

Recouping Against the Coupe: Auto
Manufacturers' Rights to Setoff and
Recoupment Against Repurchase and Other
Obligations Owed to Their Dealers

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I. Introduction

The current economic crisis has been particularly hard on the automotive industry. Chrysler filed chapter 11 on April 30, 2009,¹ and GM filed chapter 11 on June 1, 2009.² Chrysler and GM are expected to close approximately 2,000 dealerships in North America,³ and dealerships across the country are otherwise struggling in the face of “floorplan” lenders pulling their financing.⁴ Issues involving insolvencies and bankruptcies of automobile manufacturers and dealerships will continue to be a focal point for insolvency professionals over the coming months and years.

Included in the ever-growing number of dealership insolvencies and bankruptcies are the Chapter 11 cases filed by Bill Heard Enterprises, Inc. and numerous affiliates (“Bill Heard”) on September 28, 2008.⁵ Prior to seeking bankruptcy protection, Bill Heard had grown into one of the largest Chevrolet dealers in the world with annual sales of more than \$2 billion.⁶ A recent decision⁷ issued by the Honorable Jack Caddell in the Bill Heard case concerns an issue that is likely to be a hot topic of dispute between manufacturers on the one hand and dealers and their lenders on the other: setoff and recoupment rights of car manufacturers as they relate to obligations, including repurchase obligations, owed to a dealer under franchise agreements. Floor plan and other secured lenders of dealers will find the issue of particular concern, as they stand to be the primary

¹ *In re* Chrysler LLC, Case No. 09-50002, in the U.S. Bankruptcy Court for the Southern District of New York.

² *In re* General Motors Corp., Case No. 09-50026, in the U.S. Bankruptcy Court for the Southern District of New York.

³ Sharon Terlep, *GM to Close 1,100 Dealerships – Move May Indicate Chapter 11 Is Nearer Since Court Could Break Dealer Contracts*, Wall St. J., May 16, 2009, at B1.

⁴ See Michael Oneal, *Credit Crunch: Auto Dealerships Struggle, Close as ‘Floorplan’ Financing Dries Up*, Chicago Tribune, March 29, 2009, available at <http://archives.chicagotribune.com/2009/mar/29/business/chi-sun-car-dealers-0329-mar29>.

⁵ Jointly Administered Case No. 08-83029, Bankruptcy Court for the Northern District of Alabama.

⁶ Kristi E. Swartz, *Bill Heard Chevy Chain Enters Bankruptcy Filing*, Atlanta Journal Constitution, Sep. 30, 2008, at 1C.

⁷ *In the Matter of* Bill Heard Enterprises, Inc., 400 B.R. 813 (N.D. Ala. 2009).

beneficiaries of a manufacturer's obligations to a dealer under a franchise agreement, including the obligation to repurchase parts and inventory.

II. Floor Plan Lending and Dealer Accounts

Floor plan financing is a common form of financing automobile dealership inventory. Under a typical floor plan arrangement, the floor plan lender will advance the purchase-price of an automobile to a manufacturer on behalf of a dealer, gaining a purchase-money security interest in the cars sold to the dealer. Any proceeds from the sale of inventory will typically be repaid to the lender upon sale, and the lender retains a security interest in any proceeds from the sale of collateral that are not remitted to the lender.

The floor plan lender will also typically obtain a security interest in the parts inventory, accounts, and other assets of the dealer. This is relevant because “virtually all manufacturers have some form of dealer account for processing financial transactions such as parts purchases, signs lease charges, and the payment of warranty reimbursements and sales incentives.”⁸ At any given moment a dealer will have either a credit or debit balance in its dealer accounts with the manufacturer. Upon filing a bankruptcy petition, if a dealer has a net credit balance in its dealer account, the floor plan or other lender with a security interest in accounts can claim as collateral any amounts that are owing to the dealer. But as the *Heard* decision demonstrates, manufacturers are likely to claim setoff or recoupment rights against any credits owing to a dealer under these dealer accounts. Entangled with these dealer accounts and the right

⁸ *The Automotive Industry in Crisis: Strategies for Responding to the Financially Distressed Dealership*, John R. Skelton, at 5 (2009) available at <http://www.bingham.com/Media.aspx?MediaId=8219>.

to setoff and recoupment are manufacturers' obligations to repurchase inventory and other property of insolvent dealers.

