liquidation, Inc., along with related entities. As is common in Chapter 11 cases, the debtors were not reorganized under a stand-alone plan of reorganization, but instead were sold as operating entities under an auction procedure known as a Section 363 sale.

Pursuant to the order approving the sale, the buyer of the debtors’ assets purchased the assets free and clear of all claims and liens, with the liens to attach to the proceeds of the sale. Included in the purchased assets were the debtor’s accounts receivable. The sale order further provided that the purchased assets were free and clear of all setoff rights held by creditors and that these setoff rights would be preserved and would attach to the proceeds of the sale as held by the debtors.

What is the effect of these provisions? Assume a vendor is owed \$100,000 by the debtors but also owes the debtors \$30,000 for prepetition purchases from the debtors, and further assume that prepetition unsecured claims in the bankruptcy case will receive a distribution of 10 percent. Under Scenario A, assuming no sale, but after applying the vendor’s setoff rights, the vendor’s claim would be reduced by \$30,000 by virtue of the setoff against the \$30,000 the vendor owes the debtors, with the remaining claim against the estate of \$70,000 receiving a distribution of \$7,000.

As a result of the sale order in the ADI cases providing that the buyer acquired the debtors’ accounts receivable, including the \$30,000 claim, the buyer asserted that it was entitled to offset that claim against post-sale purchases from this vendor.

¹ *University Med. Ctr. v. Sullivan (University Med. Ctr.)*, 973 F.2d 1065, 1079 (3d Cir. 1992) (*emphasis in original*).

Under this Scenario B, the vendor would have no setoff right against the estate, and the vendor would have its \$100,000 prepetition claim and receive a \$10,000 distribution. However, the vendor would be out of pocket the full \$30,000 that it has to pay the buyer. Thus, instead of a recovery of \$7,000, the vendor has a loss of \$20,000, or a \$27,000 cash swing.

The payoff for vendors of the recoupment/setoff distinction.

The order approving the sale in the ADI cases, although drafted by counsel for the debtors and the asset buyer, was modified by the bankruptcy court to provide that the sale, while free and clear of setoff rights, was *not* free and clear of *recoupment* rights of the vendors, and all such recoupment rights were preserved.

The recoupment rights in the ADI cases arise from advertising credits asserted by the debtors against its vendors prior to the bankruptcy filing, which credits are common in the retail industry. The ADI debtors bought print advertisements and charged the vendors whose products appeared in the advertisements by issuing invoices to the vendors. A previous decision by a Delaware bankruptcy court held that such advertising allowances fit within the requirement of being a single integrated business transaction such that their invoices are considered a recoupment, rather than a mere setoff, against the vendor's invoices for the sale of its products to the debtor.

As a result of the court's modification of the sale order, the vendors in the ADI cases should be entitled to prevent any setoff of prepetition advertising allowances by the asset buyer against post-sale purchases by it from the vendors, because the doctrine of recoupment, rather than setoff, applies to the claims. The vendors' right to recoup payment of their invoices from the amounts they owe for advertising allowances means that they should obtain the \$7,000 recovery in Scenario A above.

However, the asset buyer, which may be feeling a bit of buyer's remorse for paying too much for the purchased assets, is challenging the analysis set out above and asserting that it is entitled to a full setoff of the prepetition advertising allowances, as purchased accounts receivable, against its post-sale purchases. In the hypothetical above, this argument would give the buyer a windfall of \$30,000 to the detriment to the vendor.

Summary of the advantage of recoupment over setoff.

The remedy of setoff has the risk that the two sets of transactions will be separated by a Section 363 sale, so that the vendor will not be able to effect the setoff and will have to pay the full amount of its obligation while receiving only partial value on the obligation owed to it. In the ADI cases, the vendors were protected by the court's modification of the sale order preserving recoupment rights, provided the claims arise from a single integrated business transaction. In light of ADI, vendor creditors who also have obligations owed to a bankruptcy debtor should object to the Section 363 sale to preserve setoff and recoupment rights.

One more twist from the ADI court.

The good news of the above decision is tempered by a subsequent decision in this case, which decided that the debtor may determine that it will first offset what it is owed by the vendor against the vendor's section 503(b)(9) administrative priority claim. The effect of this decision is that, to the amount that the debtor offsets against the 503(b)(9) claim, the ultimate distribution to the vendor on that portion of its claim is reduced from 100 percent to, in the hypothetical situation above, 10 percent. Vendors should include in their terms of sale that the vendor has the right to determine the means of applying any setoffs. However, some bankruptcy courts are often debtor and lender friendly (Delaware), and may refuse to enforce such provisions.

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