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In Defense of Recoupment: Why Setoff of Prepetition Utility Deposits against Prepetition Debt is Not Subject to the Automatic Stay

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IN DEFENSE OF RECOUPMENT: WHY "SETOFF" OF PREPETITION UTILITY DEPOSITS AGAINST PREPETITION DEBT IS NOT SUBJECT TO THE AUTOMATIC STAY

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I. INTRODUCTION

At the time of filing bankruptcy, virtually all debtors owe money to at least one utility creditor. Oftentimes the utility service account between the utility and debtor includes a deposit which was provided by the debtor at some point preceding bankruptcy. Such deposits can involve substantial amounts of money, especially when the debtor is a business concern.[1] The issue discussed herein is simple—when the customer files bankruptcy, does the utility[2] have the right to offset the prepetition deposit against amounts owed by that debtor to the utility for prepetition services without seeking approval of the bankruptcy court?

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[1] *See* Virginia Elec. & Power Co. v. Caldor, Inc., 117 F.3d 646 (2d Cir. 1997) (deciding a case in which a customer's average monthly utility bill of $3.5 million prompted utilities to demand a deposit of $5.1 million).

[2] The present Article focuses on the recoupment and setoff rights of utilities because of the recurring nature of fact patterns surrounding prepetition utility deposits. Whether a creditor qualifies as a "utility" is not particularly relevant to the issue of recoupment and setoff rights, though it is quite relevant to the subject of rights to postpetition service and payment between a debtor and the utility creditor. More specifically, the present Article does not address the issues surrounding a utility's right to, and ability to, secure payment for postpetition services. The issue of payment for and security of postpetition services is largely controlled by Bankruptcy Code § 366. *See* 11 U.S.C. § 366 (1994). For a review of this subject, see generally Cheryl F. Anderson, *Providing Adequate Assurance For Utilities Under Section* 366, 9 BANKR. DEV. J. 199 (1992).

Some debtors have successfully argued that application of a prepetition utility deposit against a prepetition debt sounds in the nature of a setoff under § 553.[3] This position constrains the utility's ability to apply the prepetition deposit without court approval, as the setoff of a deposit by a creditor is subject to the automatic stay. In jurisdictions subscribing to the "setoff" view, a utility must seek court approval before offsetting the prepetition deposit against the amounts it is owed to prevent the possibility of being found liable for violating the automatic stay. In situations involving small deposits, the cost of prosecuting a motion for relief from the automatic stay serves as a practical bar to the utility exercising its rights.

In other jurisdictions, utilities have successfully argued that application of a prepetition utility deposit to prepetition debt qualifies as "recoupment." Because the exercise of recoupment rights by a creditor is not prohibited or affected by the automatic stay, utilities in these jurisdictions may offset a prepetition deposit without the necessity or expense of obtaining the bankruptcy court's approval.

This Article provides an analysis of why the recoupment view should, in virtually all circumstances, prevail.

II. THE PREPETITION UTILITY DEPOSIT DILEMMA

Many utilities require customers to post a cash security deposit to secure payment of future utility bills. The demand for such a deposit may be made at the time utility service is initially established or may be made as the result of poor pay performance by an existing utility customer. The amount of a deposit will normally be based on a variety of factors, most importantly the credit worthiness of a customer as well as the anticipated level of utility consumption.[4]

Typically, the utility will "post" the deposit to the customer's account. Once the customer funds the deposit, the utility carries a debt owing to the customer similar to a bank deposit account. In other words, upon funding the deposit, the deposit itself is not "owned" by the customer. Rather, the utility is indebted to the customer for the deposit amount, subject to the conditions of the

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[3] *See* 11 U.S.C. § 553.

[4] A deposit of one to two months of anticipated or average usage is common in the industry. In some states, the amount of a deposit that can be demanded by a utility is expressly limited by regulation. For instance, in Indiana, an electric utility may require a two month deposit, whereas a gas utility may require a four month deposit. *See IURC Seeking to Establish Rules Setting Customer Creditworthiness,* GAS UTIL. REP., Apr. 10, 1998, at 7.

agreement dealing with application of the deposit amount to any outstanding balance. Upon termination of the account, a utility will typically apply the deposit amount to the final outstanding utility bill, and either send a bill to the customer for the net amount owed, or refund a credit.

What should a utility do with the deposit when it receives notice that its customer has filed for bankruptcy protection? Three basic options exist. First, and most conservatively, the utility may immediately refund the deposit to the debtor and file an unsecured claim in the bankruptcy case for the entire outstanding prepetition utility bill. Second, the utility may file a bifurcated claim in the bankruptcy case, indicating that such claim is secured to the extent of the deposit, with the balance unsecured. Finally, the utility may apply the prepetition deposit to the outstanding prepetition balance. If the deposit is insufficient to satisfy the outstanding prepetition bill, the utility files a claim for the resulting balance. If application of the deposit results in a credit in favor of the debtor, the utility may either post this credit as part of a postpetition deposit or refund the difference to the debtor.

Among the foregoing options, the choice of any utility should (and hopefully is) dictated by how the particular bankruptcy court will characterize its act of applying the prepetition deposit to the outstanding prepetition bill. In jurisdictions in which courts characterize the act of applying the deposit as "setoff," the utility may either take affirmative steps to seek approval of the bankruptcy court or be faced with the prospect of refunding the entire deposit to the debtor. In jurisdictions in which courts view the application of the prepetition deposit to prepetition debt as "recoupment," the utility may unilaterally apply the deposit to the outstanding prepetition bill.

III. RECOUPMENT, SETOFF, AND THE AUTOMATIC STAY

A. *The Automatic Stay Requires Court Approval for Creditor to Exercise Setoff Rights*

1. *The Parameters of Setoff and § 553*

The right of setoff arises when two parties owe mutual debts to each other, and one party exercises its right to offset its claim against the claim of the other. The theory underlying the concept of setoff rights is to avoid "the absurdity of making A pay B when B owes A."[5] A simple example of setoff is the case of a general contractor who pays the supplier of a subcontractor, and who offsets this payment against the balance owed to the subcontractor.[6]

The right of one to claim setoff against another is generally created by state common law. Although setoff is an equitable right of a creditor based generally on state substantive law, courts in the various states apply a generally accepted standard.[7] To possess a setoff right, a party must show that he holds a mutual obligation against the party asserting a claim against him which is unrelated to the transaction upon which the other party bases his claim. As for the requirement of a "mutual obligation," the defendant seeking to assert a right of setoff must possess a legal right against the same party making demand of him.[8] It is well established that a right to setoff only exists when the party asserting the right has a claim which arises out of a transaction unrelated to the matter upon which plaintiff is asserting his claim.[9]

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[5] Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913).