III. Repurchase Obligations of Manufacturers

Franchise agreements will typically place certain repurchase obligations on a manufacturer if the manufacturer terminates the franchise agreement or in the event of the dealer's insolvency.⁹ The obligations may require the manufacturer to repurchase inventory, parts, signs, other personal property, or even real property sold to the dealer.¹⁰ Such an arrangement is beneficial to the dealer because the dealer will not have to liquidate its entire inventory and parts at substantially reduced rates. The dealer's secured lender benefits because the repurchase of the inventory and other property increases available funds with which the dealer can pay the amount of debt owing to the lender. The manufacturer typically benefits from such an arrangement because it does not have a glut of its product dumped onto a market at reduced prices, and the arrangement prevents situations where a defunct dealership is sitting idle in a key market, disparaging or decreasing the value of the manufacturer's brand.

Repurchase obligations will play a key role in disputes between manufacturers, dealers and lenders. Specifically, once a repurchase obligation takes effect, must the manufacturer remit funds to the dealer or secured lender, or can the manufacturer simply credit the dealer account? If a manufacturer chooses to credit a dealer's account for the repurchase funds, must it separate these funds as proceeds of collateral on behalf of the secured lender, or can it treat the funds the same as any other amounts in the dealer account, deducting amounts owed by the dealer to the manufacturer under setoff and

⁹ A sample of the repurchase obligations under GM's standard Dealer Sales and Service Agreement is attached as Exhibit A.

¹⁰ See Exhibit A.

recoupment rights? If the funds for repurchase of inventory must be maintained separately, can the manufacturer still claim setoff or recoupment rights against these funds? If so, what claims or damages may a manufacturer setoff or recoup? These are a few of the questions raised by the interplay between repurchase obligations and setoff and recoupment rights of a manufacturer.

State repurchase laws are another factor to weigh into the discussion. Many states have adopted mandatory repurchase statutes that place repurchase obligations on manufacturers in the event that a franchise agreement between a manufacturer and dealer is terminated.¹¹ These statutes can vary considerably in terms of when and how the repurchase obligations come into effect, what inventory or other property must be repurchased, how the price for such repurchases are set, and many other variables, but often times the statutes will expand a manufacturer's duty to repurchase inventory. Will a manufacturer's rights to recoupment and setoff for statutory repurchase obligations be treated the same as repurchase obligations under a franchise agreement?

IV. Overview of Setoff and Recoupment

Setoff and recoupment are similar concepts but are two distinct doctrines with different requirements and effects. For example, setoff is subject to the automatic stay,¹² whereas recoupment is generally recognized not to be a violation of the automatic stay.¹³ It is sometimes said that recoupment, while much more limited in its scope, is a more

¹¹ See, e.g., Ala. Code § 8-20-5 (Alabama); Ark. Code Ann. § 23-113-403 (Arkansas); Fla. Stat. § 320.64 (Florida); O.C.G.A. § 10-1-651 (Georgia); Ky. Rev. Stat. Ann. § 190.045 (Kentucky); Miss. Code Ann. § 63-17-141 (Mississippi); N.C. Gen. Stat. § 20-305(6) (North Carolina); Va. Code Ann. § 46.2-1569 (Virginia); W. Va. Code § 17A-6A-8 (West Virginia).

¹² B.F. Goodrich Employees Federal Credit Union v. Patterson (*In re Patterson*), 967 F.2d 505, 509 (11th Cir. 1992) (“right [to setoff] is limited . . . to the provisions of the automatic stay”).

