

A Creditor's Right to Setoff: When Does a Creditor Impermissibly Improve Its Position?

Written by:

Ben Caughey

Ice Miller LLP; Indianapolis
ben.caughey@icemiller.com

Editor's Note: For another article on setoff rights, see page 24.

It is generally well recognized that the use of setoff promotes efficiency, simplicity and fairness in everyday business transactions. The right of setoff is an equitable remedy that has historically been respected by the laws of every state and is also recognized in the Bankruptcy Code¹—specifically in § 553. Section 553 recognizes and preserves rights of setoff when (1) a creditor holds a valid and enforceable claim against a debtor that arose pre-petition, (2) the creditor owes a valid and enforceable debt to a debtor that arose pre-petition and (3) the claim and debt are mutual. At its core, § 553 simply provides that the right of setoff is not affected by the filing of a bankruptcy proceeding as long as mutual debts existed between the parties before the commencement of the proceeding.



Ben Caughey

Because the right of setoff is in the nature of a secured claim, exercising a setoff pre-petition is generally not avoidable as a preference or a fraudulent conveyance.² What some lawyers do not fully understand, however, is that the Code does contain a limitation on pre-petition transactions when the net effect of a setoff during the 90 days preceding bankruptcy allows a creditor to improve its position in a manner not permitted by the Code. The limited exception to setoff, which is mandated by § 553(b), is founded on the policy goal of discouraging creditors from artificially creating or enlarging their right to setoff during a debtor's slide into bankruptcy.

Bankruptcy courts consistently and frequently have permitted creditors to

About the Author

Ben Caughey is a partner in Ice Miller's Bankruptcy Practice Group in Indianapolis and concentrates his practice in commercial litigation, bankruptcy and debt workouts.

exercise rights of setoff even though the right is arguably at odds with the fundamental bankruptcy principle of equality of distribution among creditors, since it permits a creditor to obtain full satisfaction of a debt by extinguishing an equal amount of the creditor's debt to the debtor. Bankruptcy courts have rejected arguments that it is somehow inequitable to allow a creditor to set off its claim by finding that equity does not mandate that one creditor lose its state law rights solely to benefit other creditors.³ Courts have refused to permit setoff only in very unusual factual situations and only after a finding that allowing the setoff to remain

Feature

intact would violate principles of equity (beyond principles of equity of distribution) (e.g., denying setoff against property held in constructive trust for the estate⁴ where the creditor violated the automatic stay and the terms of a confirmed plan⁵ and when the creditor was guilty of conversion).⁶ However, § 553(b)(1) may act to limit or undo a setoff when a creditor has acted fully within its state law rights and done nothing improper.

Improvement-in-Position Test

While basic setoff analysis is second nature to most bankruptcy practitioners, the treatment of improvements of position under § 553(b) is less familiar. Section 553(b)(1) is dense and difficult to parse, and hinges on application and analysis of the term "insufficiency." At its core, § 553(b)(1) acts as a miniature preference section—giving rise to a cause of action in favor of the trustee to the extent that a pre-petition setoff

improves the creditor's position in the 90 days prior to bankruptcy.⁷ Section 553(b)(1) does not provide that all setoffs in the 90-day preference period may be avoided, but instead provides that setoffs may only be avoided to the extent that the creditor improved its position. The improvement-in-position test of § 553(b) provides, in relevant part, that

- (1) ... 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 [as of] 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 pre-

ceding 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.⁸

Understanding the policy behind § 553(b)(1) assists practitioners in navigating through the plain language of the statute and arriving at the proper result. The limitation on setoff in § 553(b)(1) is designed to prevent a creditor who may believe that a customer is sliding into insolvency from creating an obligation to the customer during the preference period for the purpose of improving its position through a setoff remedy.⁹

⁷ Trustees bear the burden of proof with respect to claims based on pre-petition setoff.

⁸ 11 U.S.C. § 553(b).