[6] *See, e.g., In re* Davidson Lumber Sales, Inc., 66 F.3d 1560, 1566-68 (10th Cir. 1995).

[7] Although the substantive rights to setoff may involve slight variances based on state law, these variances are unimportant in the context of this Article. This follows from the fact that regardless of the definition or requirements of setoff in a particular jurisdiction, the exercise of setoff rights invariably requires the creditor to seek relief from the automatic stay.

[8] *See* Mark VII Fin. Consultants Corp. v. Smedley, 792 P.2d 130, 133 (Utah 1990) ("In order to be mutual the cross demands set up ordinarily must be shown to belong individually to defendant, with a corresponding right to sue for them in his individual name, and defendant, as a general rule, cannot set off a demand on which he is not entitled to sue in his own name.") (quoting 80 C.J.S. *Set-off and Counterclaim* § 48a(2) (1953)).

[9] *See* Barrett v. LFP, Inc., 1986 WL 7698, at *28 (N.D. Ill. June 27, 1986) ("For a claim to be properly treated as a setoff, it must arise out of a transaction independent of the primary claim."); Household Consumer Discount Co. v. Vespaziani, 387 A.2d 93 (Pa. 1978).

The Bankruptcy Code generally acknowledges and preserves a creditor's substantive right to exercise its otherwise available setoff rights.[10] The applicable Code provision, entitled "Setoff," is § 553, which provides:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title 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.[11]

As made express by this provision, the Code acknowledges only the right of a creditor to setoff a mutual prepetition, and not postpetition, debt. The requirement in § 553 that such debts be "mutual" mirrors the mutuality requirement of setoff as established by substantive state law.[12]

Some courts have held that a postpetition debt may not be setoff against a prepetition debt under the terms of § 553.[13] Courts so holding reason that the "mutuality" requirement is missing, as the debtor-in-possession is viewed as a legal entity distinct from the debtor.[14] In this way, the Code alters, rather than preserves, the setoff rights of a creditor under state law.[15] The Code also provides express exceptions to the right of a creditor to setoff prepetition debts, and these exceptions to some extent track the logic and operation of the preference provisions of § 547.[16]

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[10] *See In re* Patterson, 967 F.2d 505 (11th Cir. 1992); *In re* Whitaker, 173 B.R. 359 (Bankr. S.D. Ohio 1994).

[11] 11 U.S.C. § 553(a) (1994).

[12] For purposes of setoff under § 553, "mutuality" requires: (1) debts are in the same right; (2) debts are between the same parties; and (3) parties stand in the same capacity. *See In re* Donnay, 184 B.R. 767, 787 (Bankr. D. Minn. 1995).

[13] *See*, e.g., *In re* Bram, 179 B.R. 824 (Bankr E.D. Tex. 1995).

[14] Other courts have chosen to read between the lines of § 553 by holding that a creditor may setoff mutual postpetition obligations. *See*, e.g., *In re* Apex Int'l Mgmt. Servs., Inc., 155 B.R. 591 (Bankr. M.D. Fla. 1991).

[15] *See, e.g., In re* Gehrke, 158 B.R. 465 (Bankr. N.D. Iowa 1993).

[16] There are three specific exceptions to a creditor's ability to setoff a prepetition debt owing to a debtor against the debtor's prepetition claim against the creditor. The first is that no such setoff is permitted if the creditor's claim against the debtor is disallowed. *See* 11 U.S.C. § 553(a)(1). This exception parallels the substantive law of setoff to the extent it requires the creditor to prove the existence and validity of his claim against the debtor. One of the other two exceptions mirrors the preference provisions of § 547. Section 553(a)(3),

2. *Section 362 (a) (7) and the Exercise of Setoff Rights*

While the Bankruptcy Code preserves a creditor's substantive right to perform setoff against a mutual debt owing to and by the debtor, the Code does erect a procedural hurdle. This is accomplished by § 362(a)(7), which provides:

> (a) [The filing of a bankruptcy petition] operates as a stay, applicable to all entities, of-
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> . . . .
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> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim of the debtor . . . .[17]

This section clearly brings the exercise of setoff rights by a creditor within the ambit of the automatic stay.[18] The purpose of the automatic stay in preventing a creditor from unilaterally exercising setoff rights without court approval is to preserve an orderly distribution of assets and to provide the debtor with a breathing spell from actions by creditors.[19] Congress's use of the legal term-of-art "setoff" in § 362(a)(7), is consistent with bankruptcy courts holding that this section does not operate as a stay to creditors exercising rights of recoupment.[20]

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based on the improvement of position theory of § 547, invalidates setoff in circumstances in which the debt owed to the debtor by the creditor was incurred: (1) within 90 days before the bankruptcy filing; (2) while the debtor was insolvent; and (3) for the purpose of obtaining a right of setoff against the debtor. *See* 11 U.S.C. § 553(a)(3). The third exception invalidates a setoff if the creditor's claim was obtained from a party other than the debtor either within 90 days before the bankruptcy filing while the debtor was insolvent, or postpetition. *See* 11 U.S.C. § 553(a)(2).

[17] 11 U.S.C. § 362(a)(7).

[18] Depending on the nature of the creditor's and debtor's rights and obligations, the exercise of setoff rights may also be stayed by § 362(a)(4). This section provides that the filing of bankruptcy operates as a stay of "any act to create, perfect, or enforce any lien against property of the estate." 11 U.S.C. § 362(a)(4). In other words, depending on the nature of the rights of the parties involved, an act which may constitute a setoff proscribed by § 362(a)(7) may also violate § 362(a)(4). *See In re* Moreira, 173 B.R. 965 (Bankr. D. Mass. 1994).

