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Recoupment – Back in Its Bankruptcy Box

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When the Court of Appeals for the Ninth Circuit recently stated that a payment deduction sought by the State of California "would obliterate the distinction between recoupment and setoff," it expressed a sentiment shared by many experienced bankruptcy practitioners confounded by the inability to separate the two doctrines. The Bankruptcy Code permits – but narrowly confines – a creditor's exercise of its common law right of setoff. Only pre-petition debts and claims can be offset and the act of making the deduction is subject to the automatic stay. Recoupment, on the other hand, is a defense *embedded within* a debt and is both exempt from the automatic stay and its exercise can cross the petition date divide. Naturally, then, if an offset can be recast as a recoupment, there are significant advantages to the creditor. Over time, as more and more offsets are labeled recoupments, the distinction between the two doctrines has been seriously eroded. The Ninth Circuit's decision in *In re Gardens Regional Hospital*, 975 F.3d 926 (9th Cir. 2020), has finally restored the proper boundaries between recoupment and setoff.

By way of background, a brief glossary will be useful. The Bankruptcy Code defines a "claim" broadly to include every right to payment, whether or not reduced to judgment, liquidated or unliquidated, fixed or contingent, matured or unmatured. A creditor is an entity that holds a claim against the debtor that arose prior to the commencement of the bankruptcy case. A "debt," on the other hand, is a liability on a claim. For purposes of setoff, the Code treats an obligation owed by a creditor to the debtor as a debt, whereas the obligation owed by the debtor to the creditor is a claim. Usually it will be advantageous for a creditor to reduce its debt by deducting the amount of its claim because a debt is payable in full to the estate, whereas a claim may receive only a negligible dividend from the estate. As the Supreme Court succinctly stated, setoff allows entities that owe each other money to apply their mutual debts again each other, "thereby avoiding the absurdity of making A pay B when B owes A." *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995).

Setoff is derived from common law rules of pleading under which parties to litigation are permitted to assert opposing claims. Recoupment, on the other hand, is an equitable doctrine that is intended to compute the "proper amount" of a particular claim. Section 553 of the Bankruptcy Code ensconces the right of setoff in all bankruptcy cases, subject to three key limitations. First, the offsetting obligations (the debt and the claim) must each have arisen before the bankruptcy petition is filed. A creditor cannot acquire, post-petition, a claim for purposes of offset. *See* Bankruptcy Code § 553(a)(2) (setoff prohibited to the extent that the claim against the debtor was transferred to the creditor owing a debt to the debtor "after the commencement of the case.").

Second, each of the obligations must be mutual – that is, they must be held by the creditor and the debtor standing in the same bilateral right and capacity. For example, if the creditor owes a debt wearing a "fiduciary" hat, yet holds a claim wearing a "vendor" hat, the required mutuality will be lacking. For the same reason, a "triangular" setoff (A owes Debtor, Debtor owes B, A offsets against B), will also fail. Similarly, each entity within a corporate family is treated separately for purposes of mutuality – if a corporate parent owes $10 to the debtor, but the debtor owes an affiliate or subsidiary of the parent $10, the parent may not satisfy the $10 debt by deduction against its affiliate's claim. (The agencies and branches of the U.S. government, however, are considered a "unitary" creditor.) Private contracts can neither create mutuality (for purposes of Section 553), nor opt-out of the mutuality requirement. *In re Orexigen Therapeutics,* 990 F.3d 748 (3rd Cir. 2021).

Third, the exercise of the right of setoff is subject to the automatic stay. In order to actually make a permanent deduction, the creditor must first seek relief from the stay. The Supreme Court in *Strumpf* permitted a creditor to temporarily "freeze" countervailing obligations (*i.e.,* preserve the status quo as of the petition date) without violating the stay until the outcome of a subsequent motion to lift the stay. Such an administrative hold, pending further instructions from the court or the parties, does not result in the permanent settlement of accounts that is needed for a setoff to actually occur.

