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## Recoupment and Bankruptcy: How to Effectuate Bankruptcy Policy through the Same Transaction Test

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## NOTE

# Recoupment and Bankruptcy: How to Effectuate Bankruptcy Policy Through the Same Transaction Test

*Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 981 (8<sup>th</sup> Cir. 2012)

JACOB THESSSEN\*

### I. INTRODUCTION

Mixing the federal Bankruptcy Code with common law claims can certainly be a precarious endeavor. The complexity of applying common law doctrines to bankruptcy cases is apparent when a defendant invokes the defense of recoupment to reduce his liability against a bankrupt plaintiff's claim.

Recoupment has been described as a “powerful tool” in bankruptcy, capable of seriously influencing an individual's income or an organization's ability to reorganize.<sup>1</sup> In essence, the common law equitable doctrine of recoupment allows a “creditor's claim against a debtor to be reduced by reason of some claim the debtor has against the creditor.”<sup>2</sup> It was first applied under the Bankruptcy Code in the 1980's and has since become well established.<sup>3</sup> More recently, however, a number of courts have shown a “judicial distaste” for the doctrine and have refused to allow defendants to successfully utilize the recoupment defense against bankrupt plaintiffs.<sup>4</sup> Some scholars would seek to abolish recoupment completely or, at the least, severely limit its scope in the context of bankruptcy.<sup>5</sup>

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1. Marvin E. Sprouse III, *Governmental Recoupment: An Equitable Remedy with an Equitable Result?*, AM. BANKR. INST. J., Oct. 26, 2007, at 12, 57.

2. Harold L. Kaplan & Timothy R. Casey, *Recoupment in Health Care Bankruptcies: A Shrinking Issue?*, AM. BANKR. INST. J., Oct. 26, 2007, at 16.

3. Shalom L. Kohn, *Recoupment Re-Examined*, 73 AM. BANKR. L.J. 353, 353 (1999).

4. *Id.*

5. Craig H. Averch & Blake L. Berryman, *Getting Out of the Code: When Equitable Remedies Obtain Priority over General Unsecured Claims*, 5 J. BANKR. L. & PRAC. 285, 300 (1996) (“The historical preference of recoupment claimants over other general unsecured creditors in bankruptcy finds no support in the Bankruptcy

This Note will explore the interaction between recoupment and bankruptcy by focusing on the Eighth Circuit's decision in *In re Terry*.<sup>6</sup> *Terry* is significant because the Eighth Circuit allowed an insurance company to recoup pre-petition overpayments from the bankrupt debtor's post-petition benefits.<sup>7</sup> In doing so, the Eighth Circuit refused to acknowledge a separate balancing of the equities test, independent from the traditional same transaction requirement, when determining a creditor's recoupment defense.<sup>8</sup>

This discussion will center on recoupment's "same transaction" test and why it can be utilized to achieve sound bankruptcy policy by denying recoupment claims. It is this Note's contention that *Terry*'s precedent, that the doctrine of recoupment does not include a separate equitable balancing test, will not be as devastating to bankrupt plaintiffs as initially thought by bankruptcy practitioners and judges. This is because the same transaction test is still a viable legal tool capable of denying recoupment.

## II. FACTS AND HOLDING

As an employee of the State of Missouri and member of the Missouri State Employees' Retirement System (MOSERS), Joseph Terry received a group long-term disability policy through Standard Insurance Company (Standard).<sup>9</sup> In the event of a disability, the Long Term Disability (LTD) policy provided eligible employees a monthly long-term benefit for the purpose of protecting the disabled employees' earning abilities and bridging the gap between the date a disability occurred and the date of recovery or retirement.<sup>10</sup>

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Code, and little or none in logic or policy. Unless the holder of a recoupment right satisfies the requirements for an allowable setoff, or the debtor assumes the underlying contract, the creditor is in the same legal position as all other general unsecured creditors. The extra-statutory doctrine by which recoupment creditors get special treatment undermines the fundamental policy of treating similar creditors similarly, and the doctrine should be rejected."); Kohn, *supra* note 3, at 353-54 ("[A]lthough there is an appropriate scope for the recoupment doctrine, it is far narrower than under the current state of the law. More specifically, this Article will contend that although recoupment should be permitted when the creditor's claim is sought to be recouped against prepetition amounts it owed the debtor, it should not be allowed to permit a prepetition creditor to be paid off by recouping against goods or services provided by the debtor postpetition.").

6. *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961 (8th Cir. 2012).

7. *Id.* at 965.

8. *Id.*

9. *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 818 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

10. MOSERS, *Long Term Disability Handbook: Coverage Available to Eligible Employees* 4 (Mar. 2013), available at <https://www.mosers.org/Members/Benefits/Long-Term-Disability.aspx> [hereinafter *LTD Handbook*].

Similar to most long term disability plans,<sup>11</sup> Standard's policy included a setoff provision that classified Social Security benefits as "deductible income."<sup>12</sup> This means that Standard's obligation to pay the disabled employee was reduced, dollar-for-dollar, by any amount the employee received from social security disability insurance.<sup>13</sup> Under the LTD policy, it was the obligation of the disabled employee to refund Standard for any overpayment of benefits that resulted from collecting social security income.<sup>14</sup>

Terry became disabled and unable to work on December 6, 2005, as the result of severe bipolar disorder with psychotic features.<sup>15</sup> He subsequently filed a long-term disability claim under the LTD policy. After the insurance company approved the claim, Terry began receiving benefits from Standard in August of 2006.<sup>16</sup> Pursuant to the deductible income provision of the LTD policy, Terry authorized Standard to automatically withdraw from his bank account any retroactive Social Security disability payments he received in order to satisfy the resulting "overpayment" of benefits obligation.<sup>17</sup> In July 2008, Terry received a \$45,316.54 lump-sum award of Social Security disability benefits retroactively dated to June 1, 2006.<sup>18</sup> Consistent with Terry's prior authorization, Standard withdrew \$45,316.54 from the Debtor's bank account on July 24, 2008.<sup>19</sup> One week later, Terry filed for bankruptcy.<sup>20</sup>

On April 20, 2009, the bankruptcy trustee sent a demand letter to Standard.<sup>21</sup> The trustee characterized the retroactive Social Security payment as a voidable preference under section 547 of the Bankruptcy Code<sup>22</sup> and instruct-

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11. Robert E. Hoskins, *Long-Term Disability Offsets: What to Look for from a Claimant's Perspective*, S.C. LAW., Sept. 2009, at 24, 26.

12. *LTD Handbook*, *supra* note 10, at 6.

13. *Terry v. Standard Ins. Co. (In re Terry)*, No. 08-43123, 2010 WL 2891710, at \*1 (Bankr. W.D. Mo. July 21, 2010) *rev'd*, 443 B.R. 816 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

14. *LTD Handbook*, *supra* note 10, at 8.

15. *Terry v. Standard Ins. Co. (In re Terry)*, 453 B.R. 760, 762 (Bankr. W.D. Mo. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

16. *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 818 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

17. *Terry*, 2010 WL 2891710, at \*1.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at \*2.

