

BY-LINED ARTICLE

Date of Incurrence of Debt Critical to Setoff Determination

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On Dec. 9, in *In re McKay*, the Bankruptcy Court for the Middle District of Florida addressed the setoff and recoupment rights of the estates of a debtor's deceased parents. The decedents' estates also sought relief from the automatic stay in order to withhold inheritance and other income from the debtor until such a time as the debtor repaid his debts to the estates.

The court held that the mother's estate was not entitled to setoff or recoupment based on when the debts were incurred, but that the father's estate was entitled to setoff through a pre-determined payment plan agreed upon before the debtor filed for bankruptcy. Both estates were denied relief from the automatic stay.

The Facts

According to the bankruptcy court's opinion, the debtor, David B. McKay, filed a petition for relief under Chapter 13 of the Bankruptcy Code on Nov. 24, 2008. David's father, Kenneth J. McKay, died before the debtor filed for bankruptcy, and a Louisiana limited liability company called McKay Properties LLC was formed as a vehicle for distributing Kenneth's assets and recovering debts owed to Kenneth from his heirs. David's mother, Patricia A. McKay, died after David filed for bankruptcy and, through her will, bequeathed certain assets to her heirs. Patricia's estate was raised in the probate court of Dallas County, Texas.

Before David's bankruptcy, on June 23 and June 30, 2005, Patricia lent David the sums of \$28,000 and \$22,000, respectively, the opinion said. At the time David filed for bankruptcy, \$47,683.46 remained outstanding on these loans. David did not execute any promissory notes or security agreements related to the loans. David also borrowed money from Kenneth prior to Kenneth's death. According to the claim asserted by McKay Properties against David's bankruptcy estate, at the time David filed for bankruptcy, \$42,164.03 remained unpaid by David under loans made by Kenneth. David did not execute any promissory notes or security agreements for the loans from his father.

David's sole sources of income, the opinion said, were distributions from the Patricia Estate and McKay Properties. These distributions, together with David's one-sixth ownership interest in McKay Properties, were the sole assets of David's bankruptcy estate.

In bankruptcy court, the Patricia Estate and McKay Properties argued that their claims against David's estate constituted secured claims by virtue of setoff rights, pursuant to the loans made by Patricia and Kenneth to their son before their deaths. As an alternative, the Patricia Estate and McKay Properties alleged they had rights of recoupment against David, and that they were entitled to relief from the automatic stay in order to enforce their setoff and recoupment rights.

The Court's Analysis

Sections 506(a) and 553 of the Bankruptcy Code govern whether the claims of the Patricia Estate and McKay Properties were secured based upon a right of setoff. Section 506(a)(1) provides that if a claim against a bankruptcy estate is subject to setoff under Section 553, then that claim is a secured claim up to the amount of the debt owed to the creditor. Section 553 preserves the right of common law setoff and, as noted by the U.S. Supreme Court in *Citizens Bank of Md. v. Strumpf*, allows entities that owe each other mutual debts to set off one debt against the other, thereby avoiding the absurdity of making A pay B when B owes A.

Three elements must be present for the right of setoff to arise under Section 553. First, the parties must owe mutual debts to each other. Second, the debts must have arisen before the debtor files a bankruptcy petition. Third, the setoff must not fall within one of the three exceptions listed in subsections 553(a)(1), (2) and (3).

The Patricia Estate

Patricia's will, the opinion said, prohibited the payment of specific bequests to any of her three children until David repaid the money he owed his mother: "I have loaned the sum of \$50,000.00 to David Blaine McKay. My Executor is directed to determine the outstanding balance, if any, of each such debt, and collect such outstanding balance prior to making any distributions to either Anna Katherine McKay Edmunds, Clair McKay Beach, or David Blaine McKay." Patricia's will also provided for a distribution of her residuary estate to her children, and did not condition this distribution upon the repayment of any loans.