⁹ The concern of Congress, in enacting the improvement-in-position test, was that creditors, primarily banks, holding mutual accounts with the debtor would foresee a bankruptcy filing and scramble to secure a better position by decreasing the "insufficiency" to the detriment of the other creditors. *Lee v. Schweiker*, 739 F.2d 870 (3d Cir. Pa. 1984), citing H.R. Rep. No. 95-595, 95th Cong. 2d Sess. at 185, 1978 U.S. Cong. & Ad. News at 6145.

¹ The right of setoff in bankruptcy allows 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." *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995), quoting *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913).

² Section 542(b) requires turnover of property to the estate, but specifically exempts property from turnover "to the extent that such debt may be offset under section 553 of this title against a claim against the debtor." 11 U.S.C. § 542(b).

³ See *CDI Trust v. U.S. Elec. Inc. (In re Communication Dynamics Inc.)*, 382 B.R. 219 (Bankr. D. Del. 2008).

⁴ *Cohen v. Savings Bldg. & Loan Co. (In re Beville, Bresler & Schulman Asset Mgmt. Corp.)*, 896 F.2d 54, 57-59 (3d Cir. N.J. 1990).

⁵ *United States v. Norton*, 717 F.2d 767, 771, 774 (3d Cir. Pa. 1983).

⁶ *Windsor Comm. Gp. v. Havertown Printing Co. (In re Windsor Comm. Gp. Inc.)*, 79 B.R. 210, 217 (E.D. Pa. 1987).

continued on page 89

When Does a Creditor Impermissibly Improve Its Position?

from page 32

With that policy goal in mind, the following framework has been recognized as being appropriate when applying the § 553(b)(1) improvement-in-position test:

- (1) Calculate the amount by which the claim of a creditor exceeded the debt owing to the debtor on the date of setoff;
- (2) Calculate the same figure for the date 90 days prior to the filing of the debtor's bankruptcy proceeding or the first date during the 90-day period when the amount of the claim of the creditor exceeded the debt owing to the debtor; [and]
- (3) Any amount by which the figure in (2) exceeds that in (1) may be avoided.¹⁰

Transactions between financial institutions and financially distressed entities in the period leading up to bankruptcy have been attacked by debtors and trustees on a number of occasions on the basis of § 553(b)(1). Notable analysis of such a situation was provided in *French v. Bank One, Lima NA (In re Rehab Project Inc.)*.¹¹ In *French*, the debtor executed a promissory note in favor of Bank One in 1993 and was current on its contractual obligations through April 1997, at which time it defaulted with a balance due of approximately \$40,000.¹² In November 1997, Bank One set off the debt against three deposit accounts maintained by the debtor, resulting in a reduction of the obligations due to the bank by approximately \$20,000.¹³ Shortly before Bank One's exercise of setoff, the debtor made deposits into the accounts, which increased the balances maintained in the accounts.¹⁴ Exactly 90 days after Bank One's setoff, the debtor filed a chapter 7 proceeding and the trustee filed an adversary proceeding seeking to recover the setoff on the grounds that it was a preferential transfer pursuant to §§ 553 and 547.¹⁵

The court analyzed and then applied the formula contemplated by § 553 and, despite the fact that new deposits had been made shortly before the setoff, found that the insufficiency figures

were exactly the same since the setoff occurred on the 90th day prior to the debtor's filing.¹⁶ The court reasoned that the language of § 553(b) was specific and required a mathematical application, and that the transaction could not be avoided.¹⁷ Interestingly, however, the court noted that its decision might have been different and it might have been willing to diverge from the mathematical application if a debtor was found to have made a very large bank deposit on the 90th day immediately preceding its bankruptcy filing and, on that very same day, a bank exercised its right of setoff against that debtor's account(s), depending on what other circumstances were present.¹⁸

Application of Improvements-of-Position Test

An illustrative example is helpful in understanding the application of § 553(b)(1). Frantic Supply LLC has shipped goods on account to ABC Co. for 10 years and has typically received payment within 30 days of transmittal of an invoice. Beginning in 2010, ABC Co. stopped making payments to Frantic Supply, and \$250,000 in open invoices have become aged and stale. Believing that ABC Co. is on the brink of filing chapter 11 and knowing that exerting collection pressure and obtaining payment will likely later lead to disbursement of the received funds as avoidable preferences, Frantic Supply decides to order \$250,000 of goods from ABC Co. Immediately upon receipt of the goods, Frantic Supply advises ABC Co. that it is affecting a setoff of the parties' mutual obligations. Sixty days after ABC Co. delivers the goods, Frantic Supply files a chapter 11 proceeding.