¹³ E.g., *In re Dist. Memorial Hosp. of Southwest N.C., Inc.*, 297 B.R. 451 (W.D.N.C. 2002) (“Because funds subject to recoupment are not the debtor's property, the automatic stay imposed upon the filing of a bankruptcy petition does not bar recoupment.”).

powerful tool of the creditor than setoff.¹⁴ While the Bankruptcy Code recognizes and preserves the rights of setoff and recoupment as they exist under non-bankruptcy law, it does not create the rights. Any creditor wishing to setoff or recoup must establish the right to do so under applicable state or federal law. A comparison of the two remedies helps to underscore their relative strengths and weaknesses.

A. Setoff

Although the Bankruptcy Code does not create the right to setoff, Section 553 of the Bankruptcy Code expressly recognizes and preserves the non-bankruptcy right of a “creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case.”¹⁵ Setoff avoids the “absurdity of making A pay B when B owes A.”¹⁶

Substantive law, usually state law, determines the validity of the right to setoff.¹⁷ Nonetheless, Section 553 limits the use of setoff and imposes additional restrictions on a creditor seeking setoff against a debtor in bankruptcy. Section 553(a) requires a creditor asserting a right to setoff to show that (1) the obligation between the debtor and creditor arose before the filing of the bankruptcy petition (timing) and (2) mutuality of obligation exists.¹⁸ The Bankruptcy Code, while requiring mutuality, does not define it. To determine mutuality of obligation one must look to state law,¹⁹ but mutuality generally

¹⁴ Philip J. Landau, *The Forgotten Defenses of Setoff & Recoupment*, ABI Young & New Member Committee Newsletter, Vol. 6 No. 3, Sep. 2008.

¹⁵ 11 U.S.C. section 553(a).

¹⁶ *In re Patterson*, 967 F.2d at 508.

¹⁷ *Id.* Although state law is relevant to any inquiry regarding either the right to setoff or recoupment, and some variations of state law will be discussed in this paper, a parsing of various states’ common law regarding the rights to setoff and recoupment is beyond the scope of this article. Suffice it to say that any analysis of a manufacturer’s right to setoff or recoupment would depend on an understanding of the underlying substantive rights within an applicable jurisdiction.

¹⁸ *Id.*

¹⁹ *Id.* (interpreting Alabama state law to define mutuality, stating that “[m]utuality is present under Alabama law when cross demands are ‘due from one party to the other in the same right’”).

requires the offsetting obligations to be held by the same parties in the same capacity.²⁰ For instance, mutuality may be lacking in a “tripartite” relationship, such as a parent/subsidiary or similar connection between two companies that do business with a common debtor.²¹

Other considerations concerning setoff are relevant in the bankruptcy context. A creditor may not effectuate its right to setoff without first obtaining relief from the automatic stay.²² Creditors with a valid right to setoff are considered secured creditors to the extent of the amount owed to the debtor, and a creditor with a valid right of setoff is therefore afforded the benefits of secured creditors under Sections 361 and 506 of the Bankruptcy Code.²³ Finally, while Bankruptcy courts generally respect a creditor’s right to setoff if the elements of setoff have been satisfied, the courts do sometimes deny the right to setoff or modify the right under the exercise of the equitable powers of the Court. “Setoff may be denied where the creditor acted inequitably; where the setoff would jeopardize the debtor’s ability to reorganize; or in a liquidation contest where the setoff would result in either a preference or priority over the other unsecured creditors.”²⁴

B. Recoupment

Recoupment, unlike setoff, does not appear anywhere in the Bankruptcy Code. But it is well recognized that a party’s right to recoupment is preserved under bankruptcy law.²⁵ Recoupment is an equitable remedy of common law that is not unlike setoff – a creditor may avoid payment of amounts owed to a debtor due to claims the creditor has

²⁰ Meyer Med. Physicians Group, Ltd. v. Health Care Serv. Corp., 385 F.3d 1039, 1041 (7th Cir. 2004).

²¹ *Id.* at 1042.

²² *In re Patterson*, 967 F.2d at 509.

²³ See 11 U.S.C. § 506(a); *In re Patterson*, 967 F.2d at 509.

²⁴ *In re Steines*, 285 B.R. 360, 363 (Bankr. D. N.J. 2002).

²⁵ *Reiter v. Cooper*, 507 U.S. 258, 265 n2 (1993).

against the debtor that arise out of the same transaction.²⁶ But therein lies the rub: the party seeking recoupment must assert claims that arise out of the “same transaction.”

