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# Recoupment: Eighth Circuit Rejects 'Balancing of the Equities' Test

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The United States Court of Appeals for the Eighth Circuit recently held that equitable considerations could not prevent a creditor's recouping amounts owed to it by a Chapter 7 debtor. Terry v. Standard Ins. Co. (In re Terry), 687 F.3d 961 at 965 (8th Cir. 2012). Reversing the bankruptcy court and the Bankruptcy Appellate Panel (BAP), the Eighth Circuit explained that "once a party meets the same-transaction test … a court should not impose an additional 'balancing of the equities' requirement" on the doctrine of recoupment. Id. Ending a three-year battle in three courts over the sum of $45,316, the court's straightforward ruling resulted in a win for a disability insurer over a disabled individual. In reality, however, nobody won.

## What Is Recoupment?

"Recoupment allows a defendant to deduct its claim from the amount the plaintiff could otherwise recover if the claim arises out of the same transaction or subject matter on which the plaintiff sued." Id. at 963, citing In re NWFX, Inc., 864 F.2d 593 (8th Cir. 1989). The doctrine comes not from the Bankruptcy Code (Code), but is a common-law rule permitting a creditor to reduce its liability by the amount of the debtor's obligation to the creditor so long as the two debts arise out of the same transaction. See, e.g., In re Anes, 195 F.3d 177, 182 (3d Cir. 1999); Newberry Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392, 1399 (9th Cir. 1996).

Ordinarily, an "overpayment [by the creditor] or something like it is required to trigger recoupment." Michael L. Temin, Bankruptcy Litigation Manual, § 10.07 at 10-15 (2011-12 rev. ed.). Recoupment "is essentially a defense to the debtor's claim against the creditor … ." Id., citing In re Eggers, 432 B.R. 577, 580 (Bankr. W.D.Tex. 2010).

At most, for recoupment to be available, the parties' obligations must "arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without meeting its obligations." University Medical Center v. Sullivan, 973 F.2d 1065, 1081 (3d Cir. 1992); Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 147 (2d Cir. 2002). But when "the contract … contemplates the business to be transacted as discrete and independent units, even claims predicated on a single contract will be ineligible for recoupment." In re Malinowski, 156 F.3d 131, 135 (2d Cir. 1998).

Other Circuits and lower courts have adopted a "more flexible," broader "logical relationship" test, relying on an early Supreme Court decision. Conopco, Inc. v. Minster Bank, 2008 U.S. Dist. LEXIS NY 552, at *28 (S.D.Ind. 2008), citing Moore v. New York Cotton Exchange, 270 U.S. 593, 610 (1926); In re Holyoke Nursing Home, Inc., 372 F.3d 1, 4 (1st Cir. 2004); In re TLC Hosps., Inc., 224 F.3d 1008, 1013-1014 (9th Cir. 2000).

## Recoupment in Bankruptcy

Recoupment, unlike a creditor's right of setoff, "is unaffected by bankruptcy." Id. A creditor with a right of recoupment in a bankruptcy case can recoup the full amount it is owed, to the exclusion of other creditors. Anes, 195 F.3d at 182. Although similar to the creditor's right of setoff, recoupment is a more powerful tool. Id.; Newberry, 95 F.3d at 1399. First, a creditor's recoupment right is not subject to the Code's automatic stay. Id.; see also Code, § 362(a)(7) (applying automatic stay only to setoff). Second, a recouping creditor may apply its pre-bankruptcy claims against the debtor's post-bankruptcy claims, a remedy not available in the setoff context. Anes, 195 F.3d at 182; Newberry, 95 F.3d at 1398-99. A recouping creditor may thus receive preferred treatment even when setoff is unavailable (e.g., a pre-bankruptcy claim by the creditor and a post-bankruptcy claim by the debtor). Newberry, 95 F.3d at 1399. As a result, "[i]n light of the Bankruptcy Code's strong policy favoring equal treatment of creditors and bankruptcy court supervision over even secured

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creditors, the recoupment doctrine is a limited one and should be narrowly construed." In re McMahon, 129 F.3d 93, 97 (2d Cir. 1997).

