

The Differences Between the Right to Setoff Under 11 U.S.C. §553 and 11 U.S.C. §558

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Introduction

In bankruptcy cases, the right to setoff is a powerful tool used by both debtors and creditors to avoid having to pay a debt owed to another. The right to setoff is defined as “[a] debtor’s right to reduce the amount of a debt by any sum the creditor owes the debtor the counterbalancing sum owed by the creditor.”¹ A right to setoff usually arises when a debtor owes a debt to a creditor and the creditor owes a debt to the debtor.² The purpose of a setoff is to “allow 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.”³ The court will reduce the two

¹ BLACK’S LAW DICTIONARY, 1496 (9th ed. 2009).

² David A. Murdoch, Jamie A. Bishop, Michael J. Crossey, & Michael J. Poss, *Bankruptcy: Getting to Know your two best friends: The Rights of Setoff and Recoupment*, K&LNG ALERT (December 2005) <http://www.klgates.com/files/Publication/56da8ca6-ba6a-4973-8fa4-3b2d8aaf05a5/Presentation/PublicationAttachment/77554d2e-5845-481f-9f1c-4f3a7f161e4d/ba1205.pdf>

³ *Citizens bank of Maryland v. Strumpf*, 516 U.S. 16, 19 (1995) (citing *Studley v. Boylston Nat’l Bank*, 229 U.S. 523,528 (1913)).

competing judgments into a single judgment and will arrive at a balance due or net figure, which is declared owing in a single judgment.⁴

The Bankruptcy Code does not create a right of setoff. Rather, it recognizes the right to setoff existing under non-bankruptcy state law.⁵ The Bankruptcy Code has two sections that permit setoff: sections 553 and 558.⁶ To enforce setoff rights in bankruptcy cases, attorneys must be mindful of the different elements and requirements set forth in the different sections of the Bankruptcy Code.

This Article will discuss the provisions in the Bankruptcy Code applicable to setoff claims brought by either the creditor or debtor. It will examine policies and case law that support these provisions. Part I will analyze a creditor's right to setoff under section 553 of the Bankruptcy Code. Part II will analyze a debtor's right to setoff under section 558 of the Bankruptcy Code. Each part will consider different scenarios to demonstrate why each party would want to enforce a setoff claim against the other. Finally, this Article will conclude by exploring how different bankruptcy courts handle setoff claims.

I. A Creditor's Right to Setoff 11 U.S.C § 553

The setoff right protects a creditor from having to pay its debt to a debtor in full while standing in line to recover a pro rata share of the debtor's debt to it.⁷ In effect, setoff elevates a

⁴ See generally *In re Hancock*, 137 B.R. 835, 845 (Bankr. N.D. Okla. 1992) (explaining that section 553 does not define a setoff, that right is established by state courts, and then if it meets the three additional requirements of the bankruptcy code are met the setoff right will be applied to net out claims).

⁵ See *Gullett v. Continental Cas. Co. (In re Gullett)*, 230 B.R. 321 (Bankr. S.D. Tex 1999).

⁶ *In re RCS Capital Development, LLC*, No. AZ-12-1381, 2013 WL 3618550 1,8 (B.A.P. 9th Cir. July 16, 2013). ("The Bankruptcy Code preserves the right of setoff for creditors under §553") ("The Code preserves a debtor's right to effectuate a setoff under §558, as it exists under state law); see also, 11 U.S.C. §§ 553, 558.

⁷ *United States V. Brunner (In re Brown)*, 282 F.2d 535, 537 (10 Cir. 1960); see also, Bruce S. Nathan, *A Trade Creditor's Setoff Rights In Bankruptcy: No Slam Dunk*, BUSINESS CREDIT: NAT'L ASSOC. OF CREDIT MGMT. (2006) <http://www.lowenstein.com/files/Publication/b4750576-43ee-4cb8-ac4e-1383ed9ec3fe/Presentation/PublicationAttachment/6184d17a-da97-4862-80cc-1516bc9d8dce/Business%20Credit%20-%20BSN%20-%20January%202006.pdf> ("A creditor's exercise of setoff

creditor's unsecured claim to secured status.⁸ Under section 506 of the Bankruptcy Code, a creditor's allowed claim that is subject to setoff is a "secured claim" to the extent of the amount subject to setoff.⁹ Accordingly, if the creditor does not timely file a proof of claim asserting its setoff rights, the creditor will lose its "allowed claim" status under section 506 and will therefore be stripped of its secured status and setoff rights.¹⁰