This “same transaction” requirement is perhaps the key distinction between the remedy of setoff and the remedy of recoupment – setoff is available between any debts that are mutual between two parties, whether related or not. Courts have struggled with the definition of “same transaction,” and there is no consensus among jurisdictions, or perhaps within jurisdictions, as to what constitutes the “same transaction.” The “same transaction” requirement will play perhaps the most important role in determining whether a manufacturer will be able to claim recoupment against amounts it might owe a debtor under a repurchase obligation. As discussed *infra*, different jurisdictions may apply different standards of what constitutes the “same transaction,” and depending on how expansively a court interprets the “same transaction” requirement, a manufacturer may be able to recoup any amounts owed to it that arise out of the same contract, *i.e.*, a dealer franchise agreement. Conversely, some jurisdictions may apply a much narrower definition of “same transaction” and would allow recoupment only for claims that arose out of “a single integrated transaction.”²⁷

The “same transaction” requirement makes recoupment a more limited remedy than setoff in some respects, but recoupment enjoys distinct advantages over the doctrine of setoff when used in a bankruptcy context that can make it a more powerful remedy. In addition to the fact that recoupment is generally not considered a violation of the

²⁶ “Recoupment 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.’ Recoupment is ‘a defense to the debtor’s claim against the creditor. . . .’ Thus, recoupment prevents the debtor from receiving more than that to which it is entitled. *In re* Consumer Health Servs. of Am., Inc., 171 B.R. 917, 921 (Bankr. D. D.C. 1994) (internal citations omitted).

²⁷ See *infra* Part V.

automatic stay,²⁸ there is no requirement that a claim for recoupment be based on debts that both arose pre-petition.²⁹ Thus, a creditor may be able to recoup a pre-petition claim against the debtor with debts owed to a debtor that arise post-petition, *e.g.*, post-petition repurchase obligations.

V. In the Matter of Bill Heard Enterprises, Inc.

A recent decision out of the Northern District of Alabama, *In the Matter of Bill Heard Enterprises, Inc.*,³⁰ raises significant issues related to the setoff and recoupment rights of an auto manufacturer as they relate to the manufacturer's obligations under a dealer franchise agreement.

A. Setoff and recoupment of damages against open account obligations

The dispute in *Heard* arose between General Motors Corporation ("GM") and GMAC LLC ("GMAC"). GMAC was the floor plan lender for 10 of Bill Heard's 14 dealerships. GMAC claimed a security interest under the floor plan on all motor-vehicle inventory, parts inventory, and accounts of the floor plan debtors. However, each of the floor plan debtors also had obligations to GM under their dealer-franchise agreements. Pursuant to the dealer-franchise agreements, GM maintained an open account for each of the floor plan debtors that would track all amounts due to or due from each individual floor plan debtor. These accounts would track such items as parts, tools, sales advertising purchases, incentive payments and payments for warranty work, among other things. The accounts kept track of debits owed by the floor plan debtors for items such as parts purchased from GM and credits for amounts GM owed to the floor plan debtors for items

²⁸ *In re* Visiting Nurse Ass'n, 121 B.R. 114 (Bankr. M.D. Fla. 1990); *but see In re Izagirre*, 166 B.R. 484, 493 (Bankr. N.D. Ga. 1994) (although creditor may not "technically" need relief from the stay, "the better approach is to seek relief from the stay as a precaution.")

²⁹ *Davidovich v. Welton (In re Davidovich)*, 901 F.2d 1533, 1537 (10th Cir. 1990).

³⁰ 400 B.R. 813 (Bankr. N.D. Ala. 2009).

such as advertising allowances, incentive payments and warranty work, all as provided for in the dealership franchise agreements. Periodically, whichever party currently owed a net debit on the account would pay the balance owing, but the dealerships would quite often allow their credits to remain in the account to be used against future charges. As of the petition date, the open accounts reflected credit balances due to various floor plan debtors.

