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Debtor Setoff Rights Can Endanger Recoveries on § 503(b)(9) Claims



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Section 503(b)(9) of the Bankruptcy Code enhances the ability of goods sellers to recover from financially troubled companies in bankruptcy by granting sellers an administrative priority claim (referred to as a “§ 503(b)(9) claim”) for “the value of any goods received by the debtor within 20 days before the date of commencement of a case ... in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.”² This seemingly straightforward statutory provision has generated significant litigation, where debtors and secured lenders have raised numerous arguments to limit recoveries on § 503(b)(9) claims.

In 2009, the U.S. Bankruptcy Court for the Eastern District of Virginia in *In re Circuit City Stores Inc.*³ became the first court to hold that a debtor could set off⁴ credits and similar claims owing by its vendors to first reduce the vendors’ more collectible § 503(b)(9) claims, instead of their far less collectible general unsecured claims. In May 2015, faced with a similar issue, the U.S. Bankruptcy Court for the District of Delaware, in *In re ADI Liquidation Inc.*,⁵ adopted the *Circuit City* court’s reasoning and also allowed a debtor to set off or recoup credits and similar claims against its vendors to first reduce vendors’ secured and administrative priority claims, including vendors’ § 503(b)(9) claims, that would otherwise be paid in full, instead of their general unsecured claims, where the recovery potential is limited and uncertain.

These decisions are significant because they uphold the priority of a debtor’s setoff and recoup-

ment rights over the setoff and recoupment rights of secured and priority creditors. This may reduce creditors’ recoveries on their secured and priority claims, including their § 503(b)(9) claims, by barring creditors from exercising their right to setoff and recoup their obligations owing to a debtor against the creditors’ general unsecured claims.

The Circuit City Decision

Circuit City Stores Inc. and certain of its affiliates (collectively, Circuit City) was a specialty retailer of consumer electronics. After its chapter 11 filing on Nov. 10, 2008,⁶ Circuit City conducted going-out-of-business sales at all of its store locations.⁷

Circuit City subsequently filed three omnibus objections to certain administrative-expense claims, including § 503(b)(9) claims, and sought authority to set off receivables, returns and other amounts owed by creditors to Circuit City (collectively, the “receivables”) against the creditors’ § 503(b)(9) claims.⁸ Circuit City requested that the bankruptcy court first rule on the common threshold issue of the permissibility of Circuit City’s setoff of the receivables against the § 503(b)(9) claim, prior to adjudicating the allowed amount of individual § 503(b)(9) claims.⁹

Many § 503(b)(9) claimants objected to the relief requested on both procedural and substantive grounds.¹⁰ They asserted a violation of their due-process rights because the dispute concerning their setoff rights was bifurcated from individual substantive claim objections.¹¹ They then argued that Circuit City must assert its setoff rights first in

¹ The views expressed in this article do not necessarily represent the views of Lowenstein Sandler LLP, its attorneys or its clients.

² 11 U.S.C. § 503(b)(9).

³ *In re Circuit City Stores Inc.*, 2009 WL 4755253 (Bankr. E.D. Va. Dec. 3, 2009).

⁴ “Setoff” is a state law remedy that is available to a party with a claim against and an obligation owing to another party. Setoff enables the party asserting a claim to cancel out or apply its claim in reduction of its obligations to the other party.

⁵ *In re ADI Liquidation Inc.*, 2015 Bankr. LEXIS 1611 (Bankr. D. Del. May 5, 2015).

⁶ *Circuit City* at *1.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

reduction of creditors' general unsecured claims instead of against creditors' more valuable § 503(b)(9) claims.¹²

The court found no due-process violation because all parties had adequate notice of the relief being sought.¹³ The court then reviewed Circuit City's rights under § 558,¹⁴ which preserves a debtor's personal defenses, including setoff rights that could be asserted prior to bankruptcy. The court found mutuality between the parties that justified Circuit City's invocation of setoff rights where each § 503(b)(9) claim was a debt owed by Circuit City to each creditor and each receivable was a debt owed by each creditor to Circuit City.¹⁵ The court then examined Circuit City's setoff rights as though Circuit City had not filed its chapter 11 case, because § 558 preserves defenses for a chapter 11 debtor that would have been available to a debtor pre-petition.¹⁶

The court authorized Circuit City to set off the receivables first against the § 503(b)(9) claims instead of against general unsecured claims in order to maximize the distribution to all of Circuit City's creditors.¹⁷ The court contrasted Circuit City's setoff rights under § 558 with the creditors' setoff rights under § 553. Section 553 does not create a right of setoff, but only preserves creditors' setoff rights that existed under nonbankruptcy law. However, § 553 limits creditors' setoff rights to claims and obligations that arose pre-petition.¹⁸ By comparison, § 558 does not contain similar restrictive language precluding a debtor from setting off its pre-petition claims against post-petition obligations that it owes creditors.¹⁹

