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Exercising Rights to Setoff and Recoupment in Bankruptcy

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Current market conditions are straining business relationships in the oil and gas industry. In a growing number of cases, distressed companies are seeking chapter 11 bankruptcy protection. In that event, a creditor-debtor relationship is formed between the bankrupt company and the performing partner. For example, in the context of a joint operating agreement, an operator (the performing partner) may seek to recapture drilling costs from a non-operator (the bankrupt company). In these bankruptcy cases, the performing partner should consider its ability to offset debts with the bankrupt company through “setoff” or “recoupment”.

Setoff is simply a creditor's right to offset mutual debts. Setoff is captured in Section 553(a) of the Bankruptcy Code, which preserves a creditor's right to offset the mutual debts of the creditor and debtor provided that both debts (the debt owed by the creditor to the debtor and the debt owed by the debtor to the creditor) 1) arose before commencement of the bankruptcy case and 2) are mutual, meaning that both parties owe a debt to the other.¹ The mutual debt need not, however, arise out of the same transaction in order for setoff to be available under the statute.² In fact, debts subject to setoff generally arise from *different* transactions.³

For example, A and B are jointly developing two wells and A is the operator of the wells. One well, called Boom, is producing, but the other, called Bust, is not. Boom generates \$500,000 a month in revenue, but B owes A \$1 million for B's share of operating costs on Bust. In this case, setoff may allow A to withhold B's share of revenue from Boom and credit it to B's unpaid costs from Bust. This is because the purpose of setoff is to avoid “the absurdity of making A pay B when B owes A.”⁴

Setoff is limited in three ways. First, setoff is not a right created by the Bankruptcy Code.⁵ While Section 553(a) preserves a right to setoff, that right must first exist under “applicable non-bankruptcy law” (e.g. state law).⁶ Second, unlike recoupment (discussed below), a creditor can only offset pre-bankruptcy (pre-petition) debts. In other words, a creditor cannot use setoff to recover a pre-bankruptcy debt out of post-bankruptcy (post-petition) payments owed to the debtor.⁷ Third, a creditor's right to setoff is automatically stayed (i.e. suspended) when a debtor files for bankruptcy protection.⁸ Creditors seeking to setoff must first obtain relief from the automatic stay imposed by Section 362(a) of the Bankruptcy Code and should consult bankruptcy counsel to assist in that effort.

Recoupment is similar to setoff in that it recognizes the basic inequities of allowing a debtor to enjoy the benefits of a transaction without also meeting its obligations.⁹ But, recoupment only permits a creditor to

withhold funds to offset debts arising from the *same* transaction.¹⁰ Claims arise from the “same transaction” when both debts arise out of a single, integrated contract or similar transaction, such as a joint operating agreement.¹¹

For example, A operates a well and B is a non-operator with an obligation to reimburse A for 25% of the drilling costs. A incurs \$1,000,000 in costs and B fails to pay its \$250,000 share. If B files for bankruptcy protection, then A has a \$250,000 claim against the bankruptcy estate. In this case, recoupment may allow A to withhold B's revenues from the well and credit the revenues against the costs incurred by A. This example illustrates how recoupment functions like a security interest in that it grants priority to a creditor's claim in the bankruptcy estate, provided that the estate has a claim against the creditor arising from the “same transaction” as the creditor's claim.¹²

Recoupment has certain benefits that are unavailable under setoff. First, a creditor can exercise its right to recoupment without regard to the timing and other requirements of Section 553 of the Bankruptcy Code.¹³ Second, recoupment allows a creditor to recover a pre-bankruptcy debt out of post-bankruptcy payments owed to the debtor.¹⁴ Third, a creditor who properly exercises its right to recoupment will not violate the automatic stay imposed by Section 362(a) of the Bankruptcy Code.¹⁵ However, a creditor may wish to seek relief from stay to clarify its right to exercise recoupment and to avoid any uncertainty about the amount the creditor can recoup. Bankruptcy counsel can help a creditor analyze its right of recoupment and assist in seeking relief from the automatic stay.

¹¹ 11 U.S.C. § 553(a).

² *In re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990).

³ *Conoco, Inc. v. Styler (In re Peterson Distrib.)*, 82 F.3d 956, 959 (10th Cir. 1996).

⁴ *Citizens Bank v. Strumpf*, 516 U.S. 16, 18 (1995).

⁵ *Id.*

⁶ *Id.*

⁷ See 11 U.S.C. § 553(a).

⁸ 11 U.S.C. § 362(a)(7).

⁹ *Peterson Distrib.*, 82 F.3d at 960.

¹⁰ *In re Adamic*, 291 B.R. 175, 181-82 (Bankr. D. Colo. 2003).

¹¹ *Davidovich*, 901 F.2d at 1538.

¹² *Peterson Distrib.*, 82 F.3d at 960.

¹³ *Davidovich*, 901 F.2d at 1537.

¹⁴ *Beaumont v. VA (In re Beaumont)*, 586 F.3d 776, 780 (10th Cir. 2009).

¹⁵ *Id.* at 777.

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