22. *Id.* A bankruptcy trustee is armed with the power to avoid (make the creditor return the transferred amount/goods to the debtor) pre-bankruptcy preferential transfers made by the bankrupt debtor to a creditor under 11 U.S.C. § 547. Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 713 (1985). In order for a trustee to avoid a preferential transfer, the transfer must be:

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

ed Standard to return the \$45,316.54 it withdrew from Terry's account pre-petition.<sup>23</sup> Standard immediately complied, apparently with little or no resistance, and sent the money to the trustee.<sup>24</sup> After Standard transferred the \$45,316.54 to the trustee, the insurance company began to deduct \$430.20 each month from Terry's post-petition disability benefits in order to recover the amount of the retroactive Social Security benefits forfeited to the trustee.<sup>25</sup> Standard ceased these deductions and repaid Terry the benefit withholdings after the bankruptcy court voiced its concern that Standard may have violated the automatic stay.<sup>26</sup>

On July 30, 2009, Terry commenced an action against Standard in the United States Bankruptcy Court of Western Missouri seeking, in relevant part, a declaratory judgment requiring Standard to pay, without any deductions based on Social Security payments, all of his future disability benefits as provided under the MOSERS LTD plan.<sup>27</sup> Standard asserted the right of recoupment as a defense against Terry's claim for post-petition insurance payments, arguing that Terry owed the company \$45,316.54 for pre-petition overpayments under the insurance policy.<sup>28</sup>

The bankruptcy court granted Terry's declaratory judgment and found that Standard did not have the right to recoup \$45,316.54 from Terry's claim for future benefits.<sup>29</sup> Because there was, in fact, a transfer of \$45,316.54 from the debtor to the creditor before the bankruptcy filing in this case, the court concluded that Terry's overpayment obligation was already satisfied.<sup>30</sup> The dispositive issue, therefore, was whether Standard could assert a claim

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- (3) made while the debtor was insolvent;
  - (4) made –
    - (A) on or within 90 days before the date of the filing of the petition; or
    - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
  - (5) that enables such creditor to receive more than such creditor would receive if –
    - (A) the case were a case under chapter 7 of this title;
    - (B) the transfer had not been made; and
    - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (2006). *But see* § 547(c), (i) for exceptions.

23. *Terry*, 2010 WL 2891710, at \*1.

24. *Id.* at \*2.

25. *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 962 (8th Cir. 2012).

26. *Id.* The automatic stay is a mechanism of section 362(a)(1) of the Bankruptcy Code that prevents a creditor from bringing an action against the debtor after the debtor has filed for bankruptcy. 11 U.S.C. § 362(a)(1).

27. *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 819 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

28. *Terry*, 2010 WL 2891710, at \*2.

29. *Id.* at \*4.

30. *Id.* at \*2.

through section 502(h) of the Bankruptcy Code.<sup>31</sup> According to the court's interpretation, the statutory language of section 502(h) and the Eighth Circuit's decision in *U.S. Postal Service v. Dewey Freight System, Inc.*<sup>32</sup> did not permit recoupment.<sup>33</sup> The court further justified its holding, denying Standard's recoupment claim, as being consistent with the purpose of the Bankruptcy Code to facilitate equal distribution among creditors.<sup>34</sup>

Standard appealed the adverse decision to the Eighth Circuit's Bankruptcy Appellate Panel (BAP),<sup>35</sup> which found some major flaws in the legal analysis of the bankruptcy court's opinion.<sup>36</sup> The BAP stated that the bankruptcy court erred in holding that section 502(h) of the Bankruptcy Code precluded Standard from recouping the overpayment from Terry.<sup>37</sup> Additionally, the BAP concluded *Dewey's* precedent was inapplicable to the present case.<sup>38</sup>

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31. *Id.* Section 502(h) of the Bankruptcy Code allows a creditor to recover a preferential transfer and satisfy its claim through the defense of recoupment. *Id.* at \*3. 11 U.S.C. § 502(h) states:

A claim arising from the recovery of property under section 522, 550, or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

32. 31 F.3d 620 (8th Cir. 1994). *See infra* notes 130-143 and accompanying text for a discussion of this case.

33. *Terry*, 2010 WL 2891710, at \*3. Although *Dewey* involved section 502(g)(1) instead of 502(h), the court explained that this distinction was not vital because the circumstances were analogous and that 502(g)(1) contained the same operative language as 502(h). *Id.*

34. *Id.* (“[I]t would be inimical to that purpose to interpret § 502(h) in such a way that would permit that creditor to once again obtain preference over other creditors by use of the doctrine of recoupment.”).

35. *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 818 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012). Depending on the jurisdiction, a federal bankruptcy court's ruling may be appealed to the district court, or, a bankruptcy appellate panel (BAP). *The Appeals Process*, U.S. COURTS, <http://www.uscourts.gov/FederalCourts/UnderstandingtheFederalCourts/HowCourtsWork/TheAppealsProcess.aspx> (last visited June 15, 2013). BAPs have been established by several courts of appeal to directly review cases from bankruptcy courts. *Id.* No matter which entity reviews the bankruptcy court's decision (the district court or BAP), the losing party may, thereafter, appeal to the federal circuit court. *Id.*

36. *See Terry*, 443 B.R. at 820.

37. *Id.* at 820. According to the BAP, the Bankruptcy Code's termination of Standard's affirmative claim under section 502(h) had no effect on the common law defense of recoupment. *Id.* (quoting *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993)) (“[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.”).

38. *Id.* at 821. The reason recoupment was not allowed in *Dewey* was because the creditor's claim arose from the “[d]ebtor's failure to perform its *future* contractual

Since both parties' rights and obligations arose under the LTD plan and Terry did not adequately argue that the parties' obligations were not sufficiently distinct, the BAP determined that Standard's recoupment claim met the requirement that both debts arise from the same transaction.<sup>39</sup> The BAP went on to emphasize the equitable nature of recoupment and how the doctrine should be narrowly construed in bankruptcy.<sup>40</sup> The case was remanded back to the bankruptcy court so it could properly balance the equities to determine if recoupment was appropriate.<sup>41</sup> The BAP's opinion concluded by offering some relevant considerations the bankruptcy court should examine when balancing the equities.<sup>42</sup> This guidance was highly preferential to Terry.<sup>43</sup>

On remand, the bankruptcy court employed a balancing approach and found that the equities weighed in favor of Terry for two reasons.<sup>44</sup> The first was transactions based: allowing Standard's recoupment claim would essentially force Terry to repay his debt a second time, and, not to mention, Standard failed to put up any sort of fight when it immediately sent the money to the bankruptcy trustee.<sup>45</sup> The second rationale centered on Terry's medical prognosis, bleak employment prospects and minute income.<sup>46</sup> In the end, the court felt that the hardship imposed on Terry by the recoupment claim was too severe and held that "Standard [wa]s simply in a better position to sustain this loss."<sup>47</sup>

The Eighth Circuit reversed and held that Standard was entitled to invoke the common law equitable defense of recoupment because the obligations of both Terry and Standard arose under the same transaction, the LTD plan.<sup>48</sup> Thus, Standard would be able to offset the \$45,316.54 in "overpayments" Terry owed it under the deductible income provision of the LTD plan

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commitments, a failure that is inextricably tied to its status as a chapter 11 debtor." *Id.* (quoting *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994)). It was clear to the BAP that Terry's obligation was akin to a mere "overpayment" and was not "inextricably tied to [his] status as a debtor in bankruptcy." *Id.* (internal quotation marks omitted).

