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Setoff: Preference Defense 2.0

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Preference claims are the ultimate kick to the unsecured creditor who is down. Section 547(c) defenses to these claims are well known and may provide little room to maneuver beyond rote ordinary course disputes. Yet creative lawyers continue to seek new ways to free their clients from § 547's shackles. A bankruptcy court's recent decision provides hope for relief to preference defendants holding administrative expenses allowed in post-petition bankruptcy proceedings.

Official Committee of Unsecured Creditors of Quantum Foods LLC v. Tyson Foods Inc. (In re Quantum Foods LLC) lends support to a creditor seeking to set off an allowed administrative expense against its preference liability.[1] In *Quantum Foods*, an unsecured creditors' committee filed suit against two creditors, seeking to avoid and recover transfers totaling more than $13 million. One creditor's response asserted a counterclaim for declaratory judgment that it had a right to set off a previously allowed § 503(b)(1)(A) administrative expense totaling approximately $2.6 million against any potential preference liability. The committee then filed a motion for judgment on the pleadings with respect to the creditor's claimed setoff right, asserting that the creditor's defense was nothing more than a disguised (and impermissible) new value defense for post-petition new value.

In determining whether the creditor's setoff defense was valid, the court examined whether the "setoff claim is allowed under the law concerning setoff."[2] The court held that "[t]he judicial consensus is that setoff is only available in bankruptcy when the opposing obligations arise on the same side of the bankruptcy petition date. Indeed, many courts have held that setoff applies to mutual, post-petition obligations."[3] Noting that an administrative expense is "clearly a post-petition obligation," the court held that setoff would be permissible "only if the allegedly opposing obligation — the preference claim — also arises post-petition."[4] While noting that a preference claim concerns facts arising in the pre-petition preference period, the court held that the preference claim itself also "necessarily arises *only* post-petition" because "it can be asserted only *after* the filing of a bankruptcy petition."[5] Accordingly, the court denied the committee's motion and allowed the creditor to assert its setoff defense.

1 554 B.R. 729 (Bankr. D. Del. 2016).
2 *Id.* at 734.
3 *Id.* (citations omitted).
4 *Id.*
5 *Id.* at 735 (emphasis in original).

As practitioners know, administrative expenses are not always paid in full. The court's decision highlights an important tool that a creditor might seek to use to monetize an otherwise unpaid administrative expense and reduce the creditor's preference liability.

While seemingly straightforward, creditors have faced numerous issues in seeking to set off an administrative expense against preference liability. The general rule is that a "creditor cannot offset its liability against either a separate debt owed to it by the debtor or the original liability on account of which the preferential transfer was made" because such a setoff would render the preference statute useless and distort the Bankruptcy Code's priority scheme.[6] Several courts have also held that § 547(c) provides the exclusive list of defenses to a preference claim.[7] This article examines the legal underpinnings of asserting a setoff in defending a preference claim.

Setoff and the Bankruptcy Code

The right of setoff (also called "offset") is a right of equitable origin that "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A."[8] Setoff has long been "favored and encouraged by the law, to avoid circuity of action and injustice."[9]

The Bankruptcy Code does not create a right of setoff; rather, it preserves whatever right may otherwise exist outside of bankruptcy.[10] Specifically, § 553(a) of the Bankruptcy Code addresses pre-petition setoffs and provides that the filing of a bankruptcy case "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case."

Courts have generally held that four conditions must exist to assert a setoff under § 553(a): (1) the creditor must hold a "claim" against the debtor that arose before the commencement of the case; (2) the creditor must owe a "debt" to the debtor that also

6 *Collier on Bankruptcy* ¶ 553.03[3][e][v] (16th ed. 2010).
7 *Patterson v. Irwin Mortg. Corp. (In re Patterson)*, 330 B.R. 631, 642 (Bankr. E.D. Tenn. 2005) (holding that "the exclusive meritorious defenses to a § 547(b) preference action are set forth in § 547(c)"); *Gonzales v. Food Mktg. Grp. (In re Furr's Supermarkets Inc.)*, 320 B.R. 1, 6 (Bankr. D.N.M. 2004) ("First, § 547(c) is the exclusive list of defenses available to preferential transfers.").
8 *Citizens Bank v. Strumpf*, 516 U.S. 16, 18 (1995) (citations omitted).
9 *N. Chi. Rolling Mill Co. v. St. Louis Ore & Steel Co.*, 152 U.S. 596, 615-16 (1894).
10 *Citizens Bank*, 516 U.S. at 18.

arose before the commencement of the case; (3) the claim and debt must be "mutual"; and (4) the claim and debt must each be valid and enforceable.[11] Thus, for a creditor to set off an administrative expense against preference liability under § 553(a), (1) the administrative expense must be considered a "claim" that arose before the commencement of the case, (2) the preference liability must be considered a "debt" that also arose before the commencement of the case, (3) the expense and liability must be "mutual," and (4) the expense and liability must constitute valid obligations.