The reach of the plain language of § 553(b)(1) and the proper result for the above scenario was clarified in *Lawndale Steel Co. v. Magic Steel Co.*¹⁹ In *Lawndale*, the debtor purchased steel on Dec. 5 from a supplier for \$11,225.31, and on Dec. 22, the supplier purchased steel from the debtor for \$18,682.70.²⁰ On Feb. 16, the supplier paid the debtor \$7,457.39 (the differ-

ence between the mutual debts between the parties).²¹ A chapter 7 petition was filed on Feb. 23, and the debtor later filed a complaint against the supplier to avoid the \$11,225.31 setoff effected by the supplier.²² The debtor argued that the amount of the first "insufficiency" under § 553(b)(1) must be compared to the amount of the "insufficiency" on the date the supplier exercised its right to setoff, and on that date, the supplier decreased its insufficiency to zero by purchasing steel and exercising a setoff.²³ The supplier argued that, according to the definitions in § 553, there was no "insufficiency" until there were mutual debts and credits between the parties, and thus, on the date of the setoff, no insufficiency existed and the transaction was immune from attack.²⁴ The court opined that § 553(b)(1) was "ambiguous" but rejected the supplier's position that mutual debts must exist before the first insufficiency could be determined under § 553(b)(1), as the supplier's position would lead to a result that was inconsistent with the remainder of § 553 and the goals of ensuring equality of distribution among creditors of the debtor.²⁵

Applying the *Lawndale* ruling to the hypothetical previously outlined, ABC Co. is liable to Frantic Supply for the difference between the insufficiency on the date of the setoff (\$0) and the insufficiency on the date that was 90 days prior to the filing of Frantic Supply's bankruptcy proceeding (\$250,000). With that unfavorable result for the trade creditor in mind, what does the reach of § 553(b)(1) mean for creditors? Does it mean that creditors in a position similar to ABC Co. should not proactively look to use setoff to resolve obligations prior to a possible bankruptcy filing?

Final Analysis

Much like with the risk/benefit analysis that a creditor undertakes when attempting to collect pre-bankruptcy amounts knowing that they may later be subject to attack as preferences, it still makes sense for creditors to do what is necessary to collect money from financially troubled entities. Even if a bank-

¹⁰ 4 *Collier on Bankruptcy*, ¶ 553.01 at 553-9 (15th ed. 1992).

¹¹ *French v. Bank One, Lima NA (In re Rehab Project Inc.)*, 238 B.R. 363 (Bankr. N.D. Ohio 1999).

¹² *Id.* at 367.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 368.

¹⁶ *Id.* at 371.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Lawndale Steel Co. v. Magic Steel Co. (In re Lawndale Steele Co.)*, 155 B.R. 990 (Bankr. N.D. Ill. 1993).

²⁰ *Id.* at 991.

²¹ *Id.*

²² *Id.*

²³ *Id.* at 992.

²⁴ *Id.*

²⁵ *Id.* at 996.

continued on page 90

When Does a Creditor Impermissibly Improve Its Position?

from page 89

ruptcy is expected, other factors may delay or ultimately forestall the filing. Furthermore, even if a bankruptcy is ultimately filed, a creditor can attempt to evaluate whether other rationale or arguments might protect the transac-

tion from avoidance (including whether the transaction is actually in the nature of recoupment not setoff). Ultimately, trade creditors doing business with a financially distressed company can and should exercise their state law setoff

rights to increase the recovery on their claims; however, they must be aware of the potential pitfalls of the incurrence of debt, which has the effect of improving the creditor's setoff rights and improving their position. ■

Copyright 2010
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.