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *See id.* The BAP surmised that it may be inequitable to allow recoupment because "Terry would be required to repay the funds a second time . . . [and] allowing recoupment might compromise the debtor's fresh start" and "Standard did not defend itself against the trustee's preference demand." *Id.*

44. *See Terry v. Standard Ins. Co. (In re Terry)*, 453 B.R. 760, 763-64 (Bankr. W.D. Mo. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

45. *Id.* at 763.

46. *Id.* at 764.

47. *Id.*

48. *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 965 (8th Cir. 2012).

against Terry's claim for future benefits.<sup>49</sup> Of crucial importance, the Eighth Circuit made clear that an equitable balancing test was unnecessary because the singular requirement for recoupment, that both party's claims arise from the same transaction, already incorporates elements of "[f]airness and equity" into the doctrinal analysis.<sup>50</sup>

### III. LEGAL BACKGROUND

#### A. *The Doctrine of Recoupment and Its Application in Bankruptcy*

The common law defenses of recoupment and its more familiar colleague, setoff, are ostensibly similar. As put by the bankruptcy court in *Terry*, both doctrines are defenses employed by "a defendant to reduce or extinguish a plaintiff's claim by reason of a claim the defendant has against the plaintiff."<sup>51</sup> However, significant distinctions between the two remedies do exist and are significant for purposes of the Bankruptcy Code.

First, the Bankruptcy Code's automatic stay enjoins "the *setoff* of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor."<sup>52</sup> In contrast, the automatic stay provision does not expressly apply to recoupment, and, consequently, most courts have held that a creditor may exercise the right of recoupment without restraint.<sup>53</sup>

Second, unlike setoff, recoupment does not require mutuality of obligations.<sup>54</sup> Recoupment allows a pre-petition obligation to be "recouped" from a post-petition claim.<sup>55</sup> Setoff, on the other hand, requires that both obligations must arise at the same time, either pre-petition or post-petition, because section 553 of the Code prohibits its use unless the right of the creditor stems from a "mutual debt."<sup>56</sup> A helpful illustration can be seen under the facts of the instant case. Joseph Terry's obligation to refund Standard the amount of the social security overpayment occurred pre-petition or before he filed for

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49. *See id.*

50. *Id.*

51. *Terry v. Standard Ins. Co. (In re Terry)*, No. 08-43123, 2010 WL 2891710, at \*2 (Bankr. W.D. Mo. July 21, 2010), *rev'd*, 443 B.R. 816 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

52. 11 U.S.C. § 362(a)(7) (2006) (emphasis added).

53. Averch & Berryman, *supra* note 5, at 293 (citing *Holford v. Powers (In re Holford)*, 896 F.2d 176, 179 (5th Cir. 1990); *Lee v. Schweiker*, 739 F.2d 870, 875-876 (3d Cir. 1984); *Rooster, Inc. v. Raphael Roy, SRL (In re Rooster, Inc.)*, 127 B.R. 560, 570 (Bankr. E.D. Pa. 1991); *Brock v. Career Consultants, Inc. (In re Career Consultants, Inc.)*, 84 B.R. 419, 426 (Bankr. E.D. Va. 1988)).

54. *Id.* at 289.

55. *Terry*, 2010 WL 2891710, at \*2.

56. 11 U.S.C. § 553(a).



bankruptcy.<sup>57</sup> Conversely, Terry's claim against Standard sought a judgment to pay him post-petition benefits.<sup>58</sup> Accordingly, Standard had to assert the defense of recoupment to recover against Terry's suit for future, post-petition benefits because the mutuality requirement for setoff was not met.<sup>59</sup>

Thus, because recoupment does not require mutuality of obligations and is not subject to the automatic stay in bankruptcy, recoupment is strikingly favored in bankruptcy over setoff.<sup>60</sup> As the authors of one journal article put it, for a defendant in bankruptcy court, "Setoff Is Good, Recoupment Is Better."<sup>61</sup>

It is only fitting, then, that the highly preferred doctrine of recoupment should be burdened with an extra requirement. For recoupment to apply, the parties' obligations must arise from the same transaction.<sup>62</sup> This third distinction, the same transaction test, does not apply to the doctrine of setoff.<sup>63</sup> The right to a setoff can arise both when the parties' obligations constitute a single transaction and when they are based on separate transactions.<sup>64</sup> Thus, when a creditor's claim fails to give rise to a setoff because the obligations of the parties are not mutual, the recoupment defense can still be successfully used only if the same transaction test is met.<sup>65</sup>

As the singular requirement for recoupment (besides having a claim against the petitioner in the first instance), the same transaction test is usually determinative in recoupment cases.<sup>66</sup> Although the same transaction test is crucial to the defendant's recoupment defense, the legal bounds of the requirement are not quite clear.<sup>67</sup> Legal scholars explain, "[t]here is no general standard governing whether events are part of the same or different transactions for purposes of applying recoupment."<sup>68</sup> Given the "equitable nature of the doctrine," recoupment can be permitted only after a court has examined the facts and the equities of each case.<sup>69</sup> Furthermore, judges across the country disagree on the correct application of the test: while some courts give the test a "liberal and flexible construction,"<sup>70</sup> other jurisdictions use the

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57. *Terry*, 2010 WL 2891710, at \*1.

58. *Id.*

59. *Id.* at \*2.

60. Averch & Berryman, *supra* note 5, at 289, 293.

61. *Id.* at 293.

62. *Terry*, 2010 WL 2891710, at \*2.

63. Averch & Berryman, *supra* note 5, at 289.

64. *Id.*

65. *See id.* at 288.

66. *Id.* at 293-94.

67. Sprouse III, *supra* note 1, at 12.

68. 9C AM. JUR. 2D *Bankruptcy* § 2746 (2013).

69. *Id.*

70. *Id.*

phrase “same transaction” as a “term of art that must be narrowly defined for recoupment purposes in bankruptcy.”<sup>71</sup>

The Eighth Circuit has adopted the position that “[t]o justify recoupment in bankruptcy, ‘both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.’”<sup>72</sup> Likewise, the Eighth Circuit has stated, “[a] fundamental tenet of bankruptcy law is that a petition for bankruptcy operates as a ‘cleavage’ in time. Once a petition is filed, debts that arose before the petition may not be satisfied through post-petition transactions . . . Any recoupment exception to this general principle perhaps should be narrowly construed.”<sup>73</sup> This approach to recoupment is known as the “integrated transaction test.”<sup>74</sup>

The leading case on the application of the integrated transaction test is *In re University Medical Center*.<sup>75</sup> In that case, the Department of Health and Human Services (HHS) withheld Medicare payments owed to University Medical Center (UMC) for post-petition services on the basis that it overpaid UMC for pre-petition services.<sup>76</sup> After reasoning that a strict recoupment standard was “in accord with the principle that this doctrine, as a non-statutory, equitable exception to the automatic stay, should be narrowly construed,”<sup>77</sup> the court denied HHS’s recoupment claim.<sup>78</sup> Specifically, the Third Circuit held that the ongoing relationship between Medicare and UMC was insufficient for purposes of the same transaction test because UMC’s current and future reimbursements were “independently determinable” and “completely distinct” from the overpayments made by Medicare in the past.<sup>79</sup>

In *In re University Medical Center*, the Third Circuit expressly rejected the alternative approach to the integrated transaction test, the more liberal and flexible “logical relationship test.”<sup>80</sup> The court concluded, “[A] mere logical relationship is not enough: the fact that the same two parties are involved, and that a similar subject matter gave rise to both claims, . . . does not mean that

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71. *Id.*

72. *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 963 (8th Cir. 2012) (quoting *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994)).