GMAC, pursuant to its floor plan agreements, maintained security interests in these account balances owing to the floor plan debtors. Therefore, any amounts owing to the floor plan debtors on the accounts represented collateral pledged to GMAC. GMAC filed a motion seeking turnover of the positive balances in the accounts.

GM did not dispute GMAC's security interests in the account balances, but claimed that it had rights to setoff and recoupment resulting from various amounts owed to the manufacturer under the dealership agreements. GM also argued that it had the right to deduct any damages from the open accounts under the terms of the dealer franchise agreements. Significantly, GM argued that it was entitled to setoff and recoup any damages that resulted from the dealer's breach of the dealer franchise agreements. GMAC, on the other hand, argued that its perfected security interest in the open accounts gave it priority over any recoupment claims or setoff rights GM may have asserted in the accounts.

The court agreed with GM and held that GM could recoup and setoff any proven amounts owing to GM resulting from the dealer's breach of the dealer franchise agreement. In so finding, the court stated that the only element of recoupment that was in serious dispute was whether GM's claims for damages resulting from the breach of the dealer franchise agreements arose from the "same transaction" as the debtor's claims to

the funds in the open accounts. The court found that GM's claims did arise from the "same transaction."³¹

GMAC argued that the "same transaction" standard should be construed narrowly in the bankruptcy context to include only claims arising from one integrated transaction. GMAC relied upon *In re Delta Air Lines*,³² in which the court "followed the strict 'single integrated transaction test' under which recoupment is applied only in situations in which it would be considered 'inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.'"³³ Indeed, many courts have applied this standard in applying the doctrine of recoupment within the context of bankruptcy.³⁴ A party seeking to apply this standard would argue, for example, that a debit in the open account in favor of the dealer for a transaction such as warranty work is not "integrated" with the manufacturer's damage claims for breach of the franchise agreement. The *Heard* court, however, rejected GMAC's argument that bankruptcy context requires a strict interpretation of the "same transaction" test.

Instead, the court relied upon the rationale of the United States Supreme Court's opinion in *Travelers Casualty & Surety Co. of Am. v. Pacific Gas and Electric Co.*³⁵ to hold that a party's right to recoupment should not be narrowly construed in the context of

³¹ *Id.* at 823.

³² 359 B.R. 454 (Bankr. S.D.N.Y. 2006).

³³ *Heard* 400 B.R. at 821 (citing *In re Delta*, 359 B.R. at 467).

³⁴ *See, e.g.*, *In re Univ. Med. Ctr.*, 973 F.2d 1065 (3rd Cir. 1992); *In re California Cannery and Growers*, 62 B.R. 18 (B.A.P. 9th Cir. 1986) (each delivery under a single distributor's agreement a separate transaction for recoupment purposes); *Reeves v. Columbia Gas of Ohio (In re Reeves)*, 265 B.R. 766, 771 (Bankr. N.D. Ohio 2001); *In re Affiliated of Florida, Inc.*, 258 B.R. 495, 499 (Bankr. M.D. Fla. 2000) ("[T]he term 'transaction' is interpreted restrictively in view of the Bankruptcy Code's policy favoring equality of treatment among creditors.").

³⁵ 127 S.Ct. 1119 (2007).

bankruptcy, but rather should be construed in accordance with relevant state law.³⁶ The *Heard* court then applied Michigan state law to the claim for recoupment because the dealer franchise agreement contained a Michigan choice of law provision. Citing to Michigan law, the court found that recoupment is allowed whenever the two obligations arise out of the same contract or transaction,³⁷ or when the claims arise “out of the same subject-matter, and that they are susceptible of adjustment in one action.”³⁸ The court then explained that, because all of GM’s claims for damages arose out of the same contract as the dealer claims, *i.e.*, the dealer franchise agreement, it “would be inequitable to allow the debtors, or GMAC, to obtain the funds owed under the dealership franchise agreements without first allowing GM to recoup its damages arising from the dealerships’ breaches of the same agreements.”³⁹

The court also analyzed GM’s right to setoff damages caused by the dealer’s breach of the dealer franchise agreement. Unlike recoupment, the “same transaction” requirement does not apply to setoff rights. The primary issue in the context of setoff is whether the debts owing between the parties both arose pre-petition.