[19] *See In re* Homan, 116 B.R. 595, 602 (Bankr. S.D. Ohio 1990) ("Conditioning a creditor's exercise of a potential setoff to the Code's requirement that the creditor first obta*In re*lief from the stay is consistent with an acknowledged purpose of the Code to grant a debtor an immediate breathing spell, free from creditor pressure."); *see also In re* Corland Corp., 967 F.2d 1069 (5th Cir. 1992).

[20] *See* discussion *infra* part V.B.

In light of § 362(a)(7), creditors of the bankrupt are required to seek bankruptcy court approval as a prerequisite to exercising their setoff rights. This approval is sought in the form of a motion for relief from the automatic stay.[21] Failure of a setoff creditor to seek and procure relief from the automatic stay can lead to draconian consequences, as the Code allows for the recovery of damages by an individual debtor, which can include attorney fees as well as punitive damages.[22] The possibility of facing liability for violating the automatic stay by failing to seek bankruptcy court approval provides a creditor wrestling with the setoff issue a powerful incentive to err on the side of seeking bankruptcy approval of the proposed transaction.[23]

B. *Recoupment is not Subject to the Automatic Stay*

1. *Recoupment in General*

Much like setoff, the doctrine of recoupment is a common law concept which dates to legal antiquity.[24] Recoupment tracks the requirements of setoff in that it is asserted as an equitable defense against a party with whom the defendant has dealt.[25] Unlike a setoff, however, recoupment requires that the defense asserted arise out of

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[21] *See In re* Patterson, 967 F.2d 505, 509 (11th Cir. 1992) ("In order to exercise a valid right of setoff, a creditor must move the court for relief from the stay."); *In re* Women's Technical Inst., 200 B.R. 77 (Bankr. D. Mass. 1996); *In re* Morgan, 196 B.R. 758, 760 (Bankr. E.D. Ky. 1996) ("A party seeking to setoff a mutual pre-petition debt as permitted by 11 U.S.C. [§] 553 must secure a lifting of the automatic stay.").

[22] *See* 11 U.S.C. § 362(h).

[23] Courts have awarded substantial damages for "willful" violations of the automatic stay. *See, e.g., In re* Miller, 200 B.R. 415 (Bankr. M.D. Fla. 1996) ($10,000 in actual and punitive damages); *In re* Toll, 175 B.R. 406 (Bankr. N.D. Ala. 1994) (punitive damages of $10,000); *In re* Coats, 168 B.R. 159 (Bankr. S.D. Tex. 1993) (damages award included $34,000 in attorney fees).

[24] *See* Hubley Mfg. & Supply Co. v. Ives, 70 A. 615, 616 (Conn. 1908) ("Equity recognizes rights of set-off which go far beyond those which the early legislation of England and of Connecticut introduced in actions at common law."). The doctrine of recoupment is similarly ancient. *See* Keegan v. Kinare, 14 N.E. 14 (Ill. 1887); Charley v. Potthoff, 95 N.W. 124 (Wis. 1903).

[25] *See* Jeffrey L. Schwartz, *When Is The Same Contract Not the 'Same Transaction'?*, BANKR. STRATEGIST, Oct. 1996, at 1 ("An equitable doctrine, recoupment basically allows a party to show that, because of circumstances arising out of the transaction in question, he is not liable for the full amount of the claim.").

the same transaction or matter upon which plaintiff bases his claim.[26]

The requirement that a defense arise out of the "same transaction" is the very essence of the doctrine of recoupment. While in large part the victim of legal obsolescence,[27] the spirit of recoupment survives today outside of the bankruptcy context in the Rules of Civil Procedure as the "compulsory counterclaim" provision of Rule 13.[28] The federal version of Rule 13(a) provides that a defendant must assert a counterclaim "if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim . . . ."[29] Similarly, the doctrine of setoffs survives in the "permissive counterclaim" provision of Rule 13(b), which provides that a claim "*may* state as a counterclaim any claim against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim."[30] As can be discerned from a comparison of these two rules, recoupment differs from setoff in two important respects. First, a matter properly assertable as recoupment *must* be asserted defensively against a plaintiff's claim or it will be waived. Second, a recoupment right properly asserted enjoys immunity from the various statutes of limitations, as it may "relate back" when asserted as a counterclaim.

In sum, recoupment is fairly viewed as a species related to setoff. Like a setoff, recoupment involves the defensive right to offset a debt against one owing a mutual debt to the party asserting the recoupment right. Unlike a setoff, for the right to recoup to exist, the asserting party must possess a right against the debtor that arose in or as an offspring of the "same transaction."

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[26] *See* Harlan v. St. Paul M&M Ry., 18 N.W. 147, 148 (Minn. 1884) ("If the defendant can show that the plaintiff himself has violated some stipulation of the same contract sued on, he may recoup his damages arising from such breach . . . .").

[27] While the common law doctrines of setoff and recoupment have lost relevance as a result of the adoption of standardized rules of civil procedure, most jurisdictions continue to recognize the substantive right of a party to assert those rights. *See, e.g.*, Constantino v. New York, 415 N.Y.S.2d 966, 969 (N.Y. Ct. Cl. 1979).

[28] *See* Coplay Cement Co. v. Willis & Paul Group, 983 F.2d 1435, 1440 (9th Cir. 1993) (characterizing recoupment as the "ancestor" of the Rule 13(a) compulsory counterclaim); *Constantino*, 415 N.Y.S.2d at 969 ("The right to plead recoupment as a defense remains intact, notwithstanding the subsequent absorption of the common law doctrines of setoff and recoupment by the present statutory definition of counterclaim.").

[29] FED. R. CIV. 13 (a).

[30] FED. R. CIV. 13 (a) (emphasis added).

2. *Recoupment in Bankruptcy*

In the context of bankruptcy, the doctrine of recoupment provides a creditor with a rarely sanctioned method for obtaining preferential treatment over other creditors. Many creditors overlook recoupment as a possible vehicle for recovery from the debtor not requiring the involvement of the bankruptcy court.[31]

Furthermore, while recoupment is a defensive doctrine, a creditor may assert its rights without waiting for the debtor to bring a suit.[32]

The value of recoupment is grounded in the Code's treatment, or more accurately, nontreatment, of recoupment rights. Specifically, the Code fails to provide mention of, much less a system for dealing with, common law recoupment rights.[33] Nonetheless, courts have virtually uniformly agreed[34] that the Code preserves the right of a creditor to claim, and unilaterally exercise, any common law recoupment rights available against the debtor.[35] As such, the "same transaction" requirement within the context of bankruptcy provides the foundation for the equitable right of recoupment against the debtor: "[A]llowing the creditor to recoup damages simply allows the debtor precisely what is due when viewing the transaction 'as a whole.'"[36]

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[31] *See* Drew S. Norton, *Recoupment: From Last in Line to First in Line*, AM. BANKR. INST. J., June 1997, at 32 ("One of the most overlooked methods for what amounts to a permissible preference is the common law concept of recoupment—and the best part is that you do not need court approval.").