73. *U.S. Postal Serv.*, 31 F.3d at 623 (quoting *In re B & L Oil Co.*, 782 F.2d 155, 158 (10th Cir. 1986)).

74. COLLIER ON BANKRUPTCY ¶ 553.10 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2013).

75. *Id.* (citing *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065 (3d Cir. 1992)).

76. *Univ. Med. Ctr.*, 973 F.2d at 1070.

77. *Id.* at 1081.

78. *Id.*

79. *Id.*

80. *Id.*

the two arose from the same transaction.”<sup>81</sup> Under this more lenient logical relationship standard, courts are more likely to allow recoupment because the parties’ obligations need only be “sufficiently interconnected.”<sup>82</sup>

The doctrine of recoupment inherently conflicts with a major policy objective of the Bankruptcy Code that equally situated creditors be treated equal.<sup>83</sup> The Supreme Court reinforced this fairness notion when it held that “[e]quality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor’s property.”<sup>84</sup> With recoupment, a creditor can circumvent this equality of distribution purpose and receive preferential treatment by recovering the full amount of the debt (if recoupment is permitted) as opposed to receiving a pro rata share of the debtor’s liquidated assets like other general unsecured creditors.<sup>85</sup> As discussed earlier, the favoritism shown to recoupment in the bankruptcy process, most notably the opportunity to bypass the Code and recover more than other equally situated creditors, is buttressed by the requirement that the parties’ obligations arise from the same transaction.<sup>86</sup> The Eighth Circuit explains, “To prevent a bankrupt’s creditors from using recoupment to gain unwarranted preferences, courts require that ‘the creditor . . . have a claim against the debtor that arises from the same transaction as the debtor’s claim against the creditor.’”<sup>87</sup>

### B. Narrowing the Same Transaction Test

It can certainly be said that the same transaction test has “evolved into a fluid concept whereby a court that wants to permit recoupment finds it part of the same transaction, while a court that disfavors recoupment finds some means of holding that two transactions are involved.”<sup>88</sup> Courts have engaged in what has been called the “stretching” and “narrowing” of the same transaction principle in order to achieve what they feel is sound bankruptcy policy.<sup>89</sup> It is likely that those who preclude recoupment by narrowing the scope of the same transaction test do so for two reasons. First, recoupment can frustrate a debtor’s fresh start,<sup>90</sup> and, second, recoupment bypasses the Bankruptcy

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81. *Id.* (internal quotation marks omitted).

82. COLLIER ON BANKRUPTCY, *supra* note 744.

83. *See, e.g.*, H.R. REP. NO. 95-595, pt. II.C, at 19 (1977).

84. *Begier v. I.R.S.*, 496 U.S. 53, 58 (1990).

85. *Averch & Berryman*, *supra* note 5, at 285.

86. *See supra* notes 60-62 and accompanying text.

87. *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994) (quoting *In re NWFEX, Inc.*, 864 F.2d 593, 597 (8th Cir. 1989)).

88. *Kohn*, *supra* note 3, at 358.

89. *Id.*

90. *See Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 821 (B.A.P. 8th Cir. 2011), *reh’g denied*, (Feb. 15, 2011), *rev’d*, 687 F.3d 961 (8th Cir. 2012).

Code's objective that one creditor should not be given preferential treatment over similarly situated creditors.<sup>91</sup>

Multiple courts have fashioned a narrow version of the same transaction test in order to follow the design of the Bankruptcy Code and deny recoupment. A Ninth Circuit bankruptcy appellate panel went to great lengths in *In re California Cannery & Growers* to rationalize its holding that the same transaction test was not met, even though the parties' obligations arose from the same distribution agreement.<sup>92</sup> The court reasoned that the two parties' claims constituted a number of steps in "separate and distinct transactions" and that "[t]he goods in California Cannery's post-petition invoice are not the same goods as in Military Distributors' pre-petition invoices."<sup>93</sup> In addition, the court pointed out that allowing defendant Military Distributors to recoup the payments would "permit anyone to offset post-petition claims against pre-petition claims. This would result in preferential treatment among creditors."<sup>94</sup>

*In re Malinowski* involved a debtor who moved for an order requiring the state labor department to turn over funds that the department withheld from debtor's unemployment insurance benefits to recover overpayments made to the debtor pre-petition.<sup>95</sup> After rejecting a same-contract-equals-same-transaction test and examining the context of the obligations at issue, the court also discussed equitable factors and stated, "[I]n light of the equitable nature of the recoupment remedy, the facts in the particular case are important."<sup>96</sup> The court then held that the same transaction requirement was not met.<sup>97</sup>

The Ninth Circuit refused to allow a creditor's recoupment claim because the defendant-creditor effectuated a transfer in violation of the court's order in *In re Straightline Investments, Inc.*<sup>98</sup> The *Straightline* court narrowed the same transaction test to the point of a nullity because it did not even analyze whether the parties' obligations arose from a single occurrence. Instead, the court denied recoupment at the very outset "because it is an equitable remedy and equitable remedies may not be invoked to compensate someone who has engaged in inequitable conduct."<sup>99</sup>

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91. See *supra* notes 83-87 and accompanying text.

92. See 62 B.R. 18, 19 (B.A.P. 9th Cir. 1986).

93. *Id.* at 20.

94. *Id.*

95. 156 F.3d 131 (2d Cir. 1998).

96. *Id.* at 135.

97. *Id.*

98. 525 F.3d 870, 882 (9th Cir. 2008).

99. *Id.*

### C. A Separate Equitable Balancing Test

There have been a small number of appellate court decisions touching on the use of recoupment in bankruptcy cases. Accordingly, there is a dearth of precedent on the precise issue presented in *Terry* of whether a balancing of the equities test can be employed after the same transaction test is met. The most direct appellate decision addressing that precise question is *In re Slater Health Center, Inc.*<sup>100</sup>

*Slater* involved a bankrupt but operational nursing home that failed to compensate third party providers after it received money from Medicare to pay for medical expenses.<sup>101</sup> *Slater* instituted a proceeding against the government when Medicare sought to recover these misused payments by reducing *Slater*'s future Medicare reimbursements.<sup>102</sup> Thus, the broad issue in *Slater*, whether a creditor could recover overpayments from a bankrupt debtor by reducing future post-petition obligations, was virtually identical to *In re Terry*.<sup>103</sup>

The *Slater* court analyzed three narrow questions in order to determine the broader issue of whether a creditor could recover overpayments from a bankrupt debtor by reducing future post-petition obligations. First, did the Medicare overpayments constitute a recoupment or a setoff?<sup>104</sup> Second, if the Medicare payments did, in fact, constitute a recoupment, did the parties' obligations arise under the same transaction?<sup>105</sup> Third, and most importantly, should an equitable balancing test be employed to determine whether the recoupment should be granted?<sup>106</sup>

While the two lower courts agreed that the Medicare overpayments constituted a recoupment and that the parties' obligations arose from the same transaction, there was disagreement on the issue of applying an equities test.<sup>107</sup> The bankruptcy court invoked equitable principles and rejected Medicare's recoupment defense after performing a "careful weigh[ing]" of "the relative harm to both parties."<sup>108</sup> Foremost, the bankruptcy court reasoned that Medicare's recoupment claim, if allowed, would significantly reduce the

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100. 398 F.3d 98, 103 (1st Cir. 2005).