Four days prior to the petition date, the floor plan debtors closed their doors to business. Two days prior to the petition date, GM provided notice to the floor plan debtors that, due to the closing, they were in breach of their franchise agreements, to be effective on a date that would turn out to be several days after the petition date. Each of the dealership agreements were terminated post-petition either by sale of the dealership

³⁶ *Heard* 400 B.R. at 822. The Supreme Court in *Travelers* stated that it “must generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed.” *Travelers*, 127 S.Ct. at 1206.

³⁷ *Heard* 400 B.R. at 822 (citing to *Mayco Plastics, Inc. v. TRW Vehicle Safety Systems, Inc.* (*In re Mayco Plastics, Inc.*), 389 B.R. 7 (Bankr. E.D. Mich. 2008)).

³⁸ *Heard* 400 B.R. at 822 (citing to *Frank v. ITT Commercial Fin. Corp.* (*In re Thompson Boat Co.*), 230 B.R. 815, 824 n11 (Bankr. E.D. Mich 1995)).

³⁹ *Heard* 400 B.R. at 823.

under Section 363 of the Bankruptcy Code or by cause with consent of the Court.⁴⁰

Arguably, any damages caused by GM's obligation to repurchase parts and inventory from the dealer arose after the petition was filed, because the obligation to repurchase did not take effect until termination of the dealer franchise agreements.

However, relying upon the *Piper* test, the court stated that a claim arises once the plaintiff arguably had a remote claim against a debtor, and that there must be a preconfirmation relationship between debtor and creditor where pre-petition conduct of the debtor gives rise to the claim.⁴¹ The court, while not addressing specifically the issue of repurchase obligations, held that the damages claimed by GM were caused by a pre-petition breach of the dealer franchise agreements, even if termination occurred post-petition. Therefore, under the court's reasoning, setoff was appropriate because any claims resulting from that pre-petition breach arose pre-petition, even if the damages may not have actually occurred until post-petition.

B. Manufacturer's right to setoff or recoup against repurchase obligations.

GM continued post-petition to maintain the open accounts and continued to debit or credit the accounts accordingly. As part of this practice, GM credited certain of the floor plan debtor accounts as a result of GM's post-petition repurchase of certain vehicles and parts from the floor plan debtors pursuant to mandatory repurchase provisions under the dealership agreements.⁴² GMAC argued that it had a security interest in the proceeds of the collateral repurchased by GM and placed into the open accounts. The court stated, "[t]hus, it appears that GMAC is not only claiming a security interest in the accounts

⁴⁰ *Id.* at 818.

⁴¹ *Id.* at 824 (citing *Epstein v. Official Committee of Unsecured Creditors of Estate of Piper Aircraft Corp.*, 58 F.3d 1573 (11th Cir. 1995)).

⁴² A sample of the repurchase clause found in GM's standard Dealership Franchise Agreement is attached as Exhibit A.

themselves, but further in certain proceeds in those accounts that are traceable to the sale of the parts and vehicles upon which it has a security interest.”⁴³ GMAC further asserted that, to the extent that GM was entitled to recoup or setoff its damages against the open accounts, recoupment or setoff rights should be limited to the funds that did not represent the repurchase of parts because such funds would represent proceeds of collateral upon which GMAC had a lien. The court specifically declined to settle the issue of whether GM could setoff or recoup against the funds in the accounts represented by the parts repurchases.⁴⁴

Although not specifically resolved in the *Heard* decision, the issue of whether a manufacturer can setoff or recoup against amounts owing to a dealer under repurchase obligations of a manufacturer under a franchise agreement, and the affect on the rights of a secured lender in such proceeds, is significant.⁴⁵ How the issue will be decided is not clear from the current authority. There is scant case law that addresses the rights of manufacturers to setoff or recoup damages pursuant to dealership agreements, and the few cases that do address the issue do not specifically address how a manufacturer’s right to setoff or recoupment will relate to mandatory repurchase obligations.⁴⁶

Even though the case does not decide the issue of the repurchase funds, the *Heard* decision could prove insightful into how other courts might come down on the issue. Referring again to the court’s analysis of the recoupment doctrine, the court’s broad

⁴³ *Id.* at 818.