In addressing the Patricia Estate's right of setoff, the court determined that the Patricia Estate did not satisfy the requirements of Section 553. The court noted that the debts owed by David to the Patricia Estate and by the Patricia Estate to David did not both arise before David's bankruptcy filing, as required by Section 553: David's debts to Patricia arose pre-petition, but Patricia died after the petition was filed. Consequently, the sums "owed" to David under Patricia's will did not arise until after the petition date. Under these circumstances, the court found that the requirements of Section 553 were not satisfied, and the Patricia Estate was not entitled to a setoff.

Further, the court noted that setoff pursuant to Section 553 is not mandatory, but rather is within the discretion of the court. The court found that the potential impact on other creditors of David's bankruptcy estate was relevant to whether the Patricia Estate should be entitled to setoff. Finding that it would be unfair to David's other unsecured creditors for the claim of the Patricia Estate to be paid in full (while these creditors would not achieve a 100 percent distribution), the court held that setoff was not available to the Patricia Estate.

Next, the court addressed whether the Patricia estate was entitled to exercise the common law right of recoupment against David's bankruptcy estate. The court cited to *In re SunCruz Casinos LLC*, a bankruptcy case from the Southern District of Florida, for the proposition that "recoupment requires that the mutual obligations involved arise out of the same transaction or occurrence, regardless of whether the respective claims both arose pre- or post-petition."

In order for a claim to qualify as a recoupment action, the debtor's claim and the creditor's claim must have arisen from the same transaction; the creditor must assert its claim as a defense to the debtor's claim; and the "main action" must be timely. The court concluded that there was no integrated transaction between David and the Patricia Estate, and the Patricia Estate was attempting to use recoupment as a basis for affirmative relief, rather than as a defense to David's claim.

Finally, the court found that the Patricia Estate was not entitled to relief from the automatic stay, and ordered that the Patricia Estate distribute David's inheritance benefits to David. The court held unenforceable the requirement that David pay the debt he owed to Patricia before he could receive his inheritance.

McKay Properties

Before David's bankruptcy petition, in June 2005, counsel to Kenneth's probate estate sent a letter to David setting forth the amount David still owed to his father. The letter showed that David had a beginning indebtedness of \$89,780. The letter acknowledged that David received allocations of income on account of David's one-sixth membership interest in McKay

Properties. The letter proposed that 50 percent of David's monthly income from McKay properties be withheld and applied to David's indebtedness to Kenneth on a 100 month amortization schedule. The letter requested that David provide his approval of those terms; and David did not object to the letter, thereby tacitly agreeing to its terms. Pursuant to this understanding, McKay Properties made distributions to David pursuant to the terms of the letter from 2005 to 2008.

McKay Properties argued that its claim against David's bankruptcy estate was a secured claim by virtue of a right of setoff. As to McKay Properties, the court found that the three elements of setoff had been satisfied. First, David and McKay Properties owed mutual debts to one another: McKay Properties owed David monthly income on account of his ownership interest; and David was indebted to McKay Properties based on Kenneth's loans to David. In addition, David agreed to the terms of the June 2005 letter agreement. Second, both of these debts were incurred before David filed for bankruptcy. Third, the court found that none of the statutory exceptions to setoff applied to this case.

Because the court found that McKay Properties had a right of setoff against David's bankruptcy estate, the court determined that McKay Properties' \$42,164.03 claim was a secured claim. In order to satisfy its secured claim against David's estate, McKay Properties was permitted to apply David's income distributions from McKay Properties against David's indebtedness pursuant to the allocation scheme established in the June 2005 letter agreement. The court did not permit McKay Properties to retain David's entire monthly income distribution from McKay Properties, reasoning that allowing McKay Properties to do so would be detrimental to David's other creditors.

Conclusion

The In re McKay case provides clear parameters for a creditor's right of setoff. The case is instructive because it compares two apparently similar scenarios, and reaches two different results based on the dates on which the debtor's claims against two distinct creditors arose.

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