Once a debtor files for bankruptcy, a creditor can only take a setoff after being granted relief from the automatic stay by the bankruptcy court. Any setoff taken by a creditor without first obtaining relief from the automatic stay will be void. Therefore, before considering the provisions of the Bankruptcy Code, a creditor must first obtain relief from the automatic stay.¹¹ Courts will grant a creditor relief from the stay where the debtor cannot adequately provide protection for the creditors unexercised setoff claim.¹²

After a creditor is granted relief from the automatic stay, a creditor can proceed to its setoff right defined in section 553 of the Bankruptcy Code. Section 553 preserves a creditor's right to setoff debts under state law if (1) the debtor owes a creditor a pre-petition debt, (2) the

rights also avoids the unfair result of allowing the debtor to collect 100 percent of its claim against the creditor while limiting the creditor to the di minimus distribution that might otherwise be available to the debtor's other unsecured trade creditors.").

⁸ See 11 U.S.C. § 506(a).

⁹ *Id.*; see also, Bruce S. Nathan & Scott Cargill, *Failing to Adequately Assert Setoff Rights Could Jeopardize Recovery*, AM. BANKR. INST. J., Oct. 2013, at 16, 85, available at: <http://www.lowenstein.com/files/Publication/e0a16807-efa0-4ce2-b6ba-20f8ce501dda/Presentation/PublicationAttachment/54b58bd7-0720-49a6-b5b9-2c92c4337ca1/Failing%20to%20Adequately%20Assert%20Setoff%20Rights.pdf> (explaining how setoff provides a creditor a secured claim).

¹⁰ *Id.* (describing the steps necessary for a creditor to ensure its claim is treated as a secure claim).

¹¹ See 11 U.S.C. § 362(a)(7); see also, Murdoch, Bishop, Crossey, & Poss, *supra* note 2.

¹² 11 U.S.C. § 362(d) (2006). The concept of adequate protection is defined in 11 U.S.C. § 361 (2006). It roughly means that the trustee must establish a way to compensate a creditor for or protect a creditor against any loss in value to the creditor's claim that occurs during the bankruptcy case.

creditor owes the debtor a pre-petition debt, (3) the debts are mutual, and (4) the claim and debt are each valid and enforceable.¹³

The first two requirements are timing restrictions. To qualify as a pre-petition debt, the obligation must have come into effect before the commencement of the case.¹⁴ Conversely, post-petition debts will be any debt that occurred after the filing.¹⁵ A creditor can never offset a post-petition debt against a pre-petition debt.¹⁶ Section 553 further restricts a creditor's setoff rights by narrowing the types of claims that the creditor can offset. A creditor cannot setoff a claim that was assigned to the creditor after the debtor's filing or within ninety days of the filing while the debtor was insolvent.¹⁷ Without this restriction creditors indebted to a debtor would have an incentive to purchase claims at a discount shortly before or after the bankruptcy in order to reduce their indebtedness, dollar for dollar, to the debtor by exercising their recently acquired setoff rights.¹⁸ Further, section 553 prohibits a creditor's use of setoff rights that accrued during the ninety-day period prior to the bankruptcy in order to obtain a preference.¹⁹

¹³ See generally *In re Hancock*, 137 B.R. 835, 845 (Bankr. N.D. Okla. 1992) (explaining that section 553 does not define a setoff, that right is established by state courts, and then if it meets the three additional requirements of the bankruptcy code are met the setoff right will be applied to net out claims); see also *In re Steines*, 285 B.R. 360, 362 (Bankr. D. N.J. 2002).

¹⁴ *In re Concept Clubs, Inc.*, 154 B.R. 581, 586 (D. Utah 1993); *In re Steines*, 285 B.R. 360, 362 (Bankr. D. N.J. 2002).

¹⁵ 5 COLLIER ON BANKRUPTCY, ¶ 553 at 553.03[1][b] (Alan N. Resnick & Henry J. Sommer eds, 16th ed. 2009).

¹⁶ See, Murdoch, Bishop, Crossey, & Poss, *supra* note 2, at 3; see also e.g. *In re Genuity, Inc.*, 323 B.R. 79, 82–83 (Bankr. S.D.N.Y. 2011); *In re Shopper's Paradise, Inc.*, 8 B.R. 271, 278 (Bankr. S.D.N.Y. 1980).

¹⁷ 11 U.S.C. § 553 (a)(2); see also, Nathan, *supra* note 9, at 2 (“This is intended to discourage the “trafficking” of claims shortly before or after a debtor's bankruptcy in order to create setoff rights in favor of the creditor acquiring the claim.”).

¹⁸ See, Nathan, *supra* note 9 at 2.

