

Setoff, Plan Provisions and *Espinosa*

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Editor's Note: For other articles on the issue of setoff, see pages 24 and 32.

While some of us in the states still disagree with the Supreme Court's approach in *Espinosa*² on the Rule 60(b)(4) voidness argument, we applaud the Court's decision to reject the Ninth Circuit's gratuitous holding that bankruptcy courts do not have the discretion to refuse to confirm plans that violate the Code. The holding ignored the policing authority given by § 105(a), as well as the court's warning in *Taylor v. Freeland Krontz*³ that counsel could be sanctioned for listing frivolous exemptions, even if the exemptions were protected from a belated challenge. *Espinosa* flew in the face of numerous decisions that had policed the "discharge by declaration" outbreak.⁴



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But the Supreme Court's rousing repudiation of plans that violated the Code will likely prove to be the more significant result of the case. *Espinosa* held, in no uncertain terms, that courts not only may, but *must* police plan provisions, even without an objection, and courts have begun to do so.⁵ While a court might itself miss some issues, it has no excuse when a party brings a matter to its attention that affects creditors generally. Thus, while chapter 13 student loan creditors will still have to remain alert, the largest impact of *Espinosa* may be on chapter 11 plan objections, where the relatively small number of cases should enable closer scrutiny. In earlier articles on this topic,⁶ it was noted that the states were taking

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affirmative steps to challenge improper plan provisions and to demand that they be removed. This article focuses on one particular issue—*i.e.*, where debtors attempt to bar setoff or recoupment by creditors post-confirmation.

Does § 553 Control over § 1141 (and §§ 524 and 1328)?

In analyzing the effect of *Espinosa* on setoff, the first question is what happens in the absence of a plan provision. Section 553 states that "[e]xcept as otherwise provided in this section and in Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual [pre-petition] debt [to the debtor] against a [pre-petition claim] against the debtor." That language is clear and unequivocal: Except

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for §§ 362 and 363, no other provisions in Title 11 trump a creditor's right to setoff, language that plainly applies to §§ 1123, 1129 and 1141, which prescribe the proper content of a plan, the requirements for confirmation and the effect of confirmation, respectively. As such, a plan provision barring setoff would not appear to be an "appropriate provision not inconsistent with applicable provisions of this title" (§ 1123(b)(6)); the plan would, accordingly, not "comply with the applicable provisions of this title" (§ 1129(a)(1)); and inclusion of such a provision improperly creates a conflict between §§ 553 and 1141. A parallel analysis would apply in chapters 7 and 13.

In view of that language, the clear majority of cases agree that § 553 trumps the other sections, which is particularly significant in chapter 7 cases in that § 524 explicitly references "offset" as a matter that is covered by the discharge. In the earliest circuit court case, *In re Davidovich*,⁷ the court held that the right to setoff survived the discharge even if

the creditor did not file a claim in the debtor's chapter 7 case. Despite the "no offset" language in § 524, the court held that § 553 controlled and allowed the right to setoff to continue post-discharge. (In doing so, the court revised *dicta* in a prior case that had suggested that the right to setoff only remained in place until the discharge.) The right of setoff is purely defensive, though; it can be invoked only to defeat the debtor's claim without providing affirmative relief.

In *In re De Laurentiis Entertainment Group Inc.*,⁸ the creditor had pursued its setoff claim during a chapter 11 case. The debtor's plan sold its claim against the creditor "free and clear" of any unlisted claims or interests. The creditor did not object to the plan (which did not list its claim), but after confirmation, reasserted its setoff rights. The buyer argued that confirmation inherently discharged the creditor's setoff claim. The Ninth Circuit noted that some lower court cases had found that § 1327 controlled over § 553, but that in the chapter 7 context,

§ 553 had generally been held to trump § 524. After reviewing those precedents, the court held that § 553 had to control § 1141 because otherwise rights of setoff would be effective only if a debtor wrote a provision into its plan protecting them. If so, § 553 would be redundant since the debtor could include such a provision without statutory authorization. The court noted that bankruptcy law had given preferential treatment to setoffs for hundreds of years. Finally, the court added, it was also not unfair to do so here, since the creditor had been diligently asserting its position in the case and the setoff could well have been effectuated before confirmation.

