

Are There "Set Off" Rights in Bankruptcy?

As far as we know, at least a majority of states recognize the right of a creditor to "set off" an obligation owed to its debtor against an obligation which the debtor owes to the creditor.

For example, ACME Fabricators may owe Widget Manufacturing \$500 for widgets, but Widget Mfg., in turn, owes ACME \$1,000 for heavy duty crates for the shipment of widgets. In such a situation, where there is a mutuality of obligations, ACME is free in most jurisdictions to set off the \$500 it owes to Widget for widgets, and simply bill the balance of \$500 owed.

But what happens to ACME's setoff rights if Widget files a Chapter 7 or Chapter 11 petition in bankruptcy? The answer is contained in 11 U.S.C. 553 which clearly requires explanation.

First of all, the Bankruptcy Code draws a clear distinction between setoffs by a creditor prior to a debtor filing bankruptcy versus post-petition setoffs. Post-petition setoffs are prohibited by the "automatic stay" protecting the debtor who files a bankruptcy against any attempts by a creditor to collect a debt owed it once the petition is filed, but the right of setoff is nonetheless preserved.

Pre-petition setoffs, however, are perfectly allowable so long as a creditor has the right of setoff in that state and so long as the creditor's claim against the debtor was not acquired while the debtor was insolvent for the sole purpose of exercising the

right of setoff. If, for example, ACME set off the \$500 that it owed to Widget ten days prior to Widget filing a bankruptcy petition, then the setoff is only challengeable by the trustee or Chapter 11 debtor in possession under an "improvement of position" test and other more narrow exceptions contained in Section 553 of the Bankruptcy Code. The "improvement of position" test is rather complicated, and an explanation of this formula must await a later issue of *The Arrow*.

The most common situation involving exercise of setoff is not open account sales, but that of a bank with an unsecured loan to a debtor who maintains depository accounts at the bank. Other common examples involve contractors whose subcontractors file bankruptcy.

Post-petition setoff rights, as observed above, are preserved for the creditor despite the filing of the bankruptcy petition. The so-called "automatic stay," which commences at the petition date, however, prohibits a creditor from exercising its setoff rights as it usually would. The creditor's recourse is to get an order terminating the stay to allow it to exercise its right of setoff. In such a situation, the court will either terminate the stay to allow the setoff, or allow the debtor in possession to offer the creditor "adequate protection." This adequate protection may amount to a lien on some other property of the debtor, or anything else that the court deems adequately protects the value of the creditor's setoff right.

If the court orders adequate protection in place of allowing a setoff, then the court may well allow a debtor in possession, for example, to have use of its bank account which the depository bank might otherwise be allowed to set off against the debtor's past due loan.

In our experience, neither trustees, nor debtors in possession are above running a bluff. Thus, if you have exercised your right of setoff against the debtor prior to its petition in bankruptcy, or have an as yet unexercised right of setoff in an ongoing bankruptcy, you should have your bankruptcy counsel scrutinize carefully any demands from the trustee or debtor in possession in regard thereto. Otherwise, you might surrender a very important right of unsecured creditors which the Bankruptcy Code itself generally preserves.

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