[32] *See In re* Flagstaff Realty Assocs., 60 F.3d 1031, 1035 (3d Cir. 1995).

[33] *See In re* University Med. Ctr., 973 F.2d 1065, 1079 (3d Cir. 1992) ("The Bankruptcy Code does not contain a recoupment provision.").

[34] The uniformity of this view is challenged by an occasional conscientious objector. *See, e.g., In re* Centergas, Inc., 172 B.R. 844, 851-52 (Bankr. N.D. Tex. 1994) (holding that recoupment represents an impermissible violation of the bankruptcy policy of equal distribution).

[35] *See* Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392 (9th Cir. 1996); *In re* U.S. Abatement Corp., 79 F.3d 393 (5th Cir. 1996); *Flagstaff Realty Assoc.*, 60 F.3d 1031; *In re* Smith, 737 F.2d 1549 (11th Cir. 1984); *In re* 105 E. Second St. Assocs., 207 B.R. 64 (Bankr. S.D.N.Y. 1997).

[36] United Structures of Am. v. G.R.G. Eng'g, 9 F.3d 996, 999 (1st Cir. 1993).

IV. THE COURTS SPEAK

The issue of whether a prepetition utility deposit may be offset by a utility against prepetition debt as recoupment without court involvement or approval has been the subject of substantial controversy. Some courts refuse to allow utilities to make a unilateral offset under the claim of recoupment rights. Other courts have agreed with utilities that the offset of a prepetition deposit qualifies as recoupment, and can be pursued by a utility without the necessity of court involvement.

A. *The Setoff Camp*

Some courts have held that a utility may not offset a prepetition utility deposit against the outstanding prepetition bills of a debtor without court approval. Perhaps the leading case espousing the "setoff" view is *In re Village Craftsman.*[37]

The facts in *Village Craftsman* are straightforward. In June and July of 1989, a customer provided two checks to its electric utility creditor in the total amount of $12,650 as a security deposit to offset future bills.[38] More than ninety days later, the customer filed for bankruptcy protection. The utility filed a proof of claim for prepetition services in the amount of $13,393.14.[39] Several months after the petition was filed, the utility requested that the debtor provide it with a postpetition security deposit in the amount of $11,000. Upon inquiry, the debtor learned that the utility had applied the prepetition deposit to its outstanding prepetition balance. The debtor responded by filing a motion with the bankruptcy court seeking to find the utility in violation of the automatic stay and seeking to compel the utility to reestablish the security deposit.[40]

The issue central to the court's determination of whether the utility had violated the automatic stay was whether such application of the utility deposit was a setoff or recoupment. The court began its analysis with a brief overview of setoff under § 553 and common

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[37] 160 B.R. 740 (Bankr. D.N.J. 1993). *See also In re* Utica Floor Maintenance, Inc., 41 B.R. 941 (N.D.N.Y. 1984) (applying setoff analysis to utility's request to offset prepetition deposit against debtor's prepetition bill).

[38] *See Village Craftsman,* 160 B.R. at 742.

[39] *See id.* at 743.

[40] *See id.* at 744.

law recoupment rights.[41] Citing § 362(a)(7), the court then noted that a creditor "cannot unilaterally setoff postpetition against a prepetition claim of a debtor without first obtaining court approval in the form of relief from the automatic stay."[42]

Turning to recoupment, the court conceded that unlike a setoff, "[r]ecoupment is an exception to the general rule that debts which arise prepetition may not be satisfied postpetition without obtaining relief from the automatic stay."[43] Noting that setoff and recoupment rights are determined by state law, the court then turned to the definition of recoupment under New Jersey law and found that:

> New Jersey law defines recoupment as . . . "the reduction of an offsetting claim arising out of exactly the same transaction . . . ." Recoupment is distinguishable from setoff in that the latter involves an affirmative recovery on a claim that may be independent of the transaction upon which the plaintiff's claim is based. While recoupment may be used only to reduce or extinguish the plaintiff's recovery, setoff may be awarded for any amount to which the defendant is entitled.[44]

The court determined that in light of New Jersey's definition of recoupment, the utility's act in applying the prepetition deposit to the prepetition debt was in the nature of setoff rather than recoupment.[45] In support of its conclusion, the court made two observations. First, the court reasoned that because each party can recover an amount by which its claim exceeds the others, the utility's rights in its security deposit were more in the nature of a setoff rather than recoupment. Second, the court reasoned that the posting of a security deposit and the incurring of subsequent utility bills do not arise from "exactly the same transaction" within the meaning of New Jersey law.[46]

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[41] *See id.* at 745-46.

[42] *Id.* at 746 (citing United States on Behalf of I.R.S. v. Norton, 717 F.2d 767, 773 (3rd Cir. 1983); *In re* Art Metal U.S.A., Inc., 109 B.R. 74, 83 (Bankr. D.N.J. 1989)).

[43] *Id.*

[44] *Id.* (quoting Beneficial Fin. Co. v. Swaggerty, 432 A.2d 512, 516 (N.J. 1981)).

[45] *See id.*

[46] *See id.* The court failed to explain or comment on how a deposit and the open account which it secures are not part of "exactly the same transaction."