In *In re Continental Airlines Inc.*,⁹ conversely, the court held that where the government did not assert its (known) setoff rights before confirmation, they were extinguished at confirmation as a matter of law. The ruling appeared to have been based in large part on the court's desire to protect the integrity of

¹ The opinions expressed herein are solely those of the author.

² *United Student Aid Funds Inc. v. Espinosa*, 130 S.Ct. 1367 (March 23, 2010).

³ *Taylor v. Freeland Krontz*, 503 U.S. 638, 644 (1992).

⁴ See, e.g., *In re Lemons*, 285 B.R. 327 (Bankr. W.D. Okla. 2002) (rejecting counsel's argument that its duty of zealous representation required it to try to sneak such provisions into plan).

⁵ See *In re Wright*, 2010 Bankr. LEXIS 3076 (Bankr. S.D. Ind. Sept. 7, 2010) (trustee's post-confirmation objection to student loan discharge was too late but court made very clear that debtor's counsel should not try same tactic again), and *In re Susvilla*, Case No. 10-52396 (Bankr. W.D. Tex. Sept. 23, 2010) (court imposed \$1,000 sanction on counsel that included improper student loan discharge provision).

⁶ See Karen Cordry, "Espinosa: It's Not So Simple: Part I," July/August 2010 *ABI Journal*; "Espinosa: It's Not So Simple: Part II," September 2010 *ABI Journal*.

⁷ *In re Davidovich*, 901 F.2d 1533, 1539 (10th Cir. 1990).

⁸ *In re De Laurentiis Entm't Group Inc.*, 963 F.2d 1269 (9th Cir. 1992).

⁹ *In re Continental Airlines Inc.*, 134 F.3d 536 (3d Cir. 1998).

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the plan and the debtor's feasibility calculations. The court distinguished the two prior circuit court cases on fairly flimsy grounds. It stated that *Davidovich* only looked at § 553 and did not discuss § 1141 (which was not surprising since *Davidovich* was a chapter 7 case), but ignored the fact that § 524 is, if anything, *more* supportive of the anti-setoff position than is § 1141. The court also asserted that *De Laurentiis* was based on the fact that the right to setoff had been asserted during the case, although the Ninth Circuit's opinion had clearly held that § 553 controlled as a matter of law *before* it made any reference to the assertion of the setoff during the case.

The court did not explain why, in the absence of any plan language, the statutory relation between §§ 553 and 1141 depended on whether a claimed right setoff had been asserted prior to confirmation. (Recall that § 1141(d)(1) provides that confirmation has the same effect whether or not a claim is filed or allowed.) Thus, if § 1141 automatically eliminates any setoff rights not provided for in the plan, it is unclear why merely asserting those rights during the case should make any difference. Perhaps due to the somewhat fuzzy logic of the decision in *Continental*, the last circuit court to take up the issue joined the earlier two opinions. In *In re Luongo*,¹⁰ the court held, as did "the vast majority of courts," that § 553 trumped the discharge provisions of § 524 in a chapter 7 case. The creditor, it held, could use setoff rights defensively, but not affirmatively.

Effect of Plan Provision Pre-Espinosa

None of these circuit court decisions, it should be noted, considered the effect of a plan provision specifically barring setoff rights or determined whether such a provision is proper. A number of lower courts, however, had held that regardless of whether § 1141 by its own terms would bar setoff, a confirmed plan provision that did so could be enforced.¹¹ The court held that the plan's language broadly barring setoff and recoupment would bind creditors, including those that had only received publication notice. The court held that cases such as

Davidovich and its progeny only decided the statutory conflict. Since the creditor had "legal" notice (although not actual notice) of the term, it theoretically could have objected thereto, and, not having done so, it was bound by the provision.