Claim and Debt

For a creditor to set off an administrative expense against its preference liability under § 553(a), such administrative expenses must first be considered a "claim." The Bankruptcy Code defines a "claim" as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."[12] At first blush, an allowed administrative expense seemingly constitutes a "claim" within the Code's definition because it is a "right to payment." While some courts have held that "the definition of a 'claim' in § 101(5) is sufficiently broad to include requests for payment of expenses of administration,"[13] courts have also differentiated between "administrative expenses" and "claims," at least in the context of the disallowance of claims.[14] Such distinctions might equally apply in a setoff scenario under § 553(a), leaving it uncertain as to whether an administrative expense would constitute a "claim" for setoff purposes.

A creditor's preference liability to a debtor, on the other hand, must be considered a "debt." The Bankruptcy Code defines a "debt" as "liability on a claim."[15] Therefore, liability arising from a preference claim should be considered a "debt."

Mutuality and Valid Obligations

Outside of consisting of a "claim" and "debt" that arose before the commencement of the case, setoff under § 553 also requires that a creditor's administrative expense and preference liability must be mutual and constitute valid obligations. "Mutuality" is not defined in the Bankruptcy Code, and cases interpreting the term are vast. Courts generally require that countervailing debts "must be in the same right and between the same parties, standing in the same capacity" in order to be considered mutual.[16]

Furthermore, the administrative expense and preference liability must constitute valid obligations.[17] This factor should be easily satisfied where the preference liability has been adjudicated and the administrative expense allowed. Even an administrative expense that has not been allowed due to a creditor's failure to file an application might constitute a valid obligation. As *Collier* notes, a distinction should be drawn between "claims that are invalid because of some directly disabling or limiting provision of the Code or other applicable law, and claims that are invalid because of the creditor's failure to prosecute them in the debtor's case. A setoff [might] be allowed solely as a defense in the latter instance."[18] While cases are sparse on the subject, at least one court has recognized in the proof-of-claim context that "[t]he majority of the courts do not require the creditor to file a proof of claim as a prerequisite to assert a setoff."[19] Thus, it might be possible for a creditor to argue that this factor allowing setoff under § 553(a) could be met in the context of adminstrative expenses.

> **[S]etoff is not permitted for a claim that arose against the pre-petition debtor and a debt that arose post-petition against the debtor in possession (or vice versa).**

Arose Before Commencement of Case

In addition to being considered a "claim" and "debt," a creditor's administrative expense and preference liability must have also arisen before the commencement of the case in order to qualify for setoff under § 553(a). This is the requirement that likely cannot be met when administrative expenses and preferences are at issue.

When a claim or debt arises will likely depend on the test used by the court. Courts generally employ three different tests to determine when a claim arises: the accrual test; the conduct test; and the fair contemplation, foreseeability or pre-petition relationship test.

Under the accrual test (generally not followed), a claim does not arise until a cause of action has accrued under applicable nonbankruptcy law.[20] On the other hand, a claim arises under the conduct test when the conduct by the debtor giving rise to liability occurs, even if the actual injury is not suffered until later.[21] Finally, the fair contemplation, foreseeability or pre-petition relationship test looks at whether there is a pre-petition relationship between the debtor and creditor, such that a possible claim was within the fair contemplation of the creditor at the time that the petition was filed.[22]

When a creditor's preference liability is deemed to have arisen will also depend on the test used by the court. A preference claim against non-insiders stems from property transferred by the debtor to a creditor on or within 90 days before the date of the filing of the petition. The conduct giving rise to the claim certainly arises pre-petition.[23] However,

11 *In re Pub. Serv. Co.*, 884 F.2d 11, 14 (1st Cir. 1989); *In re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990).
12 11 U.S.C. § 101(5)(A).
13 *MicroAge Inc. v. Viewsonic Corp. (In re MicroAge Inc.)*, 291 B.R. 503, 508 (B.A.P. 9th Cir. 2002).
14 *See In re Renew Energy LLC*, No. 09-10491, 2009 Bankr. LEXIS 3352, at *13-14 (Bankr. W.D. Wis. Sept. 30, 2009) (collecting cases).
15 11 U.S.C. § 101(12).
16 *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1398-99 (9th Cir. 1996) (citations omitted).
17 *See, e.g., Stair v. Hamilton Bank of Morristown (In re Morristown Lincoln-Mercury Inc.)*, 42 B.R. 413, 417 (Bankr. E.D. Tenn. 1984) ("However, Citicorp failed to establish the validity of its claim underlying its asserted setoff right.").
18 *Collier on Bankruptcy*, *supra* n.6, ¶ 553.03[4].
19 *Neal v. Golden Knights Inc. (In re Laughter Inc.)*, No. 95-4022-B, 1995 Bankr. LEXIS 2163, at *10 (Bankr. E.D. Va. Oct. 13, 1995) (collecting cases).
20 *See Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332, 337 (3d Cir. 1984), *overruled by JELD-WEN Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010).
21 *See Watson v. Parker (In re Parker)*, 264 B.R. 685, 697 (B.A.P. 10th Cir. 2001).
22 *See In re City of Detroit*, 548 B.R. 748, 763 (Bankr. E.D. Mich. 2016).
23 *See, e.g., Phoenix Rest. Grp. Inc. v. Proficient Food Co. (In re Phoenix Rest. Grp. Inc.)*, No. 303-0568A, 2004 Bankr. LEXIS 2186, at *62-63 (Bankr. M.D. Tenn. Dec. 16, 2004) ("As ... explained in *Roberts*, this action to recover pre-petition preferential payments does not raise the same issues of law or fact as Proficient's request for reimbursement of post-petition expenses. Administrative expenses are post-petition charges entitled to statutory priority. They cannot be set off against pre-petition claims.").