Recoupment, unlike setoff, does not involve the netting of independent obligations but rather the determination of the proper liability on a claim. The competing obligations that give rise to recoupment must arise from the same transaction or occurrence. In order to meet this requirement, courts typically assess whether there is a "logical relationship" between the obligations. That test does not measure temporal proximity (*i.e.,* did the claims arise contemporaneously), but whether they are logically connected. If so, recoupment may be used to recover across the petition date divide and without any automatic stay perils.

Virtually every recoupment decision acknowledges that, as an equitable exception to the automatic stay, the doctrine must be "narrowly construed." Neither a single contract, nor the same parties, nor a similar subject matter, nor a shared legal framework necessarily satisfies the 'same transaction test' to permit recoupment. *In re University Medical Center*, 973 F.2d 1065 (3rd Cir. 1992). Nor, as *Gardens* has now established, will a statutory right of deduction of "any" debts or claims between two parties meet the same transaction test.

As might be apparent from the foregoing, applying these principles to varying factual patterns can lead to rather disparate results. Over time, the line separating setoff from recoupment has blurred. Now, *Gardens* teaches that one cannot "cross the payment streams" (to borrow a classic phrase from *Ghostbusters*). The payment streams must arise from the "very same acts" to meet the logical relationship test for recoupment. The mere fact that dueling payment streams can be cabined within a single contract, a single statute or even a single commercial relationship, is insufficient to qualify for recoupment.

The facts in *Gardens* were not complicated. The debtor operated Gardens Regional Hospital, a private, not-for-profit acute care hospital located in Hawaiian Gardens, California. The hospital participated in the State of California's Medicaid program, known as Medi-Cal. Under the Medi-Cal relationship, the hospital was paid for medical services under a fee-for-service ("FFS") model. Under that model, the State of California would retrospectively reimburse the hospital for the cost of treatment (either at negotiated rates, or pursuant to a regulatory scheme) provided by the hospital to Medi-Cal patients. (By contrast, under a managed care model, the State prospectively remits a fixed capitation payment to a hospital provider regardless of the ensuing need for, or actual cost of, care given to patients.)

As is common under the FFS model, from time to time in the normal course of business, the State might occasionally make an overpayment to a hospital provider. Overpayments can be due to patient ineligibility, inadvertent double-payments or inaccurate coding, among other reasons. Under the Medi-Cal system, the State is entitled to deduct overpayments mistakenly paid to the hospital from future FFS reimbursements due to a hospital. These overpayment adjustments, based on a constant account balancing process (*i.e.,* recurring payments due to and from a hospital for the provision of medical services), fit within the classic parameters of recoupment and, typically, continue unabated and unchallenged in most bankruptcy cases.

Separately, the hospital was also entitled to receive a supplemental Medi-Cal payment based on the State's assessment of a tax (specifically, a hospital quality assurance fee, or "QAF") on non-public acute care hospitals in the State. The QAF revenues were deposited in a segregated fund and later redistributed to a variety of beneficiaries (such as public hospitals, or health coverage for low-income children), including some of the same private hospitals that had contributed to the fund by paying the QAF assessments. Under the QAF program, the State was entitled to deduct any unpaid QAF assessments against ***any*** State payments owed to the hospital, whether or not derived from the QAF program.

At the time Gardens Regional Hospital filed its Chapter 11 case, it owed the State about $700,000 in missed QAF assessments. The State used this claim to reduce its Medi-Cal debts owed to the hospital, including the supplemental Medi-Cal payments the hospital was entitled to receive under the QAF program ***and*** the FFS reimbursements that it had earned. The hospital later filed a motion to compel payment of the withheld amounts because the State had violated the automatic stay by making an impermissible setoff across the petition date divide. The State countered that its deductions were recoupment and thereby exempt from the automatic stay.

At the outset, the *Gardens* court recognized that properly delimiting the border between setoff and recoupment would have important consequences in bankruptcy cases. As noted, recoupment is neither subject to the automatic stay nor restricted to pre-petition debts and claims (*i.e.,* it may be deployed across the petition date). A setoff typically arises from separate and distinct transactions. Recoupment, however, must arise from the same transaction or occurrence. A setoff entails the net adjustment of independent obligations. On the other hand, recoupment is a right to reduce the common nucleus of a single obligation.