Finally, the court in *Village Craftsman* briefly acknowledged and rejected other cases in which courts held that the application of a prepetition utility deposit was in the nature of recoupment.[47] In rejecting the views of the "recoupment" courts, the court provided two justifications. First, the court noted that none of the "recoupment" cases applied or analyzed New Jersey substantive law on recoupment and setoff.[48] Second, and significantly, the court noted that in all of the "recoupment" cases, the courts failed "to discuss the fact that a security deposit which was posted prepetition by a debtor and which had not been applied to the debt when the petition was filed is cash collateral as defined by the Code Section 363(a)."[49] The court held that viewing application of such a deposit as recoupment rather than setoff would undermine the "purposes of" the cash collateral provisions.[50]

Another bankruptcy court also treated the application of a prepetition utility deposit to prepetition debt as a setoff in the case of *In re Cole*.[51] The precise issue in *Cole* was whether a consumer debtor was entitled to have a prepetition utility deposit, which was claimed as an exempt asset, applied to satisfy a utility's demand for postpetition adequate protection under § 366. The debtor had a prepetition deposit in the amount of $175.98 posted to her prepetition utility account.[52] Upon filing bankruptcy, the debtor included her interest in this deposit under her claimed exemptions, and the utility did not object to this claim. After the debtor had filed bankruptcy, the utility demanded a postpetition deposit in the amount of $265 as adequate protection under § 366. The debtor requested that the bankruptcy court require the utility to apply the prepetition deposit as a postpetition deposit. The utility claimed that it had the right to setoff the prepetition utility deposit against the prepetition debt.[53]

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[47] *See id.* at 747 ("There is a divergence of authority in other jurisdictions on the issue of whether application in bankruptcy of a utility deposit is in the nature of setoff or recoupment.").

[48] *See id.*

[49] *Id.*

[50] *See id.*

[51] 104 B.R. 736 (Bankr. D. Md. 1989); *accord In re* Utica Floor Maintenance, Inc., 41 B.R. 941 (N.D.N.Y. 1984).

[52] *See Cole*, 104 B.R. at 736.

[53] Although the court treated application of the prepetition utility deposit as setoff, such treatment apparently was the result of acquiescence by the utility. Whether asserted by the utility or not, the court did not directly analyze the issue of whether the utility's application of

The *Cole* court held that because the debtor's prepetition deposit with the utility was claimed as an exempt asset, the utility had no right to setoff this deposit against the debtor's prepetition utility bill. In so holding, the court found that the debtor's right to claim an asset as exempt under the laws of Maryland preempted the utility's right to effectuate a setoff under § 553.[54]

B. *The Recoupment Camp*

Several courts have concluded that the application of a prepetition utility deposit to prepetition debt constitutes the exercise of recoupment rights by the utility.

The leading case espousing the recoupment view is *In re McMahon*.[55] The facts in *McMahon* are typical. Here, the customer paid the utility a $6,000 deposit on April 4, 1994. On April 10, 1995, the customer filed chapter 13 bankruptcy. On May 16, 1995, with full knowledge of the customer's bankruptcy and without permission or approval from the bankruptcy court, the utility applied the deposit to the unpaid prepetition balance. On August 11, 1995, the bankruptcy court held that the utility's unilateral application of the deposit to debtor's prepetition account was a setoff in violation of the automatic stay.[56] Despite this finding, the bankruptcy court provided an ex post facto "approval" of this "setoff" by not requiring the utility to return this deposit. On motion of the debtor, the bankruptcy awarded debtor $500 in attorney fees for the utility's violation of the automatic stay.[57] The utility appealed this decision.

The appeals court began its review of this matter by crystalizing the issue of whether the utility's application of the deposit was setoff or recoupment. The appeals court acknowledged the role of recoupment in bankruptcy:

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this deposit was a recoupment.

[54] *See Cole*, 104 B.R. at 740.

[55] 129 F.3d 93 (2d Cir. 1997).

[56] *See id.* at 95.

[57] *See id.* The court refused to award the debtor punitive damages.

> It is well settled . . . that a bankruptcy defendant can meet a plaintiff-debtor's claim with a counterclaim arising out of the same transaction, at least to the extent that the defendant merely seeks recoupment. Recoupment permits a determination of the just and proper liability on the main issue and involves no element of preference.[58]

The court noted that while setoff is subject to the automatic stay, exercise of common law recoupment rights by a creditor is not.

The court then acknowledged that the recoupment rights of the utility are defined by New York law and turned its focus thereto. Quoting a New York Court of Appeals opinion, the court in *McMahon* provided New York's definition of recoupment:

> Recoupment means a deduction from a money claim through a process whereby cross demands arising out of the same transaction are allowed to compensate one another and the balance only to be recovered. Of course, such a process does not allow one transaction to be offset against another, but only permits a transaction which is made the subject of a suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.[59]

After citing this definition, the court focused on the requirement that recoupment involves claims arising out of "the same set of transactions."[60] Applying New York's definition of recoupment, the court concluded that the "deposit plainly arose out a single electricity contract between the debtor and [the utility]."[61]

Another court also characterized the offset of a prepetition utility deposit against prepetition debt as "recoupment" in *Brooks Shoe Manufacturing Co. v. United Telephone Co.*[62] The facts in *Brooks Shoe* involve a typical prepetition utility deposit securing a prepetition utility account. On September 11, 1981, the debtor provided its telephone utility creditor with a deposit in the amount of $15,000 to secure future performance.[63] On October 23, 1981, the debtor

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[58] *Id.* at 96 (quoting Reiter v. Cooper, 507 U.S. 258, 265 n.2 (1993)).

[59] *Id.* (quoting National Cash Register Co. v. Joseph, 86 N.E.2d 561, 562 (N.Y. 1949)).

[60] *Id.* (citing Constantino v. State, 415 N.Y.S.2d 966, 969 (N.Y. Ct. Cl. 1979)).

[61] *Id.* at 97.

[62] 39 B.R. 980 (E.D. Pa. 1984). *See also In re* Miner Indus., Inc., 119 B.R. 6 (Bankr. D.R.I. 1990).

[63] *See* Brooks Shoe, 39 B.R. at 981. It is noteworthy that the debtor was not required to provide this deposit at the time the telephone service account was established. Rather, the

filed bankruptcy. The utility creditor applied this deposit against the outstanding prepetition arrearage in November 1981. The debtor maintained that the telephone utility's act in applying the deposit was a setoff under § 553 in violation of the automatic stay.