101. *Id.* at 99.

102. *Id.* at 100.

103. *See id.*

104. *Id.* at 103. While a recoupment is allowed under the Bankruptcy Code, a set-off would have violated the code's automatic stay provision. *See supra* notes 52-59 and accompanying text.

105. *In re Slater*, 398 F.3d at 103.

106. *See id.* at 104.

107. *Id.* at 101-02. Whether the overpayments constituted a recoupment and whether the same transaction test was met were at issue before the First Circuit because the precedent from *In re Holyoke* was not laid down until after both the Bankruptcy and District Court's came down with their decisions in *Slater*. *Id.* at 102.

108. *Id.* at 101-02.

amount owed to Slater's uncompensated third party providers, now creditors of Slater's bankruptcy estate.<sup>109</sup> In addition, Medicare would receive a windfall if it were to recoup its payments because Slater provided all of the Medicare services and the third-party providers had earned the money.<sup>110</sup> Thus, there was no actual "loss" to Medicare.<sup>111</sup>

On appeal, the district court<sup>112</sup> held that the "bankruptcy court had erred in ranging so broadly to balance the equities in order to nonetheless deny Medicare its right of recoupment and, at any rate, the equities cut in Medicare's favor."<sup>113</sup> The district court found that the bankruptcy court's equities test was fundamentally flawed in that it balanced the relative harms between Medicare and the third-party providers.<sup>114</sup> The proper analysis was to balance the equities between the actual parties in the case, Slater and Medicare, to determine if recoupment should be granted.<sup>115</sup> Under this analysis, the equities showed that it was in fact Slater who would gain a windfall if it were allowed to retain the payments.<sup>116</sup> According to the district court, the money rightly belonged to Medicare and Slater was never entitled to the payments because Medicare agreed to reimburse only Slater's reasonable expenses that were actually paid.<sup>117</sup>

The First Circuit agreed with the lower courts and affirmatively answered the first question, whether the Medicare payments constituted a recoupment, in accordance with its decision in *In re Holyoke Nursing Home, Inc.*<sup>118</sup> *Holyoke* held that a government adjustment to recover a Medicare overpayment constitutes a recoupment, not a setoff, and was therefore permissible in bankruptcy.<sup>119</sup> Likewise, the First Circuit agreed with the lower courts that the same transaction requirement was met and dismissed Slater's argument that the payments owed to its third-party providers were wholly extrinsic to its relationship to Medicare.<sup>120</sup> Instead, the court pointed out that under Medicare regulations,<sup>121</sup> "overpayment" is defined to include a provider's failure to liquidate costs in a timely manner.<sup>122</sup> The recoupment

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109. *Id.* at 102.

110. *Id.*

111. *Id.*

112. See *supra* note 35 for more information about the appeals process for bankruptcy cases.

113. *In re Slater*, 398 F.3d at 102.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.* at 103 (citing *In re Holyoke Nursing Home, Inc.*, 372 F.3d 1, 4-5 (1st Cir. 2004)).

119. *In re Holyoke Nursing Home, Inc.*, 372 F.3d at 4.

120. *In re Slater*, 398 F.3d at 103.

121. 42 C.F.R. § 413.100(c) (2012).

122. *In re Slater*, 398 F.3d at 103.

analysis in *Holyoke* treated Medicare adjustments for over- and underpayments as part of an ongoing stream to ensure that providers get only the money to which they are actually entitled.<sup>123</sup> Flowing from this rationale, the court concluded that the same transaction test was met because Medicare's recoupment claim was "integral" to the relationship between Medicare and Slater.<sup>124</sup>

Because the First Circuit decided the first two questions against Slater, the case hinged on the equitable balancing test.<sup>125</sup> Rather than affirming the district court's analysis that the equities favored Medicare, the First Circuit, relying on *Holyoke*, categorically prohibited using an equitable balancing test after the same transaction analysis was completed.<sup>126</sup> According to the court, "the same transaction analysis itself inherently embodies competing issues of equity, for the simple reason that 'it would be *inequitable* for [a debtor] to enjoy the benefits of the same transaction without also meeting its obligations.'"<sup>127</sup> Additionally, the First Circuit concluded that equitable principles should not interfere with the congressional policy that Medicare payments operate as a "continuous stream."<sup>128</sup> This congressional policy led the court to conclude that the overpayments met the same transaction test, and Medicare was entitled to recoup the third-party provider overpayments from Slater without regard to supplementary equitable factors of the case.<sup>129</sup>

A case from the Eighth Circuit, *U.S. Postal Service v. Dewey Freight Systems, Inc.*, also played a role in the *Terry* decision.<sup>130</sup> The recoupment conflict in *Dewey* arose when the U.S. Postal Service sought to reduce damages incurred when the Chapter 11 debtor, Dewey Freight System, Inc., refused to perform certain executory contracts.<sup>131</sup> Dewey refused to perform because it argued that the Postal Service failed to pay for trucking services under those executory contracts.<sup>132</sup>

While the Eighth Circuit agreed that the parties' obligations arose under the same contract, it was not so confident that the claims arose under the same transaction.<sup>133</sup> It was true, the court pointed out, that case law support-

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123. *Id.* at 104.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* (quoting *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992)) (first internal quotation marks omitted).

128. *Id.* at 104-05.

129. *Id.*

130. See *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 963-64 (8th Cir. 2012); *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 821 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

131. *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 621 (8th Cir. 1994).

132. *Id.*

133. *Id.* at 623.

ed the argument that the Postal Service could recoup claims arising from Dewey's pre-petition trucking services against claims for post-petition services under the same contracts.<sup>134</sup> But the court held that the Postal Service's recoupment claim against Dewey was inherently different because it stemmed from Dewey's failure to perform its *future* contractual commitments.<sup>135</sup>

This type of contract repudiation deserved to be treated as a distinction with a difference because Dewey's failure to perform its future obligations was "inextricably tied to its status as a Chapter 11 debtor."<sup>136</sup> As such, the court needed to examine the treatment of executory contracts under the Bankruptcy Code to determine if recoupment should be allowed.<sup>137</sup> Under section 365 of the Bankruptcy Code, a debtor is authorized to assume or reject an executory contract with the approval of the court.<sup>138</sup> The court recognized that section 365 reflects sound bankruptcy policy because the authority to reject an executory contract can "release the debtor's estate from burdensome obligations that can impede a successful reorganization."<sup>139</sup> From the court's perspective, it necessarily followed that the remedy for rejecting an executory contract<sup>140</sup> "must be administered through bankruptcy and receive the priority provided general unsecured creditors."<sup>141</sup>

It was clear to the Eighth Circuit that the Postal Service's claim of recoupment should be denied when viewed in light of the Bankruptcy Code's treatment of executory contracts.<sup>142</sup> In the end, the court was unwilling to allow the doctrine of recoupment to "frustrate" both the remedy for a debtor rejecting an executory contract and the overriding purpose of Chapter 11 to "prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."<sup>143</sup>

#### IV. INSTANT DECISION

The Eighth Circuit's rather short opinion in *Terry* can be broken down into two parts. In the first half of the decision, the court clarified its precedent in *Dewey*<sup>144</sup> concerning the application of recoupment for pre-petition

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134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.* (citing 11 U.S.C. § 365(a) (2006)).

139. *Id.* at 624 (quoting *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984)).

