

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

## Recoupment and Setoff under State Law

### Contributing Editor:

Andrew P. Moratzka  
Mackall, Crouse & Moore PLC  
Minneapolis  
apm@mcmlaw.com

Relying on *Travelers Casualty & Surety Co. of Am. v. Pacific Gas and Electric Co.*, 127 S.Ct. 1199 (2007), the bankruptcy court in *In the Matter of Bill Heard Enter. Inc.*, 2009 WL 416313 (Bankr. N.D. Ala. 2009), recently determined that state law governed the issue of recoupment. The *Heard* court provided further state law analysis under setoff. Finding in favor of the manufacturer, the bankruptcy court denied the creditor's motion to compel turnover of certain funds, thereby allowing recoupment and setoff by the manufacturers.



Andrew P. Moratzka

The dispute arose between General Motors Corporation (GM) and GMAC LLC (GMAC) after GMAC moved to compel GM to turn over funds being held in GM's open accounts for the debtor's car dealerships. By agreement of the parties, the threshold issue before the bankruptcy court was whether GM could recoup or set off the damages it claimed against the GMAC floorplan debtors and whether these recoupment/setoff rights trumped GMAC's lien claims against those same debtors. *Id.* at \*1.

### Background

Of the debtors' 14 dealerships, GMAC provided floorplan financing to 10 dealerships (GMAC floorplan debtors). To secure the obligations due to GMAC, the GMAC floorplan debtors granted GMAC a security interest in all motor-vehicle and inventory and

### About the Author

Drew Moratzka is an attorney in the Banking & Financial Institutions and Bankruptcy & Creditors' Rights groups at Mackall, Crouse & Moore PLC in Minneapolis.

accounts. The GMAC floorplan debtors also had obligations to GM under certain dealer-franchise agreements, under which GM maintained open accounts to track the amounts due from and to each of the GMAC floorplan debtors for parts, tools, sales advertising and incentive payments.

The dealer-franchise agreements also contained a Michigan choice-of-law provision. GM held credit balances for the GMAC floorplan debtors when the petition was filed. GMAC claimed a perfected security interest in these open accounts, which GM did not dispute. Pursuant to this perfected security interest, GMAC moved to compel

turnover of the positive balances in the open accounts.

GM's three-pronged argument opposing GMAC's motion for turnover was that it (1) was entitled to recoup its damages from the open accounts, (2) had a right to set off against the open accounts any damages incurred resulting from the debtors' breaches of the dealer franchise agreements and (3) was entitled to deduct any damages from the open accounts, resulting from the debtors' breach of the dealer-franchise agreements. GMAC argued that its perfected security interest in the open accounts gave it priority over any recoupment claims or setoff rights asserted by GM.

### Recoupment

With respect to the recoupment claim, the bankruptcy court began its analysis by noting that the party asserting entitlement to recoupment bears the burden of proof by a preponderance of the evidence. The court then went on to explain that a successful recoupment claim establishes that: (1) the debtor's and creditor's respective claims arise out of the same transaction; (2) the creditor is asserting recoupment as a defense; and (3) the "main action" is timely. *Bill Heard Enter.*, 2009 WL 416313 at \*4. Of these elements, the bankruptcy court found only the first to be in dispute.

Citing *In re Delta Air Lines*, 359 B.R. 454 (Bankr. S.D.N.Y. 2006), GMAC claimed that the "same transaction" requirement was not met and argued that, in order to meet the same transaction requirement, the bankruptcy court must follow the

## Lien on Me

"single-integrated transaction test." GMAC asserted that under this test, recoupment is only applied if it would be inequitable for the debtor to enjoy the benefits of a transaction without also being subject to the obligations. *Bill Heard Enter.*, 2009 WL 416313 at \*5. GMAC claimed that GM's damages, if any, were part of a series of transactions and therefore failed to meet the "single-integrated transaction test."

GM disagreed that recoupment was to be interpreted so narrowly. Citing *Travelers Casualty and Surety Co. of Am. v. Pacific Gas and Electric Co.*, 127 S.Ct. 1199 (2007), GM claimed that recoupment was a state-law issue.

In *Travelers*, the Supreme Court stated that it must “generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed” under the Bankruptcy Code. *Travelers*, 127 S.Ct. at 1206.

The bankruptcy court adopted this approach and analyzed the issue under Michigan law because the Code is silent on recoupment. In light of the fact that Michigan law allows recoupment so long as the claims arise out of the same subject matter, the bankruptcy court ruled in favor of GM.

## **Setoff**

Despite this holding, the bankruptcy court went on to analyze GM’s claims under setoff. The court stated that “[s]etoff avoids ‘the absurdity of making A pay B when B owes A.’” *Bill Heard Enter.*, 2009 WL 416313 at \*6 (citing *B.F. Goodrich Employees Fed. Credit Union v. Patterson (In re Patterson)*, 967 F.2d 505, 509 (11th Cir. 1992)).

The party claiming the setoff bears the burden of proof by a preponderance of the evidence. The court also noted that, although §553 of the Code governs setoff rights, it does not create a right to setoff and instead merely preserves those rights under nonbankruptcy law (typically state law). *Id.* at \* 7. To prevail under a setoff claim, the party must show that: “(1) the creditor held a claim against the debtor that arose before the commencement of the case, and the creditor owes a debt to the debtor that arose before the commencement of the case (timing); and (2) the claim and debt must be mutual and valid (mutuality).” *Id.* (citations omitted).

There being no issue of mutuality under Michigan law, GM and GMAC disputed the timing analysis under §553. GMAC attempted to refute GM’s setoff claim by arguing that the open accounts arose from prepetition actions and the dealer franchise agreement breaches were postpetition actions. The bankruptcy court disagreed because it viewed the bankruptcy term “claim” more broadly.

Although the damages resulting from the dealer-franchise agreements could not be determined with certainty prepetition, the bankruptcy court found that the claim for damages arose before the bankruptcy case. *Id.* It also held that GM satisfied the timing analysis by demonstrating that the open accounts and breaches were both prepetition.

---

*[T]he bankruptcy court continued on to analyze GM’s claims under setoff. The court stated that “[s]etoff avoids ‘the absurdity of making A pay B when B owes A.’” ... The party claiming the setoff bears the burden of proof by a preponderance of the evidence.*

---

## **Contractual Rights**

Finally, the bankruptcy court determined that the broad-netting provision in the dealer-franchise agreement permitted GM to debit amounts owed from the dealerships against any debt GM owed to the dealerships. The dealer-franchise agreement stated that “all monies or accounts due [d]ealer are net of [d]ealer’s indebtedness to General Motors and its subsidiaries. In addition, General Motors may deduct any amounts due or to become due from [d]ealer to General Motors or its subsidiaries, or any amounts held by General Motors, from any sums or accounts due or to become due from General Motors, or its subsidiaries.” *Id.*

## **Conclusion**

The bankruptcy court’s analysis is relevant and timely in today’s economy. Attorneys representing floorplan financiers should take three points from this opinion. First, review the dealer-franchise agreement. Second, review the floorplan finance agreement to determine whether there is a choice-of-law provision (or alternatively, where the dispute will likely be venued). Third, analyze potential recoupment and setoff claims in light of that state’s law. In the event the law is similar to that in Michigan, consider other avenues and collateral to protect the floorplan financier’s interests, especially if the dealer-franchise agreement contains a broad netting provision. ■

*Reprinted with permission from the ABI Journal, Vol. XXVIII, No. 4, May 2009.*

*The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit ABI World at [www.abiworld.org](http://www.abiworld.org).*