The court rejected the creditors' arguments that permitting a debtor to utilize its setoff rights under § 558 deprives creditors of the option of relying on § 553 to set off their obligations to pay for the receivables against their general unsecured claims. Setoff is an equitable remedy that a court could "limit or bar" based on the equities of the case.²⁰ The *Circuit City* court found nothing in the Bankruptcy Code that grants a creditor's setoff rights under § 553 priority over a debtor's setoff rights under § 558.²¹ The court ruled that Circuit City has the discretion to apply its setoff rights under § 558 in any manner it so chooses because the Code does not require a debtor to exercise its setoff rights in any particular order.²²

ADI Adopts *Circuit City* Decision

ADI Liquidation Inc. (f/k/a AWI Delaware Inc.) and certain of its affiliates (collectively, ADI) filed their chapter 11 case on Sept. 9, 2014.²³ ADI was a cooperative food distributor that provided distribution and retail services to retailer members. It serviced 800 supermarkets, specialty stores and convenience stores with grocery, meat, produce, dairy, frozen foods and other merchandise.²⁴

¹² *Id.*

¹³ *Id.* at *2.

¹⁴ Section 558 provides that "[t]he estate shall have the benefit of any defense available to the debtor as against any entity other than the estate, including statutes of limitations, statutes of frauds, usury, and other personal defenses. A waiver of any such defense by the debtor after the commencement of the case does not bind the estate."

¹⁵ See *Circuit City* at *3.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at *4.

²¹ *Id.*

²² *Id.*

²³ *ADI* at *2.

²⁴ *Id.*

As in the *Circuit City* case, many trade creditors asserted § 503(b)(9) claims against ADI. Prior to bankruptcy, ADI had earned certain credits owing by many of these trade creditors and had additional claims based on (1) overpayments; (2) promotions, volume discounts, advertising and warehousing allowances, rebates and similar refunds owing under supply agreements and other arrangements between the debtors and the creditors; and (3) other amounts that the creditors owed the debtors (collectively, the credits).²⁵

Following the sale of substantially all of ADI's assets to a third-party buyer, ADI and its creditors' committee jointly filed a motion seeking to allow ADI to set off or recoup²⁶ the credits, first against secured and administrative claims (including § 503(b)(9) claims) and then against general unsecured claims.²⁷ Similar to the relief sought in *Circuit City*, the motion sought only a determination of the threshold issue of the proper application of setoff and recoupment rights, not a determination on the merits of the proper allowed amount of individual § 503(b)(9) claims.²⁸

The court ruled that ADI, in its discretion, was authorized to first set off the credits against secured and administrative claims, including § 503(b)(9) claims.²⁹ The *ADI* court's analysis largely followed and adopted *Circuit City*'s reasoning.³⁰ The court then held that a debtor's setoff and recoupment rights trump a creditor's setoff rights based on the differences between the setoff rights that are available to debtors under § 558 and setoff rights that are available to creditors under § 553.³¹ The court noted that creditor setoff rights under § 553 are restricted to pre-petition debts and obligations, while no there is no such restriction limiting debtor setoff rights under § 558. The court also found that granting ADI's setoff and recoupment rights priority over the setoff and recoupment rights of ADI's creditors is consistent with the language, and furthers the goals and objectives of the Bankruptcy Code.³²

The *ADI* court rejected creditor arguments premised on the priority afforded to § 503(b)(9) claims compared to general unsecured claims. The court held that while the allowed amount of a § 503(b)(9) claim is entitled to priority over general unsecured claims, that priority does not preclude a debtor from asserting its defenses, including its setoff and recoupment rights, under § 558 to determine the allowed amount of the § 503(b)(9) claims.³³

Similarly, the court rejected arguments that a debtor must provide adequate protection to the extent that a debtor exercises its own setoff rights to reduce the creditor's secured claim amount because creditor setoff rights are considered secured claims under § 506(a). The court doubted whether adequate-protection rights are ever implicated in the context of a creditor's assertion of setoff rights. In any event, the *ADI* court followed *Circuit City* in holding that any adequate-protection requirements were satisfied because the creditor "gets the benefit of the extinguishment

²⁵ *Id.* at *6.

²⁶ "Recoupment" is a special category of setoff rights whereby a debtor's setoff rights against the creditor arose from the same transaction as the creditor's claim against the debtor.

²⁷ *Id.* at *5-7.

²⁸ *Id.* at *8.

²⁹ *Id.* at *16.

³⁰ Like *Circuit City*, the *ADI* court found no procedural or due-process defects with the motion seeking a determination of threshold issues common to all § 503(b)(9) claims. *Id.* at *9.

³¹ *Id.* at *12.

³² *Id.* at *11-12.