The traditional test for recoupment asks whether the countervailing obligations enjoy a "logical relationship." In the Ninth Circuit, temporal immediacy has neither been required nor dispositive to qualify for recoupment. The Ninth Circuit, however, has also rejected, as overly restrictive, the "single integrated transaction" test adopted in the Third Circuit. But, the *Gardens* court cautioned that the test should not be applied "so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction." Indeed, to stretch the doctrine too far would impair a fundamental policy of bankruptcy law to promote equality of treatment among creditors.

The *Gardens* court dispatched the notion that a contract alone could provide the necessary linkage to permit the reduction of a post-petition debt on account of a pre-petition claim. That justification was rejected by the court in *Orexigen* in the setoff context and, now, by *Gardens* in the recoupment context. As the Ninth Circuit warned, by that logic, virtually any obligations referenced under a contractual umbrella could be recoupable – the exception (recoupment) would thus swallow the rule (Section 553). Similarly, a statutory right of deduction of "any" debts or claims is also insufficient, on its own, to create a right of recoupment.

So, what is the dividing line? According to the *Gardens* court, the crucial question is whether the two obligations at issue arise "*from the very same acts*." Coupled with other factors (such as a contractual relationship), this can create the "intertwined" legal and factual connections to permit recoupment. Applying that standard, the court had little difficulty concluding that the State's claim for unpaid QAF assessments was logically related to the State's debt for supplemental Medi-Cal payments. The deposit of QAF receipts into the QAF fund for distribution to QAF participants created a direct factual and legal "linkage between these two streams of money." Indeed, the circularity of the QAF program was unique, even though the amounts of the QAF assessment and the Medi-Cal supplemental payment were each independently calculated under separate, complex formulas. The QAF assessments were "paid *by* hospitals *into* the segregated funds and the supplemental payments [were] made *to* hospitals *from* those same funds." (emphasis in original).

On the other hand, the deduction of the unpaid QAF assessments against the FFS reimbursements was not a permissible recoupment. The FFS payments were not drawn from the same fund as the supplemental Medi-Cal payments, nor was there any "unique linkage" between the QAF program and the Med-Cal system – the court noted that the "fee-for-service system was an established part of California's Medi-Cal plan long before the QAF program, with its segregated funding, was established." Most importantly, however, the countervailing obligations did not arise from the "same acts." The QAF program was a self-contained, specialized and continuous funding vehicle with a distinct objective (to obtain greater federal Medicaid matching funds). The Medi-Cal system, by contrast, was based on differing medical services provided to individual patients from time to time pursuant to an autonomous rate structure.

According to the court, neither a statutory (*i.e.*, the State's right to offset any amount due to a State agency from any person or entity) nor a contractual underpinning (*i.e.*, the hospital's form provider agreement with the State) was enough to overcome the Bankruptcy Code. The court explained: "were we to accept California's contention that its statutory assertion of such a sweeping right of setoff *alone* establishes a sufficient logical relationship to warrant recoupment, we would effectively obliterate the distinction between recoupment and setoff and thereby exempt California entirely from the Bankruptcy Code's restrictions on setoffs." The court stressed that a factual link was critical – the competing obligations must arise from the same underlying actions.

One aspect of the *Gardens* decision that may prove helpful to debtors is the treatment of subrogation claims. As we know from Section 553(a)(2) of the Bankruptcy Code, the post-petition act of acquiring the pre-petition claim of another creditor, whether by transfer, subrogation or otherwise, does not permit the use of that claim for purposes of setoff. This result should also, practically by definition, establish the absence of the factual link needed for recoupment. After all, if the creditor/subrogee hadn't voluntarily inserted itself into the debtor-creditor relationship (the relationship between the debtor and the creditor/subrogor) there would be no factual connection at all between the debt and the new claim that the creditor might seek to recoup.

The *Gardens* court's refusal to further "expand the concept of recoupment" has reinforced the narrow strictures of recoupment. To supply the necessary logical relationship for recoupment, a creditor must demonstrate both a legal and factual connection between the competing obligations. Otherwise, the ability to recoup would encroach upon and undermine the core purposes of the Bankruptcy Code's limitations on setoff. At last, bankruptcy practitioners have a coherent and rigorous basis to disentangle setoff from recoupment.

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