Setoff is a right that allows a creditor to offset a prepetition debt owed to a debtor with its prepetition claim against the debtor. *See In re Luongo*, 259 F.3d 323, 334 (5th Cir. 2001). This remedy is aimed at preventing the inequitable and inefficient result that occurs when a creditor is forced to pay a 100% of its prepetition debt owed to a debtor, without resolving its prepetition claim. In such circumstances, the creditor is often forced to later prosecute its unresolved claim against the debtor and is commonly only awarded a fraction of the value of its claim.

This was the issue facing the Bankruptcy Court for the Northern District of Mississippi in *In re Roger Morris*, Case No. 18-10964 (Bankr. N.D. Miss. March 16, 2020) (Docket No. 149), where the Court was asked to decide whether the Government's setoff rights were timely exercised post-confirmation.

Facts

The debtor operated a farm that was enrolled in two government programs offered by the U.S. Department of

Mississippi Court Joins Majority of Courts Finding That Setoff Rights Survive Plan Confirmation

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Section 553 of the Bankruptcy Code, which governs setoff rights in bankruptcy, tries to balance this inequity. However, this remedy is not automatic, and action must be taken by a creditor in order to avail itself of its setoff rights. *See Citizens Bank of Md. v. Strumpf*, 516 U.S. 16 (1995). The timing of when to exercise this right can also be tricky. Indeed, Section 362(a)(7) of the Bankruptcy Code prevents a creditor from exercising its setoff rights without first seeking relief from the automatic stay. But, in a Chapter 11 case, if a creditor waits too long, it runs the risk that a confirmed Chapter 11 plan will attempt to cut off its setoff rights, as Section 1141 (which governs the effect of plan confirmation) generally vests property of the estate free and clear of any claims and discharges a debtor from all pre-confirmation debts. See 11 U.S.C. § 1141(b), (c) and (d). Moreover, most Chapter 11 plans attempt to cut off setoff rights, relying on the plan's re judicata effect to preclude any later prosecution of a setoff claim.

> The creditor is often forced to later prosecute its unresolved claim against the debtor and is commonly only awarded a fraction of the value of its claim.

Agriculture (USDA), which subsidized the debtor's corn, soybean and long grain rice production. The debtor signed a contract to enroll in each USDA program that provided that "[o]ffsets for debts owed to agencies of the U.S. Government shall be made prior to making any payments to participants or their assignees."

Pursuant to the USDA contracts, the debtor was owed a certain amount from the Government in 2017, but the Government withheld the payment (literally cut a check but did not send it) on account of debts owed by the debtor to the Government. Almost a year after the debtor confirmed

its plan of reorganization, the Government filed a motion for relief from the automatic stay in order to exercise its setoff rights.

The issue in the case was not whether the Government had valid setoff rights—which the debtor conceded. The issue was whether the Government had waited too long to exercise those rights. Specifically, the debtor argued, among other things, that the Government (a) could not exercise its setoff rights post-confirmation and (b) waived its setoff rights by participating in the confirmation process.

The Bankruptcy Court ultimately disagreed with the debtor.

Analysis

While Section 553 seemingly preserves the absolute right of setoff, some courts have held that a Chapter 11 plan is a final order that, under principles of *re judicata,* precludes a creditor from asserting setoff rights post-confirmation. See, e.g., *In re Lykes Bros S.S. Co. Inc.*, 217 B.R. 304, 310 (M.D. Fla. 1997). Similarly, the Third Circuit Court of Appeals has held that Section 1141 of the Code, which vests all property of

the estate in the debtor free and clear of claims upon confirmation, trumps Section 553 of the Code.

But, there is no controlling precedent in the Fifth Circuit. And, while the rule that setoff rights do not survive confirmation appears to hold true for the Third Circuit and lower courts in the Second and Eleventh Circuits, the majority rule articulated by Ninth and Tenth Circuit Courts of Appeals and followed by lower courts in the Fourth, Sixth, Seventh and Eighth Circuits appears to be the opposite. *See U.S. v. Munson*, 248 B.R. 343, 345 (C.D. Ill. 2000).

"Confirmation does not alone bar a "subsequent and otherwise valid assertion of a creditor's setoff rights."

According to the seminal case by the Ninth Circuit, "if Section 1141 were to precedence over Section 553, setoffs would be allowed under Chapter 11 only where they were written into a plan of reorganization," rendering Section 553 superfluous." *In re De Laurentiis Ent. Group, Inc.*, 963 F.2d 1269, 1277 (9th Cir. 1992). See also *In re Davidovitch*, 901 F.2d 1533 (10th Cir. 1990) (creditor could assert setoff right even post-discharge and even without filing a proof of claim).

The Court in *Morris* agreed with the majority approach and held that confirmation does not alone bar a "subsequent and otherwise valid assertion of a creditor's setoff rights."

However, even in jurisdictions that permit setoff post-confirmation, a creditor can waive the right to setoff by acting, or failing to act, in a manner that reflects "a knowing, voluntary and intentional relinquishment of that legal right." *In re BOUSA Inc.*, 2006 WL 2864964, at *4 (Bankr. S.D.N.Y. Sept. 29, 2006).

Common circumstances where courts have found a waiver include when a creditor:

- made payments to a debtor on its own debt and then later initiated a setoff action to recover them;
- failed to assert setoff rights in a proof of claim; or
- failed to object to a confirmed plan that expressly bars future setoff actions.

See, e.g., In re Holder, 182 B.R. 770, 777 (Bankr. M.D. Tenn 1995) (IRS waived setoff rights by entering into agreed order to allow debtor to use cash collateral that IRS had previously sought for setoff); *Lykes Bros. S.S. Co.,* 217 B.R. at 312 ("The filing of a proof of claim without asserting a setoff right constitutes a waiver of that right."); *Daewoo Int'l (Am.) Corp. Creditor Tr. v. SSTS Am. Corp.,* 2003 WL 21355214, at *5 (S.D.N.Y. June 11, 2003).

Here, none of the above circumstances were present, as the Government had (a) not made any payment to the debtor, (b) properly asserted its setoff rights in its proof of claim, and (c) not failed to object to a plan that extinguished setoff rights (as the debtor's plan was silent on this issue). While the Government had waited 10 months post-confirmation to assert its setoff rights, the Court found that this delay was based on the nature of agricultural disbursements (which are typically made on an annual basis), rather than "a knowing, voluntary and intentional relinquishment" of a known right. Accordingly, the Government had not waived its setoff rights and could assert them when it did.

Takeaway

While Section 553 of the Code seemingly makes the right of setoff easily applicable in bankruptcy cases, other sections in the Bankruptcy Code, as well as a body of case law, make its application more complicated. Considering potential waiver issues, as well as divergent treatment by various jurisdictions, it is not too early to start considering a creditor's setoff rights at the commencement of a case, rather than at the end. In Morris, while the Government had not effected it's setoff rights until after the debtor had confirmed its plan, it is clear that the Government had properly preserved its rights, early on, by withholding payment to the debtor and disclosing its setoff rights in its proof of claim. Lesson learned. ▪