The court in *Brooks Shoe* disagreed with the characterization of the offset as a "setoff." The court began by noting that "the distinction is between truly independent debts, which give rise to setoff rights, and reciprocal obligations arising from the same transaction or series of transactions, which give rise to recoupment."[64]

Importantly, the court characterized the deposit as a variety of "advanced pay" on the part of debtor.[65] The court then differentiated a utility deposit from a deposit with a bank or financial institution:

> It seems to me that much of the confusion engendered in this case is attributable to attempting to equate a security deposit such as that involved herewith bank deposits. In the latter situation, the depositor has unfettered access to the funds at all times, and whatever obligation the bank might seek to set off is truly an independent debt. Even more importantly, such independent offsetting obligation would almost inevitably prove to have been an antecedent debt.[66]

The court concluded that the utility was well within its recoupment rights in offsetting the prepetition deposit against the prepetition bill.[67]

Finally, in *In re Norsal Industries, Inc.*,[68] a court characterized the offset of a deposit against prepetition debt as recoupment. As

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debtor was required to fund the deposit only after failing to make timely payments to the telephone utility. *See id.*

[64] *Id.* at 982.

[65] *See id.* ("Viewed realistically, the creation of the Deposit on September 11, 1981, seems virtually indistinguishable from the debtors having paid in advance for its telephone service.").

[66] *Id.* at 983.

[67] Interestingly, one court was faced with the situation in which the proverbial shoe was on the other foot. *See In re* Public Serv. Co., 107 B.R. 441 (Bankr. D.N.H. 1989). In this case, a public utility filed bankruptcy, and the state attorney general filed an action in the bankruptcy court for the utility-debtor to return certain utility deposits to customers under the theory of recoupment. The court noted that "[t]here is little question that the deposits are part of a single electricity contract that each . . . customer had with [the debtor utility]." *Id.* at 445. The court concluded that the customers, postured as creditors of the debtor utility, were entitled to a return of their security deposits. *See id.* at 447-48.

[68] 147 B.R. 85 (Bankr. E.D.N.Y. 1992).

with the foregoing cases, the court was required to determine "whether [the utility] violated the automatic stay imposed by 11 U.S.C. § 362 when it set off a pre-petition deposit it was holding against [the debtor's] pre-petition debt."[69] The court commented on the novelty of this issue:

> Despite what must be the ubiquitousness of the issue raised here, that is whether a utility company can set off a pre-petition deposit against a pre-petition debt, there is surprisingly little case law on the subject. One explanation may be that ordinarily the utility seeks relief from stay so that it can set off the pre-petition deposit against the pre-petition debt and relief is routinely granted. In this case, however, [the utility] made no application for relief from stay and its representative stated in court that the practice which it followed here is one which is its customary and usual one, that is to simply reduce its pre-petition claim by the amount of pre-petition deposit and file a claim for the balance.[70]

The court then noted that the issue of whether the utility had violated the automatic stay turns squarely on whether its action in offsetting the deposit was a recoupment or setoff.[71] To make this determination, the *Norsal* court next turned its sight to the issue of "whether the deposit for utility services and the payment for utility services arose out of the same transaction."[72]

The debtor argued that the deposit was not part of the same transaction because it was required to make three separate deposits over a period of time.[73] The debtor also attempted to reject other cases finding utility deposits and accounts as part of the "same transaction" on the basis that its dispute was governed by New York law, whereas the other cases were based on the law of different states. The court discarded each of these arguments and held that the utility properly recouped the prepetition deposit against the debtor's prepetition utility bills.[74]

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[69] *Id.* at 86.
[70] *Id.* at 88.
[71] *See id.* at 89.
[72] *Id.*
[73] *See id.*
[74] *See id.*

V. WHY RECOUPMENT SHOULD PREVAIL

A. *Reliance on Differences in State Law Definitions of Recoupment is Misplaced*

The law of recoupment in the context of a utility offsetting a customer's deposit inescapably requires application of state law. While most states apply the generally accepted common law standard of recoupment,[75] meaningful differences exist. Specifically, the requirement that the right to recoupment arise out of "the same transaction" has been finessed by courts in certain jurisdictions. Some courts construe this requirement liberally and merely require that defendant's claim against plaintiff arise out of the same transaction or series of transactions or occurrences. Other courts apply a restrictive version of the "same transaction" requirement, announcing from time to time that a recoupment right must arise out of the "identical transaction" upon which plaintiff bases his claim.

In determining whether the offset of a utility deposit qualifies as "recoupment," a bankruptcy court's reliance on the "same transaction" requirement of its particular state is often misplaced. While it is true that the definition of recoupment varies by state, cryptic references to this fact are often made in conjunction with a failure to address the issue of whether a utility deposit and utility account are part of the "same transaction." In other words, courts desiring to characterize the offset of a utility deposit as a "setoff" may be tempted to reject "recoupment" cases by making the distinction that such cases are based on other state's laws. A predictable conse-

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[75] It is universally accepted that defensive recoupment "refers to a defendant's right in the same action, to cut down the plaintiff's demand, either because the plaintiff has not complied with some cross obligation of the contract on which he or she sues or because the plaintiff has violated some legal duty in the making or performance of that contract." 20 AM. JUR. 2D *Recoupment or Reconvention* § 5 (1995). Although the common law doctrine of recoupment is indeed ancient, courts continue to adhere to the well established definition. *See*, e.g., Sloan v. Kubitsky, 712 A.2d 966, 968 (Conn. App. Ct. 1998); Lofchie v. Washington Square Ltd. Partnership, 580 A.2d 665, 667-68 (D.C. 1990); Atkins v. Rybovich Boat Works, 561 So. 2d 594, 595 (Fla. Dist. App. Ct. 1990); Cox v. Doctor's Assocs., Inc., 613 N.E.2d 1306, 1315 (Ill. App. Ct. 1993); Norwest Bank Minn. v. Midwestern Mach. Co., 481 N.W.2d 875 (Minn. Ct. App. 1992); Ed Miller & Sons, Inc. v. Earl, 502 N.W.2d 444, 452 (Neb. 1993); M&D Masonry, Inc. v. Universal Sur. Co., 572 N.W.2d 408, 414 (Neb. Ct. App. 1997); Enrico & Sons Contracting v. Bridgemarket Assocs., 675 N.Y.S.2d 351, 352-53 (1998); Kline v. Blue Shield, 556 A.2d 1365, 1366-1369 (Pa. 1989); Howard v. Abernathy, 751 S.W.2d 432, 434 (Tenn. Ct. App. 1988); Reid v. Reid, 409 S.E.2d 155, 159 (Va. Ct. App. 1991).

quence of this position is to refrain from any meaningful analysis of whether a deposit and account are, in fact, part of the "same transaction." This truth is illustrated by an analysis of *Village Craftsman.*

In this case, the court made the naked assertion that the debtor's utility deposit and utility account were not part of "exactly the same transaction," as that phrase is defined by New Jersey law.[76]

Defending its conclusion that application of this deposit by the utility was a "setoff," the court rejected a contrary line of cases on the basis that those cases were not based on New Jersey's law.[77] While in reality, New Jersey law on recoupment is virtually indistinguishable from the other various states, the court, without explanation, excused itself from embracing any meaningful "same transaction" analysis on the basis that New Jersey law was somehow different.[78]

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[76] *See In re* Village Craftsman, 160 B.R. 740, 746 (Bankr. D.N.J. 1993).