⁴⁴ *Id.* at 817.

⁴⁵ This question will undoubtedly become much more complicated as a result of the bankruptcies of Chrysler and GM (assuming GM does in fact file for bankruptcy protection). Manufacturers might be able to reject their dealership franchise agreements and the repurchase obligations thereto. However, it is less clear how statutory repurchase obligations might affect the ability of manufacturers to avoid repurchase obligations. Such issues, however, are beyond the scope of this article.

⁴⁶ See *Bob Brest Buick, Inc. v. Nissan Motor Corp. in USA (In re Bob Brest Buick, Inc.)*, 136 B.R. 322, 324 (finding that setoff and recoupment are available to a manufacturer under the open accounts of dealers).

interpretation of the “same transaction” test might suggest that, because GM’s obligation to repurchase inventory arises under the dealership franchise agreement, any claims that GM has against the dealer that arise under the franchise agreement could be recouped against the repurchase obligations. Such claims could be quite broad, as the dealer franchise agreement casts a wide net of claims arising between a manufacturer and dealer. This right of recoupment would be a powerful tool at the disposal of the manufacturer, especially because a manufacturer would not need to seek relief from the automatic stay in order to claim the damages. Once again, however, the court’s broad interpretation of recoupment was based on Michigan state law. Other jurisdictions might apply the narrow construction of the “same transaction” test, in which case, the right of a manufacturer to recoup against its repurchase obligation would probably be quite limited. Instead of recouping against any claims arising under the franchise agreement, a manufacturer might be limited to recouping on claims that arose specifically with respect to the repurchase of parts or inventory, such as an overpayment on the repurchase.⁴⁷

In a jurisdiction applying the broad interpretation of the “same transaction” test, the right to setoff would probably add little value to the manufacturer’s arsenal for reducing amounts owed under a repurchase obligation. Where a manufacturer can recoup against any claim arising under the franchise agreement, there would probably be little need for the right of setoff. However, in jurisdictions where the recoupment doctrine is narrowly construed, the setoff doctrine would become much more significant, especially given the *Heard* court’s discussion of when a claim arises. Under the *Heard* court’s reasoning, even where repurchase of inventory occurred after the petition date, if actions

⁴⁷ *In re Photo Mech. Servs., Inc.*, 179 B.R. 604, 613 (Bankr. Minn. 1995); *In re Midway Airlines, Inc.* 175 B.R. 239, 246 (Bankr. N.D. Ill. 1994).

of the dealer that led to the breach and termination occurred prior to the petition, it seems that any amounts paid for repurchase could be characterized as a pre-petition debt. Thus, post-petition repurchases could possibly be setoff against any pre-petition claim owed by the dealer to the manufacturer.

Lenders may have arguments that U.C.C. § 9-404(a),⁴⁸ and any applicable state law thereunder, might limit the right of a manufacturer (an account debtor) to assert rights of setoff or recoupment against a lender (an assignor). First, the right of recoupment might be narrowly defined under a state's case law interpreting this section of the U.C.C. More importantly, with respect to setoff, a manufacturer might not be able to assert setoff against an assignor if the right to setoff accrued after notice of the assignment.

The existence of state repurchase laws arguably militates against a manufacturer being able to assert damages based on repurchase obligations. Would not the public policy leading to the statutory repurchase obligations be thwarted if the manufacturers can simply recoup or setoff their obligations against "damages" caused by the termination of the franchise agreements?

⁴⁸ § 9-404(a) reads as follows:

(a) Assignee's rights subject to terms, claims, and defenses; exceptions.

Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to:

- (1) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and
- (2) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

VI. Conclusion

The *Heard* decision does not answer perhaps the important question of whether a manufacturer can setoff or recoup against amounts owed under repurchase obligations. Nonetheless, the *Heard* decision demonstrates the important role that the rights of setoff and recoupment will play in dealership insolvencies.