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# The Devil Is in the Details . . . The Doctrine of Recoupment

***By Gabriel A. Morgan and Justin R. Pitcher****

*The authors of this article explain a recent case from the U.S. Court of Appeals for the Ninth Circuit bankruptcy appellate panel, which highlights how courts diverge on the application of recoupment and underscores the nuanced analysis that is needed to evaluate whether recoupment is an appropriate remedy.*

When it comes to offsets, bankruptcy law provides for two distinct remedies: (1) setoff and (2) recoupment.

Setoff allows a creditor to reduce the amount of prepetition debt it owes a debtor with a corresponding reduction of that creditor's prepetition claim against the debtor. The remedy of setoff is subject to the automatic stay, as well as various conditions under Section 553 of the Bankruptcy Code—including that it does not apply if the debts arise on opposite sides of the date on which the debtor's case was commenced.

Recoupment also allows a creditor to offset mutual debts; however, it is an equitable doctrine under common law, is not subject to the automatic stay, and does not require that both debts arise before the case was commenced. Courts have consistently defined recoupment 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."[1] Although this definition is largely uniform across jurisdictions, its application varies significantly depending on what debts a court construes as arising from the same transaction. A recent case from the U.S. Court of Appeals for the Ninth Circuit bankruptcy appellate panel highlights how courts diverge on application of recoupment and underscore the nuanced analysis that is needed to evaluate whether recoupment is an appropriate remedy.

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[1] *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996) (citation omitted); *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1079 (3d Cir. 1992) (citation omitted).

## A TALE OF TWO TESTS

In October 2018, the bankruptcy appellate panel for the Ninth Circuit affirmed the bankruptcy court's order denying the motion of Barbra Williamson, an individual debtor, for sanctions against the Public Agency Retirement System ("PARS").[2] Ms. Williamson argued that PARS had knowingly violated the automatic stay because it offset amounts Ms. Williamson owed PARS for previous overpayments against the monthly retirement benefits PARS owed to Ms. Williamson. PARS responded that it had not violated the automatic stay because the offset was a permissible recoupment. The bankruptcy court agreed with PARS and denied the debtor's motion. Ms. Williamson timely appealed.

When assessing whether the two debts arose from the same transaction, the panel applied the Ninth Circuit's "logical relationship" test, which mirrors the test used to determine compulsory counterclaims—*i.e.*, whether the two debts arose from the same set of operative facts. The panel found that the bankruptcy court had correctly applied the test when it concluded that PARS' overpayment and Ms. Williamson's monthly benefit arose from the same set of operative facts.

What was particularly interesting in this case was that Ms. Williamson did not seem to dispute the conclusion that her circumstances satisfied the logical relationship test. Rather, she argued, among other things, that the recoupment doctrine was itself an impermissible exercise of judicial authority that usurps Congress's constitutional power to pass bankruptcy laws. The panel did not consider this argument because Ms. Williamson neither raised it before the bankruptcy court nor briefed it for the appellate panel.

She further argued that the recoupment doctrine conflicted with other federal law and should be narrowed in its application. She cited to U.S. Court of Appeals for the Third Circuit case law to support the proposition that recoupment is usually applied in the context of a contractual relationship and that welfare statutes do not create contractual rights. The panel overruled her objection, finding that the case law she cited was "inapposite because the Third Circuit does not apply the logical relationship test—it applies a narrower interpretation to the term 'same transaction' than that utilized in the Ninth Circuit."[3]

For its part, the Third Circuit has bluntly concluded that the "logical

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[2] *See Williamson v. PARS (In re Williamson)*, 2018 Bankr. LEXIS 3127 (B.A.P. 9th Cir. Oct. 10, 2018 (not appropriate for publication).

[3] *Id.* at *8–9.

relationship" test applied in the Ninth Circuit is "inadequate for determining whether two claims arise from the same transaction for the purposes of equitable recoupment in bankruptcy."[4] "[A] mere logical relationship is not enough: the fact that the same two parties are involved, and that a similar subject matter gave rise to both claims, does not mean that the two arose from the same transaction."[5] Instead, the debts "must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."[6]

At issue in *University Medical Center* was a Medicare account reconciliation process that involved Medicare underpaying for future medical services in order to recover overpayments for medical services made in prior years. Although the reconciliation process was governed by one contract, the court held that overpayments issued in one year were not part of a single integrated transaction for underpayments made in another year—specifically, in this case, 1985 and 1988. The Third Circuit reasoned that the debts arose from different transactions because "[t]he 1988 payments were independently determinable and were due for services completely distinct from those reimbursed through the 1985 payments."[7] As a result, the Third Circuit held that the government was not engaged in recoupment and, therefore, its effort to recover overpayments from the debtor was barred by the automatic stay.

## CONCLUSION

Recoupment can be a powerful remedy as it allows a creditor to bypass the more rigid restrictions of setoff. With that power comes a responsibility to pay careful attention to the details of the case because recoupment is a narrow remedy of varied application depending on the jurisdiction and particular fact pattern; without the appropriate diligence and analysis, a creditor's big "win" could quickly become a knowing stay violation.

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[4] *In re Univ. Med. Ctr.*, 973 F.2d at 1081.

[5] *Id.* (internal quotation marks and citation omitted).

[6] *Id.*

[7] *Id.*