### Facts

The debtor, an individual employed by the state of Missouri, received long-term disability benefits through a policy issued by Standard Insurance Company. In August 2006, prior to the debtor's bankruptcy filing, Standard began paying him disability benefits. Those benefits, according to the policy, had to be reduced by any benefits the debtor received under the Social Security Act. The debtor therefore authorized Standard to withdraw from his bank account any retroactive Social Security disability benefits. On July 17, 2008, the debtor received a lump-sum award of retroactive Social Security benefits in the amount of $45,316.54. Standard withdrew this amount from Terry's bank account one week later.

The debtor filed a Chapter 7 bankruptcy petition on July 31, 2008. The bankruptcy trustee later demanded that Standard turn over the $45,316.54 on April 20, 2009, asserting it was a voidable preference under Code § 547. Standard immediately complied, but then began deducting $430.20 each month from Terry's bank account to recover the retroactive benefits. When the bankruptcy court suggested that these monthly deductions might violate the Code's automatic stay or its discharge injunction, Standard repaid the previous retroactive withholdings to the debtor, but reserved its rights to reinstate deductions if a court were to determine that they were permissible. The debtor then sued Standard, seeking a declaratory

judgment that Standard was not entitled to recoup the $45,316.54.

### Litigation History

The three-year litigation history between Standard and the debtor entailed two bankruptcy court rulings, and at least one decision by the BAP prior to the Eighth Circuit's dispositive ruling. Although the lower courts had eventually determined that the parties' rights arose out of the same transaction, the bankruptcy court, according to the BAP, had to weigh the "equities" of permitting recoupment. 443 BR 816, 821.

The bankruptcy court then held that it would be inequitable to permit Standard to recoup. Terry v. Standard Ins. Co. (In re Terry), 453 B.R. 760, 764 (Bankr. W.D. Mo. April 13, 2011). It reasoned that: 1) requiring a disabled debtor to repay the funds a second time would be inequitable; 2) recoupment would impose hardship and impair the debtor's fresh start; and that 3) Standard would have had a greater net recovery had it challenged the trustee's preference demand. Id. at 763-4. In short, it reasoned, Standard was "simply in a better position to sustain [the] loss than the Debtor … and not just because Standard [was] a 'big insurance company with deep pockets.'" Id. The court still allowed Standard an unsecured claim, an ineffectual remedy.

### Eighth Circuit Ruling

Standard appealed, arguing that: 1) the BAP had erred in ordering the bankruptcy court to weigh the equities; and that 2) the bankruptcy court had abused its discretion. 687 F.3d at 962.

The Eighth Circuit agreed with Standard: The "BAP [had] erred by introducing a separate 'balancing of the equities' test into the doctrine of recoupment and by invoking these equitable principles to deny Standard a right of recoupment after finding that the obligations at issue arose out of the same transaction." Id. at 965. Moreover, "[f]airness and equity may influence whether two competing claims arise from the same transaction, but a court should not impose an additional 'balancing of the equities' requirement once a party meets the same-transaction test." Id. at 965.

### Analysis

The Terry ruling is creditor-friendly, but the creditor still had to expend time and substantial funds to recover $45,316 over a three-year period. It may have won this battle over a legal principle that never should have been litigated.

Terry is consistent with the holdings of most other Circuits. In re Slater Health Center, Inc., 398 F.3d 98, 104 (1st Cir. 2005) (rejected separate balancing-of-the-equities test for recoupment in bankruptcy; "… analysis of the recoupment issue should both begin and end with the same transaction question without discussing other equitable issues"; government adjustment for Medicare overpayment constitutes recoupment); In re TLC Hosps., Inc., 224 F.3d 1005 (9th Cir. 2000) (same); United States v. Consumer Health Servs. of Am., Inc., 108 F.3d 390 (D.C. Cir. 1997) (same). See also In re Malinowski, 156 F.3d 131, 135 (2d Cir. 1998) (held, claims failed to meet same-transaction test); In re Peterson Distributing, Inc., 82 F.3d 956 (10th Cir. 1996) (same); In re University Med. Ctr., 973 F.3d 1065 (3d Cir. 1992) (each yearly payment to a Medicare provider constitutes separate transaction; recoupment of past overpayments from current payments improper).

Recoupment is thus a powerful defensive weapon, one that a creditor should never forget. But courts, like the lower courts in Terry, will often try to block its use.



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