The court did not explain how a creditor could, as a practical matter, object to a term that it never actually received notice. Moreover, and this is relevant to the post-*Espinosa* analysis as well, the court did not consider that, if § 553 controls over § 1141(c) and (d), it would equally control over § 1141(a)—the provision that states that the terms of a plan control creditors subject thereto. It could be argued that even a term expressly purporting to bar setoff and recoupment would be trumped by § 553. Nevertheless, a number of other cases have taken the same approach as *Daewoo*, and debtors frequently include anti-setoff provisions in their plans and vigorously seek to enforce them post-confirmation.

Is an Anti-Setoff Provision Objectionable?

If one takes the majority view, then it would certainly appear that including a provision that contradicts § 553 violates the Code and creates a valid objection, although there are surprisingly few cases that discuss the issue. In *In re Friedman's Inc.*,¹² the court held that § 553's supremacy was so well settled in that district that it was unnecessary for the plan to so state and rejected the Internal Revenue Service's objection. Some plans do explicitly retain setoff rights for one or more parties. Those provisions likely reflect the normal pre-*Espinosa* strategy of "placating the squeaky wheel and leaving everyone else subject to the original provisions."

In *In re NII Holdings*,¹³ the court struck recoupment from a confirmation order so that it only dealt with "setoff" rights. Barring recoupment is even more problematic than setoff, since it is well settled that recoupment is a defense, not a claim, and is not subject to the automatic stay or the discharge injunction.¹⁴ As such, even more clearly than with setoff, recoupment survives confirmation¹⁵—yet

plans almost never distinguish between the two.

Thus, it would appear that outside the Third Circuit, objections to such a provision would likely have been granted automatically prior to *Espinosa* and, even within the Third Circuit, creditors could challenge such a provision. Due to the nontextual nature of the Third Circuit's limitations on § 553, it is unclear whether creditors would have had to just object generally to such a provision, or whether they should or must also assert a specific right of setoff.¹⁶ There is nothing, though, that suggests that the court thought it should take affirmative steps to remove the provision had the creditor not objected.

What Happens Post-Espinosa?

If such proposals *are* objectionable and improper, then it would seem that courts should be on the lookout for such provisions on their own and force their removal *sua sponte*. If a creditor objects, the plan provision should be changed for all, not just the challenger. The Code only allows the court to confirm plans that contain lawful provisions and requires recognition of setoff (and recoupment). It does not require that a creditor seek to effect its § 553 rights prior to confirmation. A plan that ignores those provisions should not be confirmable.

Even the Third Circuit cases say nothing more than that the creditor should do *something* to assert its rights preconfirmation. A plan that imposes greater burdens than that is "improper," as *Alta+Cast* stated. What is not clear, though, is what action the creditor should have taken. Form 10 requires a creditor to account for setoff rights thereon. If it does so, is that enough? Must it refer to a known right of setoff or merely state that it wants to retain any such rights that it may have? Must it also send the debtor a letter? File suit? Object to the plan? No one can tell from the Third Circuit's case law, so one would expect and hope that most courts will apply § 553 as written and simply require these objectionable provisions to be removed on sight.

¹⁶ See *In re Alta+Cast LLC*, 2004 LEXIS 222 (Bankr. D. Del. March 2, 2004), where the court agreed with the creditor that a plan provision that barred it from asserting setoff rights that it had raised during the case was improper and must be deleted.

¹⁰ *In re Luongo*, 259 F.3d 323, 333 (5th Cir. 2001).

¹¹ See, e.g., *Daewoo Int'l (America) Corp. Creditor Trust vs. SSTS Am. Corp.*, 2003 U.S. Dist. LEXIS 9802 (S.D.N.Y. June 11, 2003).

¹² *In re Friedman's Inc.*, 356 B.R. 758 (Bankr. S.D. Ga. 2005).

¹³ *In re NII Holdings*, 288 B.R. 356 (Bankr. D. Del. 2002).