¹⁹ *Id.*

Despite these timing restrictions for pre-petition claims, courts will recognize that the character of a claim is not transformed from pre-petition to post-petition simply because it is contingent, unliquidated, or unmatured when the debtor's petition is filed.²⁰ Furthermore, the debt owed the debtor does not have to be calculated prior to the filing of the bankruptcy petition in order for setoff to be available to a creditor.²¹

The next restriction set forth in the Bankruptcy Code is mutuality of claims. Mutuality is a requirement that exists under many of the state laws regarding setoff and is also strictly construed under the Bankruptcy Code.²² For mutuality to exist, the debts and claims must be in the same right, between the same parties, standing in the same capacity.²³ The purpose of the mutuality requirement is to prevent “triangular setoffs” – a setoff among three or more affiliated entities. Some courts have created an exception to the general rule prohibiting triangular setoffs that permits such setoffs when the parties have entered into an express contractual agreement to allow setoff among affiliates.²⁴ A creditor that takes an assignment of a third party’s claim against a debtor satisfies the mutuality requirement and is eligible for setoff so long as the assignment occurred more than ninety days before the debtor filed for bankruptcy.²⁵

²⁰ *In re Morristown Lincoln-Mercury, Inc.*, 42 Bankr. 413, 418 (Bankr. E.D.Tenn.1984).

²¹ *See Braniff Airways v. Exxon Co.*, 814 F.2d 1030, 1036 (5th Cir. Tex. 1987).

²² *E.g.*, *Aviation Ventures, Inc. v. Joan Morris, Inc.*, 110 P.3d 59, 63 (Nev. 2005) (“Nevada law requires that each party must have a valid and enforceable debt against the other for setoff to apply.”); *see also*, Patricia W. Prewitt, *Netting/Setoff Under The Bankruptcy Code*, 27 OIL, GAS & ENERGY RESOURCES 46, 46 (March 2003) <http://www.lockelord.com/files/News/887f18ac-431a-40f7-9875-26e3f266cff0/Presentation/NewsAttachment/39a736b1-831a-4a31-8aa1-27d2d7389741/prewitt%20bankruptcy.pdf> (citing *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990)).

²³ 11 U.S.C. § 553; *see also* *United States v. Carey (In re Wade Cook Fin. Corp.)*, 375 B.R. 580, 588 (B.A.P. 9th Cir. 2007).

²⁴ *Bloor v. Shapiro*, 32 B.R. 993, 1001–2 (Bankr. S.D.N.Y. 1983).

²⁵ Nathan, *supra* note 7, at 2.

Finally, in order for a creditor to setoff a claim against a debt owed to the creditor by the debtor, both the claim and debt must be valid and enforceable. “[A]n obligation is valid for setoff purposes if it is enforceable under applicable law and is not subject to disallowance under applicable provisions of the [Bankruptcy] Code.”²⁶

The advantages to a creditor who can qualify for setoff rights against a debtor in bankruptcy may be very financially lucrative. Setoff rights create a unique advantage over other creditors in bankruptcy. Rather than being limited to filing a proof of claim in the case and likely receiving just cents on the dollar for such claim (while having to turn over to the debtor or trustee the full amount owed to the debtor), a creditor with a right of setoff may actually setoff dollar-for-dollar amounts owed between the parties. This often results in a much higher recover on the creditor’s claim.²⁷ As such, a creditor with a right of setoff is considered a secured creditor holding a secured claim in the amount of the creditor’s right of setoff.²⁸

II. A Debtor’s Right to Setoff 11 U.S.C § 558

Unlike the strict requirements set forth in section 553, section 558 contains broad language that pertains to the situation where a debtor is asserting setoff.²⁹ Section 558 provides “that the estate shall have the benefit of any defense available to the debtor,” including the right

²⁶ 5 COLLIER ON BANKRUPTCY, ¶ 553.01[1] (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2009).

²⁷ Holly A. Estioko & Paul J. Pascuzzi, *Ten Things You Should Know About Setoff and Recoupment in Bankruptcy*, 3 BUS. L. NEWS ST. BAR CAL. 29, 29 (2013).

²⁸ *Id.* at 30; 11 U.S.C § 506(a) (“An allowed claim of a creditor secured by a lien on property . . . or that is subject to setoff under section 553 of this title, is a secured . . . to the extent of the amount subject to setoff”); *see also In re Princess Baking Corp.*, 5 B.R. 587, 590 (Bankr. S.D. Cal. 1980) (“Congress clearing intended that the amount that may be set off should be treated as tantamount to a perfected security interest”).