[77] *See id.* at 747. Interestingly, the case cited by the court in *Village Craftsman* as establishing New Jersey's law on recoupment was Beneficial Fin. Co. v. Swaggerty, 432 A.2d 512 (N.J. 1981). The *Swaggerty* court, noting that New Jersey's law on recoupment requires a defense to arise out of "exactly the same transaction," determined that a Truth In Lending counterclaim against a bank qualified as recoupment. *See Swaggerty,* 432 A.2d at 516-17. In other words, the *Swaggerty* court held that a counterclaim created by a federal statute and a loan transaction were part of the "same transaction" for purposes of recoupment. In light of the somewhat attenuated relationship between these claims, it is extremely difficult to understand how the *Village Craftsman* court relied on *Swaggerty* to conclude that a utility account and a deposit securing performance of such account are not part of the "same transaction."

[78] *See Village Craftsman,* 160 B.R. at 747. While the court failed to explain why a utility account and deposit are not part of the same transaction, other case law from New Jersey has interpreted the "same transaction" quite broadly. *See* Midlantic Nat'l Bank v. Georgian, Ltd., 559 A.2d 872 (N.J. 1989). In this case, a customer borrowed money from a bank, and failed to make timely payments. The bank filed suit in New Jersey state court, and the customer asserted a counterclaim on the basis that the bank wrongfully honored a series of forged checks. The court held that under New Jersey law, "[t]he three elements of equitable recoupment are: (1) [a] single transaction, as opposed to related or connected transactions; (2) [a]n identity of interest among parties; and (3) [a] need to balance the equities." *Id.* at 875. The court then concluded that although the loan and checking account of the customer were distinct, for purposes of the "same transaction" requirement of recoupment, the court reasoned that "[i]t would be farfetched to conclude that any liability on [the customer's] part on the loans arises out of merely a connected or related transaction." *Id.* If under New Jersey law, a loan to a customer and a checking account to a customer are part of the "same transaction," the conclusion that a utility account and a deposit securing that account are not part of the "same transaction" is baffling.

B. *A Utility Deposit and Account are Quintessentially the "Same Transaction"*

Whether a utility may offset a prepetition deposit against prepetition debt as recoupment depends almost entirely on the meaning of the term "same transaction." While seemingly clear, the term "same transaction" has been the subject of much interpretation.

A review of bankruptcy cases illustrates situations outside the utility deposit context in which courts have allowed creditors to exercise recoupment rights on the basis that cross claims are part of the "same transaction." For instance, the court allowed a lessee to withhold lease payments under the doctrine of recoupment in *In re Holford*.[79] In this case, the lessee maintained that the debtor, its landlord, had committed fraud in the inducement in entering the subject lease.[80] The lessee withheld payments to the debtor in an effort to recoup its damages. The court noted that the lessee "used rental payments due under the lease to recoup losses caused by fraud in the inducement of that same lease."[81] The court concluded that "clearly, the two amounts arose out of the same transaction."[82] In holding that the lessee had the right to recoup its damages, the court subscribed to a broad definition of the "same transaction" requirement, noting that "[t]here need not have been any express contractual right to withhold payments for the transaction to be a recoupment."[83]

Similarly, another court upheld a contractor's act in offsetting payments to the debtor- subcontractor in *In re A&C Electric Co.*[84] In analyzing the contractor's claim, the court provided a garden variety articulation of the doctrine of recoupment:

> Recoupment is a mechanism by which a party may calculate the proper amounts due from it by offsetting obligations which arise from the same transaction and which are essentially a defense to debtor's claim. The essential element for recoupment is that the debts must arise from the same transaction.
>
> The justification for the recoupment doctrine is that where the creditor's claim against the debtor arises from the same transaction as

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[79] 896 F.2d 176 (5th Cir. 1990).

[80] *See id.* at 178.

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] 211 B.R. 268 (Bankr. N.D. Ill. 1997).

> the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on set-off in bankruptcy would be inequitable.[85]

The debtor's primary argument against recoupment relied on the fact that the contractor's claim was based on extra work performed under the terms of the controlling subcontract, and that because the extra work was not explicitly addressed in the subcontract, the cross claims did not arise from the same transaction.[86]

Rejecting this position, the court noted that the terms of the subcontract were flexible, and allowed the contractor to make changes and order extra work.[87] The court concluded that "[i]n essence, changes or extras are simply an extension of the original contract."[88] The court found that the contractor was allowed to recoup its payments as arising under the "same transaction" as the debtor's cross claim.[89]

A contractor also asserted recoupment as a defense in an adversary proceeding by the debtor-subcontractor in *In re Newbery Corp.*[90] The contractor had used the debtor's tools and equipment postpetition, and the debtor filed an adversary proceeding seeking payment of rent for the contractor's use.[91] The contractor asserted that it was allowed to recoup damages based on the debtor's breach of the subcontract. The terms of the subcontract did not address any right on the part of the contractor to use or rent the debtor's equipment and tools.[92]

Although the subcontract did not provide a right on part of the contractor to rent the debtor's equipment, the court in *Newbery* concluded nonetheless that the contractor's cross claim was part of the "same transaction" as debtor's claim for rent.[93] The court supported this conclusion by noting that under the subcontract, contractor had a duty to mitigate damages, and that its use of the

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[85] *Id.* at 273 (citations omitted).

[86] *See id.* at 274.

[87] *See id.*

[88] *Id.*

[89] *See id.* at 275.