¹⁴ See *Davidovich*, 901 F.3d at 1537; and *Folger Adam Security Inc. v. Dematteis/MacGregor JV*, 209 F.3d 252 (3d Cir. 2000).

¹⁵ Even the Third Circuit agreed that confirmation of a plan did not eliminate recoupment rights for a creditor that has asserted them during the case. See *Megafoods Stores v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.)*, 60 F.3d 1031 (3d Cir. 1995).

What's the Problem?

Dissenters might argue why creditors *don't* just assert their rights during the case, or object to these plan terms. Leaving aside the burden of having to repeatedly object to the same provisions, the reality is that it is not always easy for governmental claimants to even know whether they have such a right during the case. Governmental agencies are not, in the main, voluntary creditors whose debts arise from defined contracts. They often have no reason to know of a possible claim when the case is filed, and neither a reason nor the resources to kick every sleeping debtor to find out whether it might be hiding a bone of theirs. It is only if the dog wakes and attacks them that they want to be able to find and feed that bone back to the dog. A plan that arbitrarily cuts off setoff and recoupment rights violates the policy judgments made in § 553 to allow creditors to retain those defenses.

The problem is exacerbated for tax creditors because of § 505. At confirmation, a debtor may have filed every tax return and paid every tax obligation. The agency reviews its records, sees that the debtor owes nothing according to its duly-filed returns and concludes that it has little need—and no time—to review a plan under which it is not seeking to receive anything. The plan is confirmed without incident, and then the “gotcha” trap springs shut.

For example, consider the following “hypothetical.” At confirmation, a debtor is current on its sales taxes. A plan is confirmed with anti-setoff language and the debtor is allowed to destroy various business records with the promise that they are unnecessary for any future claims litigation.¹⁷ Then, following confirmation, it moves to reopen several prior returns, arguing that its own records are so inaccurate that the returns it had filed were completely wrong. Since much of the back-up data has been destroyed (in the post-confirmation purge), it then argues that the taxing authorities should just accept its refund calculations and, of course, should not even think about auditing its returns for any periods other than those that it had cherry picked to contest because doing so would violate the anti-setoff provisions!¹⁸

The solution clearly is to apply § 553 as written, to bar debtors from including such language in their plans, to require its removal if it is included, and to inform debtor's counsel that sanctions will be imposed if such language continues to appear. Chapter 13 counsel for individuals know not to include debtor discharge language in their plans; surely their far more highly paid compatriots

¹⁷ While the facts are changed slightly to protect the parties involved, this hypothetical bears a close resemblance to several actual cases.

¹⁸ As the final blow, this debtor may also argue that *because* it had not timely challenged its tax obligations and might no longer be able to have them heard in state court, its own lack of diligence *requires* that the bankruptcy court hear the matter, but that travesty is a § 505 issue for another day!

for chapter 11 debtors should be held to the same standard for their plan drafting.

In particular, a provision such as this (in a current plan to which the states have objected) has no place. In one recently filed plan, which was subsequently amended, it stated that “[a]ll persons...are permanently enjoined...from...asserting any right of setoff, subrogation or recoupment of any kind...unless such holder has filed a motion requesting the right to perform such set-off...before the confirmation date, and notwithstanding an indication in a proof of claim or interest or otherwise that such holder asserts, has or intends to preserve any right of setoff.”¹⁹ The taxing authorities in the fact pattern above would have lost their rights under such a provision at confirmation, because the debtor had asserted no claim against them to which they could have asserted a right of setoff. Even the Third Circuit has never ruled as broadly as this provision. Section 553 ensures that creditors maintain their defenses and are not required to engage in wasteful auditing of every debtor “just in case.” Courts should accord it its full weight—and debtor's counsel should be forewarned that states expect *Espinosa's* warnings to be heeded. Hopefully, like discharge-by-declaration provisions, denial of § 553 rights in chapter 11 will soon be only an unpleasant memory. ■

¹⁹ The author wishes to keep the name of the court that made this statement nameless.