²⁹ 5 COLLIER ON BANKRUPTCY, ¶ 558, at 558.01[1][a] (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2009) (“Section 558 deals with all the debtor’s defenses, affirmative as well as negative. It provides the trustee with every defensive weapon available to the debtor.”).

to setoff.³⁰ And since the debtor's right of setoff is property of the estate under section 541(a), it in turn become a defense available to the trustee in bankruptcy under section 558.³¹

One reason the debtor may assert its setoff rights is as an objection to the allowance of a proof of claim.³² In order to defeat unjust or improper claims against the estate, “the trustee [or debtor in possession] must be able to assert all the defenses that the [d]ebtor could have asserted had bankruptcy not intervened.”³³ In addition, the lack of restrictive language in section 558 allows a trustee or debtor in possession to setoff a pre-petition claim against a post-petition obligation that the debtor owes.³⁴ Courts have ruled that because section 558 preserves all defenses that debtor would have had pre-petition, the court must examine the transaction as though the bankruptcy had not been filed. Examining the transaction in this way “eliminates the pre-petition/post-petition distinction and, in essence, obliterates the requirement that the mutual debts must both be pre-petition obligations in a section 558 context.”³⁵

Next, in order for a defendant to assert setoff under section 558, the right to setoff must

³⁰ 11 U.S.C. § 558 (“The estate shall have the benefit of any defense available to the debtor as against any entity other than the estate”); *see also In re Braniff Airways, Inc.*, 42 B.R. 443, 447 (Bankr. N.D. Tex. 1984) (debtor has the right to assert setoff as defense pursuant to section 541(e), even though section 553, governing setoff, refers only to creditor's right of setoff).

³¹ 5 COLLIER ON BANKRUPTCY, ¶ 553.03, at 553-59[7][b] (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2009).

³² 5 COLLIER ON BANKRUPTCY, ¶ 558.01, at 558-5 [1][b] (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2009) (*citing, In re Stoecker*, 151 B.R. 989 (Bankr. N.D. Ill. 1992)); *see also St. Bank of Florence v. Miller (In re Miller)*, 459 B.R. 657, 675 n.16 (B.A.P. 6th Cir. 2011) (“Section 558 frequently comes into play when a debtor in bankruptcy objects to a claim filed in the case by a creditor.”).

³³ *In re PSA, Inc.*, 277 B.R. 51, 53 (Bankr. D. Del. 2002) (citing 5 COLLIER ON BANKRUPTCY, ¶ 558.02 (Alan N. Resnick & Henry J. Sommer eds. 15th ed.1991)).

³⁴ *See In re Miller*, 459 B.R. at 675 n.16 (B.A.P. 6th Cir. 2011) (Unlike setoff under section 553, setoff under section 558 does not require that the mutual debts both be pre-petition obligations); *see also In re PSA, Inc.*, 277 B.R. at 53 (citing *In re Papercraft Corp.*, 127 B.R. 346, 350 (Bankr. W.D. Pa. 1991)) (“[W]e examine only this defensive action by [d]ebtor, invoking [section] 558, to determine whether the post-petition rent may be reduced by amounts owed to [d]ebtor, pre-petition, by [l]essor.”).

³⁵ *In re PSA, Inc.*, 277 B.R. at 53 (citing *In re Papercraft Corp.*, 127 B.R. at 350).

exist under state law because section 558 merely preserves any defense that was available to the debtor prior to the bankruptcy case.³⁶ As a result, the proposed setoff under section 558 must comply with the requirements under state law that apply to setoffs, including the requirements that the claim and debt must be (1) mutual and (2) valid and enforceable.³⁷

For example, recently, in *In re RCS Capital Development, LLC*, the United States Bankruptcy Appellate Panel of the Ninth Circuit applied this interpretation of section 558 and held that a debtor in possession could setoff a pre-petition claim against a post-petition obligation³⁸ that it owed.³⁹ Importantly, the *RCS Capital* court initially noted that section 533 did not govern the proposed setoff because the debtor, not the creditor, was asserting the right to setoff. Instead, the court examined the proposed setoff under section 558. Specifically, the court found that under Nevada law there was mutuality of claims, debts, and parties, and each party had an enforceable debt against the other.⁴⁰ Therefore, the setoff was valid under section 558 of the Bankruptcy Code because there is not any restrictive language confining setoffs to pre-petition obligation.⁴¹ The setoff allowed the debtor to setoff a post-petition debt it owed to creditor from

³⁶ *Id.*; see also, *In re RCS Capital Development, LLC*, No. AZ-12-1381, 2013 WL 3618550, at *9 (B.A.P. 9th Cir. July 16, 2013) (“The Code preserves a debtor’s right to effectuate a setoff under [section] 558, as it exists under state law.”) (citing *In re TSLC I, Inc.*, 332 B.R. 476, 478 (Bankr. M.D. Fla. 2005)).