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a debtor can only assert a preference claim after the filing of the petition, as a debtor's right to assert chapter 5 causes of action arises *after* filing for bankruptcy. Thus, the claim itself and corresponding liability seemingly arise post-petition and thereby out of the purview of § 553(a).[24]

Likewise, an administrative expense may arise pre- or post-petition depending on the type of administrative expense. For example, § 503(b)(1)(A) administrative expenses are for the "actual, necessary costs and expenses of preserving the estate" and necessarily arise from post-petition conduct between a creditor and estate. However, § 503(b)(9) administrative expenses are for "the value of any goods received by the debtor within 20 days before the date of commencement of a case." Similar to a preference claim, the conduct giving rise to a § 503(b)(9) administrative expense arises pre-petition, but the expense itself does not exist until after a debtor files a bankruptcy petition and after the expense is allowed by a bankruptcy court. Thus, an administrative expense seemingly arises post-petition and also out of the purview of § 553(a).

Setoff Outside of § 553

While § 553(a) preserves pre-petition setoff rights, some courts (such as *Quantum Foods*) have looked outside of § 553(a) to find mutuality and permit setoff for claims and debts that arose *after* the commencement of the case.[25] By doing so, these courts have effectively created a federal common law setoff right, as "there is no provision in the Bankruptcy Code that deals expressly with post-petition setoff."[26] Thus, if both a creditor's preference liability and administrative expense are deemed to have arisen post-petition, the creditor might be able to successfully assert a setoff. However, setoff is not permitted for a claim that arose against the pre-petition debtor and a debt that arose post-petition against the debtor in possession (or vice versa). Both obligations must have arisen either pre- or post-petition in order to satisfy the "mutuality" requirement.[27]

Conclusion

The preference defense toolbox should include potential setoffs of the creditor against the alleged preference liability. A dollar-for-dollar setoff of an administrative expense against preference liability finds support in case law and may provide an opportunity to bolster the unsecured creditor client's defense. abi

24 *See, e.g., Official Comm. of Unsecured Creditors of Enron Corp. v. Martin (In re Enron Creditors Recovery Corp.)*, 376 B.R. 442, 466 (Bankr. S.D.N.Y. 2007) (holding that creditor's "obligation to return [a] preference results from the operation of the Bankruptcy Code, and arises upon the filing of the bankruptcy case"); *White v. Bradford (In re Tax Reduction Inst.)*, 148 B.R. 63, 76 (Bankr. D.D.C. 1992) ("The preference claim arose only on the filing of the petition and hence is not a claim of the debtor against the creditor 'that arose before the commencement of the case' within the meaning of § 553(a).").

25 *See, e.g., Gordon Sel-Way Inc. v. United States (In re Gordon Sel-Way Inc.)*, 270 F.3d 280, 292 (6th Cir. 2001) ("Since this claim arose post-petition, it [might] be set off against Sel-Way's post-petition claim for tax refunds."); *Zions First Nat'l Bank NA v. Christiansen Bros. (In re Davidson Lumber Sales)*, 66 F.3d 1560, 1569 (10th Cir. 1995) ("Despite the Bankruptcy Code's failure to address the situation, courts generally recognize that in appropriate circumstances mutual post-petition debts [might] be set off.").

26 *In re Quantum Foods LLC*, 554 B.R. 729, 732 (Bankr. D. Del. 2016); *see also In re Fordson Eng'g Corp.*, 25 B.R. 506, 511 (Bankr. E.D. Mich. 1982) ("Section 553 is silent as to the right of setoff for obligations arising post-petition.").

27 *See, e.g., Cooper-Jarrett Inc. v. Cent. Transp. Inc.*, 726 F.2d 93, 96 (3d Cir. 1984) ("It is clear under this section that a creditor may not set off its pre-petition claims against a debt owed to the debtor [that] came into existence after the filing of the bankruptcy petition."); *In re Drexel Burnham Lambert Grp. Inc.*, 113 B.R. 830, 846 (Bankr. S.D.N.Y. 1990) ("A post-petition claim by a debtor in possession is not mutual with a pre-petition debt owed by a nondebtor.").