[90] 145 B.R. 998 (B.A.P. 9th Cir. 1992), *withdrawn*, 161 B.R 999 (B.A.P. 9th Cir. 1994).

[91] *See id.* at 1000.

[92] *See id.*

[93] *See id.* at 1001.

debtor's equipment and tools was engaged for that purpose.[94] The court explained its reasoning as follows:

> Because [the contractor] had a duty to mitigate damages, both claims arise out of the same transaction. [The contractor] hired another contractor and allowed the new contractor to use the Debtor's tools and equipment in order to mitigate damages to the extent reasonably possible. The Debtor's claim for rents would not have arisen had it not been for [the contractor's] use of the equipment. [The contractor] would not have used the Debtor's tools and equipment had it not been for the Debtor's breach of contract .... [Therefore], the two claims are integral to each other and cannot be severed.[95]

Based on the court's conclusion that the claim for rent and breach of contract claim arose out of the "same transaction," the court allowed the contractor to defend debtor's adversary proceeding by asserting the defense of recoupment.

In light of the foregoing, it is clear that a utility account and the deposit which secures that account are part of the "same transaction" for purposes of establishing a right to recoupment. Indeed, it is difficult to imagine a set of facts more clearly requiring the conclusion that a creditor's claim against a debtor is part of the "same transaction" than the deposit securing performance of a utility account scenario. In the context of a utility account, the utility agrees to and does in fact provide service in return for money. The customer, for his part, agrees to pay for the services consumed. The role of a deposit, whether dubbed "advanced pay" or "security," is nothing other than an integral part of the utility services agreement. A party arguing that a deposit is an obligation "independent" of the utility services account, an argument necessary for "setoff," is simply closing his eyes to the common sense import of the phrase "same transaction."

The conclusion that a utility account and deposit are part of the "same transaction" is bolstered by analysis under the "compulsory counterclaim" provision of Rule 13(a).[96] A simple example is illustrative. Assume that a utility customer provides a

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[94] *See id.*

[95] *Id.*

[96] *See* FED. R. CIV. P. 13(a) (providing that a defendant must assert a counterclaim "if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim").

$1,000 deposit to an electric utility to secure performance of his utility account. The customer then fails to make payments, and is in arrears to the utility in the amount of $1,500. The customer then files a lawsuit to recover his deposit. The issue is simple: Must the utility under Rule 13(a) assert its right to collect the amount owing on the utility account against the customer in this lawsuit? If so, the account and deposit must necessarily be part of the same "transaction or occurrence" that forms the basis of the customer's suit to recover the deposit. If not, the utility may simply defend the action and assert by separate lawsuit its right to recover the amount owing under the utility account. Given the courts' interpretation of the same transaction or occurrence element of Rule 13(a), it is inconceivable that a utility would have the option of bringing this counterclaim in a separate suit as a "permissive counterclaim" under Rule 13(b).[97] It is also worthy of note that in this context the term "transaction" is a word of flexible meaning, depending not so much on the immediateness of the connection of the two claims, as upon their logical relationship.[98] Indeed, it has been held that "[t]he spirit and intent of Rule 13(a) requires that the entire contractual relationship be deemed to be included within the word 'transaction' in cases sounding in contract."[99]

C. *Public Policy Favors the Recoupment of Prepetition Utility Deposits*

In addition to the overwhelming merits of the position that a utility deposit is part of the "same transaction" as the account which it secures, public policy also favors the courts to characterize the offset of a prepetition deposit as recoupment.

A primary policy argument in favor of characterizing the offset of prepetition deposits as "recoupment" embraces the reality of the routine nature of setoff under § 553. Specifically, if the offset of a prepetition deposit is characterized as "setoff," a utility will be required to expend efforts and money prosecuting a motion for relief. Given the fact that the Bankruptcy Code preserves a creditor's setoff rights, it is not surprising "that ordinarily [if a] utility seeks relief

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[97] *See* 10 COLLIER ON BANKRUPTCY ¶ 7013.02 (Lawrence P. King et al. eds., 15th ed. 1993).

[98] *See* Moore v. New York Cotton Exch., 270 U.S. 593, 610 (1926).

[99] King Bros. Prods. v. RKO Teleradio Pictures, 208 F. Supp. 271, 275 (S.D.N.Y. 1962).

from [the] stay so that it can set off the pre-petition deposit against the pre-petition debt [that] relief [will be] routinely granted."[100]

Because a utility will routinely succeed in procuring the court's approval of the exercise of its setoff rights, making utilities "go through the motions" creates unnecessary costs which will ultimately be borne by consumers in the form of rate increases. Temporarily delaying the exercise of the utility's right to apply a deposit against a delinquent account would seem to serve no purpose.

A second public policy basis for favoring the recoupment characterization involves the regulated nature of utilities. Customers often lack choice in determining which utility provider to use in obtaining utility services. Utilities facing the prospect of having to seek bankruptcy court approval as a prerequisite to applying prepetition deposits may rationally react in one or two ways. First, the utility may factor the inevitable cost of obtaining bankruptcy approval into the amount of the deposit it requires.[101] This could result in higher deposits being demanded of all customers. Second and more importantly, a utility facing the reality that its deposit may be, as a pragmatic matter, without value, may choose to terminate a customer in default rather than demand a deposit. This choice would be particularly rational in the case of a distressed customer, the very customer which needs continued service to keeps its operation moving forward. Customers whose services are disconnected will have nowhere else to turn for utility services.

VI. CONCLUSION

A deposit which is provided to secure the performance of a utility account is, quite simply, part of the "same transaction" as the account itself. Even under the most restrictive state law definition of recoupment, requiring that a right arise in "exactly the same" or in the "identical" transaction, the nature of a utility deposit affords the utility the right to recoup. Furthermore, public policy strongly supports a utility's ability to recoup a prepetition deposit against a prepetition debt owed to that utility. Especially in the realm of utility accounts, a transaction is a transaction is a transaction.

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[100] *In re* Norsal Indus., Inc., 147 B.R. 85, 88 (Bankr. E.D.N.Y. 1992).

[101] Although certain utilities are constrained by state law and regulation from demanding more than a certain amount, nothing requires these utilities to demand the maximum amount. *See generally*, Anderson, *supra* note 2.