140. These remedies are contained in sections 365(g)(1) and 502(g) of the Bankruptcy Code.

141. *Id.* (quoting *Bildisco*, 465 U.S. at 531).

142. *Id.* at 625.

143. *Id.* (quoting *Bildisco*, 465 U.S. at 528).

144. See *supra* notes 130-143 and accompanying text for a discussion of this case.



obligations in post-petition bankruptcy claims.<sup>145</sup> The remaining discussion focused on the approaches taken by other circuits as to whether they require an independent balancing of the equities test, in addition to the same transaction test, in deciding recoupment cases.<sup>146</sup>

Terry argued that an independent balancing of the equities test can deny recoupment.<sup>147</sup> In particular, Terry relied on *Dewey*'s reference to recoupment as an "equitable doctrine" and the Eighth Circuit's acknowledgment that "[n]ot surprisingly, given the equitable nature of the doctrine, courts have refrained from precisely defining the same transaction standard, focusing instead on the facts and the equities of each case."<sup>148</sup> The Eighth Circuit completely rejected this reading of *Dewey*. First and foremost, the court emphasized that *Dewey* never suggested an independent balancing of the equities test and did not set forth an additional element or precondition to recoupment that supplemented the same transaction test.<sup>149</sup> Rather, the court's use of equitable phraseology in *Dewey* was designed only to illustrate the injustice of applying the common law doctrine of recoupment when the same transaction test was not met.<sup>150</sup>

The second half of the Eighth Circuit's opinion examined the relevant law of recoupment in other jurisdictions.<sup>151</sup> Terry invoked three cases from other circuits<sup>152</sup> in claiming that "the majority of Circuits to have addressed the issue of recoupment in bankruptcy have . . . applied it as directed by the equities of each case."<sup>153</sup> Again, the court rejected Terry's interpretation of the law.<sup>154</sup> While the cases cited by Terry did involve recoupment in the context of bankruptcy, all of them failed to address the particular issue

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145. See *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 963-64 (8th Cir. 2012).

146. See *id.* at 964-65.

147. *Id.* at 963.

148. *Id.* at 964 (citing *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994)).

149. *Id.*

150. *Id.*

151. *Id.*

152. *In re Straightline Invs., Inc.*, 525 F.3d 870, 882 (9th Cir. 2008) ("The doctrine of recoupment does not apply here, however, because it is an equitable remedy . . ."); *In re Malinowski*, 156 F.3d 131, 135 (2d Cir. 1998) (denying recoupment "in light of the equitable nature of the recoupment remedy"); *In re Peterson Distrib., Inc.*, 82 F.3d 956, 960 (10th Cir. 1996) ("The 'same transaction' requirement acts as a mechanism to ensure that equitable reasons for recoupment are present before a creditor may attain priority through the doctrine of recoupment . . . . A 'same contract equals same transaction' rule would be overly simplistic. Instead, as our case law illustrates, the 'same transaction' analysis involves an examination of the parties' equities.").

153. *Terry*, 687 F.3d at 964 (quoting *Malinowski*, 156 F.3d at 135) (internal quotation marks omitted).

154. *Id.*

of this case: “whether a creditor who *meets* the same-transaction test can be denied recoupment based on a separate balancing-of-the-equities test.”<sup>155</sup> As in *Dewey*, each of these three decisions noted the equitable nature of recoupment.<sup>156</sup> However, in two of the cases, *In re Malinowski* and *In re Peterson*, the defendant’s recoupment claim failed because it did not meet the same transaction test.<sup>157</sup> In the case of *In re Straightline*, the sitting court failed to apply the same transaction test and, instead, held that recoupment was denied because the parties’ transaction violated the bankruptcy court’s automatic stay.<sup>158</sup>

The Eighth Circuit agreed with the analysis in *In re Slater Health Center, Inc.*<sup>159</sup> and felt that the First Circuit’s opinion in that case unequivocally answered the legal question presented:

[T]he same transaction analysis itself inherently embodies competing issues of equity, for the simple reason that it would be *inequitable* for [a debtor] to enjoy the benefits of the same transaction without also meeting its obligations. In at least most cases, analysis of the recoupment issue should both begin and end with the same transaction question without discussing other equitable issues. Since we have already determined that the same transaction test is met in this case, we need not go further.<sup>160</sup>

Thus, the Eighth Circuit held that it was reversible error for the bankruptcy appellate panel to introduce a separate balancing of the equities test into the doctrine of recoupment and deny Standard a right of recoupment after determining that the obligations at issue arose out of the same transaction.<sup>161</sup>

## V. COMMENT

### A. Reconciling Terry with Bankruptcy Policy

*Terry* is significant for both legal analysis and policy reasons. From a policy standpoint, the Eighth Circuit’s holding could be a major blow to consumer debtors attempting to achieve a fresh start after bankruptcy. But, as discussed below, judges still have a tool in their arsenal that allows them to

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155. *Id.*

156. *Id.* (citing *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994)).

157. *Id.*; see also *Malinowski*, 156 F.3d at 135; *Peterson*, 82 F.3d at 960.

158. *Id.*; see also *In re Straightline Invs., Inc.*, 525 F.3d 870, 882 (9th Cir. 2008).

159. See *supra* notes 100-117 and accompanying text for a discussion on this case.

160. *Terry*, 687 F.3d at 964-65 (quoting *In re Slater Health Ctr., Inc.*, 398 F.3d 98, 104 (1st Cir. 2005)) (internal quotation marks omitted).

161. *Id.* at 965.

effectuate the policies of the Bankruptcy Code by considering the facts and equities of each case when applying the doctrine of recoupment. Likewise, the legal reasoning in *Terry*, as well as the other cases discussed, is quite unique and interesting in that a common law doctrine, recoupment, was applied in tandem with the statute-driven Bankruptcy Code.

Not surprisingly, comments in the aftermath of *Terry* called it a “creditor friendly” decision,<sup>162</sup> indicating that the Eighth Circuit’s holding would be a blow to bankrupt debtors. However, *Terry*’s legacy and the Eighth Circuit’s holding may not be as damning to consumer debtors as predicted. By the same token, it is doubtful that *Terry* is at complete odds with the underlying policies of the Bankruptcy Code. *Terry* obviously prohibits the use of equitable considerations when the court decides the parties’ obligations arose out of the same transaction.<sup>163</sup> Such precedent does not signal a death knell for bankrupt debtors, however. Instead, *Terry* can confidently be viewed as a narrowly tailored decision because it only prohibits the application of a distinct equities test apart from the same transaction analysis.<sup>164</sup> The solution is simple: if a bankruptcy judge wants to promote the policies of the Bankruptcy Code and deny the creditor’s recoupment claim by giving weight to the equities of the case, this action should be taken within the confines of the same transaction test.