³⁷ See, e.g., *Camelback Hosp., Inc. v. Buckenmaier (In re Buckenmaier)*, 127 B.R. 233, 237 (B.A.P. 9th Cir. 1991) (“[T]he Code does not create or expand the setoff right but instead merely preserves the common-law right under applicable non-bankruptcy law.”).

³⁸ The parties initially disputed the bankruptcy petition date sine there was an Australian insolvency case that carried into an American Bankruptcy case. However, the court did not have to address the issue if the obligation was in fact post-petition since the setoff would be permitted, regardless of the petition date applied, under section 558.

³⁹ *In re RCS*, 2013 WL 3618550, at *1, *8.

⁴⁰ *Id.* at *8; see also, *State Bank of Florence v. Miller (In re Miller)*, 459 B.R. 657, 675 n.16 (B.A.P. 6th Cir. 2011).

⁴¹ *In re RCS*, 2013 WL 3618550, at *8.

an ongoing Nevada action against a separate pre-petition debt the creditor owed the debtor from Arizona judgment for breach of contract.⁴²

III. Implications of the Differences (and Similarities) Between 11 U.S.C. § 553 and 11 U.S.C. § 558

Cases like *In re RCS Capital Developments, LLC* are important because they illustrate the differences (and similarities) between the right to setoff under section 553 and section 558. As the *RCS* court noted, section 558, unlike section 553, permits the trustee or debtor in possession to setoff a pre-petition claim against a post-petition obligation that the debtor owes. Yet, putting that distinction aside, the other requirements for enforcing the right to setoff under section 558 are the same as they are under section 553.⁴³ Therefore, in order to assert its right to setoff, a creditor, a trustee, or a debtor in possession will need to establish that the claim and the debt are mutual and valid and enforceable.

It is also important to remember that, even where the right to setoff exist, the right to setoff is an equitable right under the Bankruptcy Code, and the enforcement of such a right is entirely within the discretion of the bankruptcy court.⁴⁴ A court may refuse to allow a setoff for many reasons, including if allowing the enforcement of the setoff would have an adverse effect that a setoff would have on a debtor's reorganization.⁴⁵ Moreover, “[w]hile a creditor may hold

⁴² *Id.* at *2 (describing Arizona action where RCS sued ABC Arizona Superior Court breach contract. RCS won jury verdict \$47 million, 2012 total amount due excess of \$57 million).

⁴³ *Id.* at *8 (“As a result [the debtor in possession’s ability to setoff prepetition claims against postpetition obligations of the debtor under section 558], it [wa]s unnecessary for [the court] to resolve the dispute between the parties regarding which petition date, as between [the debtor] and [the creditor], [wa]s the applicable date for purposes of determining whether [the debtor] incurred the alleged debt owed to [the creditor] prepetition or postpetition. Otherwise, whether [section] 553 or [section] 558 applie[d] probably makes little difference to the outcome of this case.”).

⁴⁴ *In re Beville, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990).

⁴⁵ See e.g., *In re Nielson*, 90 B.R. 173, 175 (Bankr. W.D.N.C. 1988); *In re Blanton*, 105 B.R. 321, 337–38 (Bankr. E.D. Va. 1989).

valid and enforceable setoff rights prior to the commencement of a bankruptcy case, those rights can be jeopardized thereafter if they are not timely asserted and pursued during the case.”⁴⁶

Courts, however, generally agree that the right to setoff should be enforced unless there exist “compelling circumstances” require otherwise.⁴⁷

Conclusion

In a bankruptcy case, the right to setoff will be governed by section 553 if the setoff is being asserted by a creditor, or section 558 if the setoff is being asserted by the debtor.

Moreover, sections 553 and 558 both generally require that there be mutuality between the claims, the debts and the parties.⁴⁸ However, the two sections differ regarding the ability to setoff a pre-petition debt against a post-petition debt. Section 558 permits such a setoff; section 553 does not. If these conditions are met the right to setoff can be a very effective tool for creditors, trustees, and debtors in possession in bankruptcy proceedings.

⁴⁶ See Nathan & Cargill, *supra* note 9, at 86.

⁴⁷ See *supra* note 23 (citing *United States v. Arkison (In re Cascade roads, Inc.)*, 34 F.3d 756, 763–65 (9th Cir. 1994); *Brown & Cole Stores, LLC v. Assoc. Grocers, Inc. (In re Brown & Cold Stores, LLC)*, 375 B.R. 873, 879 (B.A.P. 9th Cir. 2007)).

⁴⁸ *In re RCS*, 2013 WL 3618559, at *9.