³³ *Id.* at *12.

of the debt it owes the Debtors dollar for dollar” when a § 503(b)(9) claim is set off against the obligations that the creditor owes the debtor.³⁴

The *ADI* court also considered whether ADI’s setoff and recoupment rights under § 558 could be limited by the contracts and/or prior course of dealings between ADI and its creditors.³⁵ The *Circuit City* decision did not address this issue. ADI cited a 2013 decision written by the same judge who issued the *ADI* decision in arguing that setoff and recoupment rights are not dependent on the parties’ contract but are “equitable remedies” that are available independently of any contractual remedy.³⁶ The *ADI* court created a presumption that a creditor’s prior course of dealing, industry standards and contract terms with the debtor do *not* operate as a waiver of a debtor’s equitable remedies under § 558.³⁷ However, the court preserved the creditors’ ability to rebut this presumption on the merits at a subsequent claim hearing and argued that ADI waived its equitable remedies, including ADI’s setoff and recoupment rights.³⁸

Conclusion

The *Circuit City* and *ADI* decisions mean that vendors with obligations to debtors on the bankruptcy filing date may have their § 503(b)(9) claims significantly reduced or eliminated through the debtor’s application of its setoff rights. The rulings also have broader application to the priority of setoff rights between a debtor and a secured or administrative creditor. Neither of the decisions were appealed from the bankruptcy court.

These decisions raise at least four significant issues that will likely need to be addressed through further litigation. First, do the differences in the mutuality requirement for the exercise of setoff between debtors and creditors also justify allowing a debtor to apply its recoupment rights in a manner that is most favorable to the debtor? The *Circuit City* decision did not address recoupment rights, and while the *ADI* court allowed ADI to apply recoupment rights in its discretion, there was no analysis regarding why recoupment rights should be treated the same as setoff rights. Unlike setoff rights, the Bankruptcy Code does not expressly govern recoupment rights. However, bankruptcy courts have long recognized the ability of debtors and creditors to exercise recoupment rights in bankruptcy cases. Significantly, creditors need not show that the debts were mutual (*i.e.*, that both of the debts arose pre-petition) to exercise recoupment rights.³⁹ Accordingly, if bankruptcy law does not treat debtor-recoupment rights any more favorably than creditor-recoupment rights, it does not necessarily follow that debtor-recoupment rights should “trump” creditor-recoupment rights in priority.

Second, the *ADI* court left unclear the facts that a creditor must prove to rebut the presumption that contract terms,

industry standards or a prior course of dealing do not waive a debtor’s equitable remedies under § 558. For instance, would a debtor be deemed to have waived or limited its setoff and recoupment rights by agreeing to specific contract provisions governing the application of setoff rights (*e.g.*, a debtor’s full waiver of its setoff rights with respect to credits; or a partial waiver of such setoff rights if the debtor is in default, out of business, or past-due amounts are owing; or the debtor’s agreement that the creditor’s setoff rights trump the debtor’s setoff rights)? If § 558 preserves for the estate only defenses that were available to the debtor pre-petition, how can a debtor preserve a setoff and recoupment right it had expressly waived pre-petition? Section 558 states that a debtor’s waiver of a defense post-petition does not bind the estate. Is the negative implication that a pre-petition waiver by the debtor results in the unavailability of the defense to the debtor’s estate under § 558?

Third, based on the *Circuit City* and *ADI* courts’ broad statements recognizing the priority of a debtor’s setoff rights over creditor setoff rights in order to maximize the goals and objectives of the Bankruptcy Code, will any attempt by vendors to secure a pre-petition waiver or limitation of debtor setoff rights, no matter how artfully drafted, be found unenforceable on policy grounds?

Fourth, since § 506(a) recognizes a creditor’s setoff rights as a secured claim, why shouldn’t the creditor be granted adequate protection when a debtor is seeking to have its setoff rights trump the creditor’s setoff rights to reduce the allowed amount of the creditor’s higher-priority § 503(b)(9) claim? **abi**

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³⁴ *Id.* at *14. The court also rejected arguments based on tax cases where the Internal Revenue Service (IRS) was permitted to set off general unsecured claims against the debtor before setting off against tax-priority claims. The court distinguished those cases, finding that a federal statute existed that specifically grants the IRS the discretion to apply a refund against “any liability” of the debtor taxpayer. By comparison, the court found that the creditors were unable to assert any nonbankruptcy or equitable basis that would allow them to direct how the credits should be applied. *Id.* at *13-14.

³⁵ *Id.* at *15.

³⁶ *Id.* (citing *In re Prince Sports Inc.*, 2013 Bankr. LEXIS 5224 at *2 (Bankr. D. Del. Dec. 11, 2013) (Carey, J.)).

³⁷ *ADI* at *16.

³⁸ *Id.*

³⁹ See *In re Mohawk Indus. Inc.*, 82 B.R. 174, 176-78 (Bankr. D. Mass. 1987).