The specific mechanics of the same transaction test are not well defined in relevant case law, leaving courts with little guidance and broad discretion in determining whether obligations arise from the same transaction.<sup>165</sup> The Eighth Circuit noted in *Dewey*, “[G]iven the equitable nature of the doctrine, courts have refrained from precisely defining the same-transaction standard, focusing instead on the facts and the equities of each case.”<sup>166</sup> The *Terry* court went even further in stating, “Fairness and equity may influence whether two competing claims arise from the same transaction, but a court should not impose an additional ‘balancing of the equities’ requirement once a party meets the same transaction test.”<sup>167</sup> These passages indicate that the courts in the Eighth Circuit can examine all relevant factors, especially the equities of the case, in deciding the same transaction question.<sup>168</sup> Bankrupt debtors and

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162. Michael L. Cook & Karen S. Park, *Eighth Circuit Rejects “Balancing of the Equities” Test For Creditor’s Recoupment*, SHULTE ROTH & ZABEL, Aug. 31, 2012, [http://www.srz.com/Eighth\\_Circuit\\_Rejects\\_Balancing\\_of\\_the\\_Equities\\_Test\\_for\\_Creditors\\_Recoupment/](http://www.srz.com/Eighth_Circuit_Rejects_Balancing_of_the_Equities_Test_for_Creditors_Recoupment/).

163. *Terry*, 687 F.3d at 964-65.

164. *See id.* at 965.

165. *See* Sprouse III, *supra* note 1, at 12.

166. *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994).

167. *Terry*, 687 F.3d at 965.

168. Sprouse III, *supra* note 1, at 57 (“Courts often take the view that the right to recoupment, once established, is a matter beyond a debtor’s estate, and thus not to be impeded. *Other courts, however, are willing to balance the consequences of the rem-*

recoupment-loathing bankruptcy judges in the Eighth Circuit should be relieved because the court did not foreclose the possibility that recoupment could be denied by way of a narrow same transaction test.<sup>169</sup>

### B. Same Transaction Analysis in Terry

In light of the Eighth Circuit's holding in *Terry*,<sup>170</sup> it is clear that Terry's counsel should have vehemently argued that, based on equities and fairness, Standard's recoupment claim did not arise out of the same transaction. Thus the bankruptcy appellate panel and bankruptcy court could have successfully utilized the same transaction requirement to accomplish their equitable and policy goals.

The argument that the same transaction test was not met with respect to Terry and Standard's obligation is a rather simple one to make. As discussed earlier, the Eighth Circuit has adopted the narrowly construed "integrated transaction" test for the same transaction requirement.<sup>171</sup> Hence, because of the integrated transaction test's very nature, an Eighth Circuit court would be much more sympathetic to the equitable factors that favor denying a creditor's recoupment claim.<sup>172</sup> One scholar has gone so far as to say that the integrated transaction test may be used to "deny recoupment in virtually every case."<sup>173</sup> While there is no proof that integrated transaction courts indiscriminately deny all recoupment claims, this quotation suggests that these courts can latch onto a number of reasonable theories to deny recoupment.

#### 1. Same Contract Does Not Equal Same Transaction

Here, it would be helpful to reiterate why the BAP concluded that Terry and Standard's obligations arose under a single transaction. Specifically, the BAP took a formalistic "same-contract-equals-same-transaction" approach when it held, "It is undisputed that both parties' rights and obligations arise out of a single contract, and the debtor has not persuaded us that some basis exists to view their mutual obligations as arising out of separate transactions."<sup>174</sup>

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*edy against its equitable foundations.* In any event, case law provides ample authority for both sides in any dispute over the equitable application of recoupment." (emphasis added).

169. See *supra* Part III.B. for the application of a narrow same transaction analysis.

170. See *supra* Part IV.

171. See *supra* notes 72-74 and accompanying text.

172. See *supra* notes 72-74 and accompanying text.

173. COLLIER ON BANKRUPTCY, *supra* note 74.

174. *Terry v. Standard Ins. Co. (In re Terry)*, 443 B.R. 816, 821 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

Without more, the BAP's holding leaves itself vulnerable to attack. As already mentioned, the Eighth Circuit applies the integrated transaction test to satisfy the same transaction requirement of recoupment.<sup>175</sup> Accordingly, the court posited that “[f]airness and equity may influence whether two competing claims arise from the same transaction”<sup>176</sup> and that recoupment should be “narrowly construed” as an exception to the general principle that bankruptcy serves as a “cleavage in time.”<sup>177</sup> Additionally, other circuits have shared much of the same sentiments.<sup>178</sup>

The BAP heavily weighted the fact that Terry and Standard's obligations arose out of the same contract: the LTD plan.<sup>179</sup> This is by no means dispositive on the issue. While the Eighth Circuit is silent on whether an obligation arising under the same contract, by itself, satisfies the same transaction requirement, other courts have rejected such a formalistic approach and opined that a “‘same contract equals same transaction’ rule would be overly simplistic. Instead, the ‘same transaction’ analysis involves an examination of the parties’ equities.”<sup>180</sup> The Third Circuit in *In re University Medical Center*<sup>181</sup> agreed with this view when it held, “Nor does the fact that a contract exists between the debtor and creditor automatically enable the creditor to effect a recoupment.”<sup>182</sup> Likewise, another court has reasoned that the existence of a contract between the debtor and the creditor does not guarantee the creditor's recoupment claim.<sup>183</sup>

## 2. Equitable Considerations

With these principles in mind, Terry's counsel could have made a vigorous argument that the same transaction requirement was not met. Because the Eighth Circuit expressly stated that fairness and equity are factors that can be considered in the same transaction analysis,<sup>184</sup> the BAP and bankrupt-

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175. See *supra* notes 72-74 and accompanying text.

176. Terry v. Standard Ins. Co. (*In re Terry*), 687 F.3d 961, 965 (8th Cir. 2012).

177. U.S. Postal Serv. v. Dewey Freight Sys., Inc., 31 F.3d 620, 623 (8th Cir. 1994) (internal quotation marks omitted).

178. *In re Peterson Distrib., Inc.*, 82 F.3d 956, 960 (10th Cir. 1996) (“The ‘same transaction’ requirement acts as a mechanism to ensure that equitable reasons for recoupment are present before a creditor may attain priority through the doctrine of recoupment”); *In re Adamic*, 291 B.R. 175, 182 (Bankr. D. Colo. 2003) (“[T]he phrase ‘same transaction’ is a term of art that must be narrowly defined [for recoupment purposes in bankruptcy].”).

179. Terry, 443 B.R. at 822.

180. Peterson, 82 F.3d at 960.

181. 973 F.2d 1065 (3d Cir. 1992). See *supra* notes 75-82 and accompanying text for a discussion of this case.

182. Univ. Med. Ctr., 973 F.2d at 1080.

183. See *In re HQ Global Holdings, Inc.*, 290 B.R. 78, 81 (Bankr. D. Del. 2003).

184. Terry v. Standard Ins. Co. (*In re Terry*), 687 F.3d 961, 965 (8th Cir. 2012).

cy court's rationale for denying Standard's recoupment claim via a separate balancing of the equities test could just as easily be applied to the same transaction test.

First, Terry voluntarily transferred \$45,316.54 to Standard before he filed for bankruptcy to satisfy his social security overpayment obligation.<sup>185</sup> In this respect, depriving Terry of his post-petition insurance benefits would be "tantamount to making him repay his debt to Standard a second time."<sup>186</sup> Standard's conduct could also be characterized as "inequitable"; Standard did not fight the preference demand and sent the \$45,316.54 to the trustee without resistance.<sup>187</sup> In addition, after Standard sent the lump sum to the trustee, it unilaterally began to deduct a significant amount from Terry's post-petition disability benefits in order to recover the overpayment amount.<sup>188</sup> Standard was forced to cease these deductions when the bankruptcy court voiced its concern that the setoff might violate the automatic stay.<sup>189</sup> Third, and most importantly, denying Standard's recoupment claim would effectuate the equitable principles of bankruptcy to give the debtor a fresh start and not impose any hardships that may stifle this new beginning.<sup>190</sup> Thus, considering fairness and equity, a strong case can be made that Terry and Standard's obligations no longer arise out of the same transaction. Moreover, when the issue is phrased in this way, denying Standard's recoupment claim comports with the adage that recoupment should be allowed only where it would be "inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."<sup>191</sup>

Both the bankruptcy court and bankruptcy appellate panel were hostile to allowing Standard's recoupment claim.<sup>192</sup> Both denied Standard's defense to Terry's claim, albeit by way of two different theories.<sup>193</sup> The bankruptcy court held that recoupment would be improper based on its reading of section 502(h) of the Bankruptcy Code in light of *Dewey's* precedent.<sup>194</sup> The BAP, on the other hand, disagreed with the bankruptcy court's rationale and struck down Standard's recoupment claim based on a balancing of the equities

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185. *Terry v. Standard Ins. Co. (In re Terry)*, 453 B.R. 760, 762 (Bankr. W.D. Mo. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

186. *Id.* at 763.

187. *Id.* at 762.

188. *Terry*, 687 F.3d at 962.

189. *Id.*

190. *Terry*, 453 B.R. at 764.

191. *U.S. Postal Serv. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994).

192. *See supra* notes 29-47 and accompanying text.

193. *See supra* notes 29-47 and accompanying text.

194. *Terry v. Standard Ins. Co. (In re Terry)*, No. 08-43123, 2010 WL 2891710, at \*3 (Bankr. W.D. Mo. July 21, 2010), *rev'd*, 443 B.R. 816 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

test.<sup>195</sup> Either way, it is quite evident that both courts were manipulating the recoupment doctrine to prohibit Standard's claim and achieve an equitable outcome in favor of the disabled petitioner and against the deep-pocketed insurance company. Unfortunately, these two collateral theories failed to prohibit Standard from recouping Terry's disability insurance overpayments because they did not focus on the sole element of recoupment: the same transaction test. The lower courts in *Terry* should have followed the lead of others and accentuated the equitable policies of the Bankruptcy Code by applying a narrow interpretation of the same transaction test to deny Standard's recoupment claim.<sup>196</sup>

### *C. The Eighth Circuit Leaves the Door Open for the Same Transaction Test to Deny Recoupment*

Consequently, what effect does *Slater* have on the same transaction analysis formulated above? While the Eighth's Circuit decision in *Terry* turned on the ruling in *Slater*,<sup>197</sup> *Slater* has no real bearing on the same transaction test analysis discussed here. The Eighth Circuit only cited *Slater* to support the proposition that an equitable balancing test should not be employed after it is determined that the same transaction test was met.<sup>198</sup> In addition, the obligations of the parties in *Slater* were held to meet the same transaction test chiefly because of the court's interpretation that Medicare overpayments met the same transaction test under statutory congressional policy.<sup>199</sup> In *Terry* there is no such statutory code or congressional policy that presumptively decides that the obligations arise out of the same transaction.<sup>200</sup> Thus, in these types of cases, fairness and equity can be employed in the same transaction analysis to effectuate the bankruptcy court's policies of giving the debtor a fresh start and blocking the creditor from obtaining preferential treatment.

This is not to suggest that a petitioner's same transaction defense will be an automatic victory against a creditor's recoupment claim. Of course, a court is free to conclude that the equities align in favor of allowing the creditor's recoupment claim.<sup>201</sup> However, this point does not obscure the sub-

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195. *Terry v. Standard Insurance Co. (In re Terry)*, 443 B.R. 816, 821 (B.A.P. 8th Cir. 2011), *rev'd*, 687 F.3d 961 (8th Cir. 2012).

196. See *supra* Part III.B. for the application of a narrow same transaction analysis.

197. See *supra* notes 159-161 and accompanying text.

198. See *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 964-65 (8th Cir. 2012).

199. *In re Slater Health Ctr., Inc.*, 398 F.3d 98, 104 (1st Cir. 2005).

200. See *Terry*, 687 F.3d at 964.

201. See *supra* note 112-117 and accompanying text (explaining why the district court in *Slater* held that the equities ran in favor of allowing the creditor to recoup, reversing the bankruptcy court's finding that the equities prohibited recoupment).

stance of this Note: that the Eighth Circuit's decision in *Terry* was not a complete dispatch of equity and fairness in recoupment cases involving post-petition debtors. Instead, *Terry* can be read as leaving open the possibility of the same transaction test being used to preclude recoupment when the right set of equitable facts exist in favor of the debtor.

Also of importance in this regard, the bankruptcy court and BAP in the *Terry* case were demonstrably looking for any cognizable legal theory to latch on to that would deny recoupment.<sup>202</sup> The Eighth Circuit generally follows the narrowly construed integrated transaction test and, as a result, the same transaction requirement is still a viable option for courts to effectuate sound bankruptcy policy.<sup>203</sup> Thus, *Terry* may be just as influential for leaving the door open for debtors who have valid fairness and equity considerations to escape recoupment while at the same time closing the door on debtors like *Terry* and preventing them from obtaining a completely fresh start.

It would have been much more interesting if the lower courts in *Terry* had ruled that Standard was not entitled to a recoupment of the social security overpayments because the parties' obligations did not meet the same transaction test. As exemplified by this Note, surely such a position is superior legally and would have had a much better chance to survive the Eighth Circuit's scrutiny as compared to a separate balancing of the equities test. In any event, future bankrupt debtors should focus their arguments against recoupment on the same transaction test. In doing so, the debtor should focus on the facts and equities of the case that cut against the Bankruptcy Code's policy of giving the debtor a fresh start and treating like creditors equally.

## VI. CONCLUSION

This Note argued that the *Terry* decision on recoupment in the context of bankruptcy is limited and does not necessarily signal a major blow to bankrupt debtors. Bankruptcy courts, especially those that follow the narrowly construed "same integration" test, can still effectuate their policy of giving the debtor a fresh start post-bankruptcy and denying a creditor's attempt to receive preferential treatment by prohibiting a defendant's recoupment claim by way of the same transaction test. The *Terry* decision, in essence, was limited to prohibiting an additional balancing of the equities that was applied after the same transaction analysis was complete.

The *Terry* decision made clear that the outcome of recoupment claims in bankruptcy will center on the same transaction requirement. So, how does the same transaction requirement limit the credit-friendliness of the *Terry* holding and give relief to debtors? Nowhere did the Eighth Circuit expand the scope of the same transaction test or posit that recoupment must be allowed if the parties' obligations arise out of the same contract. On the

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202. See *supra* notes 29-47 and accompanying text.

203. See *supra* notes 72-74 and accompanying text.



contrary, the court expressly stated that fairness and equity could be considered in analyzing the same transaction question.<sup>204</sup> Thus, considerations of equity are inherent in the same transaction test. Additionally, the same transaction analysis allows judges to alter the result of a specific case based on public policy. This leaves bankruptcy courts the opportunity to look at all of the facts of the case and conclude which party the equities favor in a given situation. In effect, debtors still have a chance to avoid recoupment claims, despite the *Terry* decision, if they can vigorously argue that on account of fairness and equity considerations the obligations at issue did not arise out of the same transaction.

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204. *Terry v. Standard Ins. Co. (In re Terry)*, 687 F.3d 961, 965 (8th Cir. 2012).