

BY PETER J. KEANE<sup>1</sup>

## Finger Lakes: Scope of Setoff and Recoupment Under Delaware Law

The doctrines of setoff and recoupment can be valuable rights in bankruptcy. Because state law largely defines parties' rights in bankruptcy,<sup>2</sup> litigants need to understand relevant state law when asserting the defenses of setoff and recoupment in response to claims or causes of action in bankruptcy court. A recent decision from the Delaware Supreme Court in *Finger Lakes Capital Partners LLC v. Honeoye Lake Acquisition LLC*<sup>3</sup> analyzed some important limitations with those closely related defenses. Many businesses are incorporated or formed under Delaware law or choose Delaware as the governing law for their commercial agreements, so this decision helps to clarify the limitations of those defenses,<sup>4</sup> which the Delaware Supreme Court has rarely addressed before.<sup>5</sup>



**Peter J. Keane**  
Pachulski Stang  
Ziehl & Jones LLP  
Wilmington, Del.

Peter Keane is an attorney with Pachulski Stang Ziehl & Jones LLP in Wilmington, Del. His practice includes business reorganizations and liquidations, debtor and creditors' rights, and other insolvency-related matters.

### Setoff and Recoupment Distinctions

"The doctrines of setoff and recoupment trace their origins back to the era of common law pleading."<sup>6</sup> Both doctrines have been adopted in bankruptcy: setoff by statute, through 11 U.S.C. § 553, and recoupment by common law, beginning with *In re Monongahela Rye Liquors*.<sup>7</sup>

The defense of setoff (also called "offset") allows parties to cancel mutual debts. Bankruptcy courts generally describe it as "a right grounded in concepts of fairness and equity, reflecting the absurdity of making A pay B when B owes A."<sup>8</sup> Section 553 of the Bankruptcy Code provides that bankruptcy does not affect any right of setoff that a

creditor had before the bankruptcy, but setoff under § 553 is permissive rather than mandatory, so whether setoff can be allowed is left to the court's sound discretion.

Setoff incorporates the state law rights outside of bankruptcy. A party seeking to use setoff under § 553 in bankruptcy normally cannot invoke the right unilaterally but must seek relief from the automatic stay<sup>9</sup> and show cause by establishing a right to setoff under nonbankruptcy (usually state) law.<sup>10</sup> The § 553 setoff test in bankruptcy requires that "(1) the creditor holds a 'claim' against the debtor that arose before the commencement of the case; (2) the creditor owes a 'debt' to the debtor that also arose before the commencement of the case; (3) the claim and debt are 'mutual';<sup>11</sup> and (4) the claim and debt are each valid and enforceable."<sup>12</sup> Under Delaware state law, setoff is defined as a "mode of defense by which the defendant acknowledges the justice of the plaintiff's demand, but sets up a defense of his own against the plaintiff, to counterbalance it either in whole or in part." Importantly, by statute in Delaware (10 Del. C. § 8120), setoff is subject to a three-year statute of limitations.<sup>13</sup>

On the other hand, recoupment is an equitable remedy that permits the offset of mutual debts arising from the same transaction or occurrence.<sup>14</sup> "Recoupment" is defined as "the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim."<sup>15</sup> In bankruptcy cases, recoupment is often applied when the transaction at issue provides for advance payments based on estimates of what ultimately would be owed, subject to later correction.<sup>16</sup> However, an express contractual right is not necessary to use recoupment, and the simple "fact that the same two parties are involved, and that a similar subject matter gave rise to both claims ... does

1 The views expressed in this article are those of the author and do not necessarily represent the views of any other person or entity, including, without limitation, Pachulski Stang Ziehl & Jones, LLP and its partners.

2 *Butner v. United States*, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.")

3 --- A.2d ---, 2016 WL 6678445 (Del. Nov. 14, 2016).

4 Setoff and recoupment are typically plead as counterclaims in normal civil litigation. See 3 *Moore's Federal Practice* § 13.11 (3d ed. 2016). However, in bankruptcy, setoff and recoupment can be used in other ways. For example, a creditor may file a proof of claim and assert that a portion of its unsecured claim is secured to the extent of its setoff rights, which generally can put the creditor in a better position for recovery. See, e.g., 11 U.S.C. § 506(a); *B.F. Goodrich Emps. Fed. Credit Union v. Patterson (In re Patterson)*, 967 F.2d 505, 509 (11th Cir. 1992).

5 See Francis Pileggi, "Delaware Supreme Court Addresses Recoupment and Setoff," *Del. Corporate & Commercial Litigation Blog* (Nov. 20, 2016), available at [delawarelitigation.com/2016/11/articles/delaware-supreme-court-updates/delaware-supreme-court-addresses-recoupment-and-setoff](http://delawarelitigation.com/2016/11/articles/delaware-supreme-court-updates/delaware-supreme-court-addresses-recoupment-and-setoff) (observing that not many Delaware decisions cover setoff or recoupment and pointing out paucity of Delaware case law on those two defenses).

6 *Miller v. Zurich Am. Ins. Co. (In re WL Homes LLC)*, 2017 WL 104443, \*2 (Bankr. D. Del. Jan. 10, 2017).

7 *Id.* See also *In re Monongahela Rye Liquors*, 141 F.2d 864 (3d Cir. 1944).

8 *In re WL Homes LLC*, 471 B.R. 349, 351 (Bankr. D. Del. 2012) (quoting *United States v. Myers (In re Myers)*, 362 F.3d 667, 672 (10th Cir. 2004); see *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995).

9 See 11 U.S.C. § 362(a)(7).

10 *WL Homes LLC*, 471 B.R. at 351. Section 558 also preserves a debtor's pre-petition defenses under state law.

11 Mutuality exists when "the debts and credits are in the same right and are between the same parties, standing in the same capacity." *Scherling v. Hellman Elec. Corp. (In re Westchester Structures)*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995).

12 *St. Francis Physician Network Inc. v. Rush Prudential HMO Inc. (In re St. Francis Physician Network)*, 213 B.R. 710, 715 (Bankr. N.D. Ill. 1997) (quoting 5 *Collier on Bankruptcy* ¶ 553.01 (15th ed. rev.)).

13 10 Del. C. § 8120 ("This chapter shall apply to any debt alleged by way of setoff or counterclaim on the part of a defendant. The time of limitation of such debt shall be computed in like manner as if an action therefor[e] had been commenced at the time when the plaintiff's action commenced.")

14 *WL Homes LLC*, 2017 WL 104443, \*3.

15 *In re Comm'n Dynamics Inc.*, 300 B.R. 220, 226 (Bankr. D. Del. 2003).

16 *WL Homes LLC*, 2017 WL 104443, \*3.

not mean that the two arose from the ‘same transaction.’”<sup>17</sup> “Rather, 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>18</sup> Delaware law describes recoupment as

a species of defense somewhat analogous to set-off in its character, the chief distinction, however, being that the defense of set-off arises out of an independent transaction, but the defense of recoupment goes to the reduction of the plaintiff’s damages for the reason that he ... has not complied with the cross-obligation arising under the same contract.<sup>19</sup>

Another critical distinction between setoff and recoupment is that a claim for recoupment is not subject to a statute of limitations; however, it must meet the other aforementioned requirements to be successful. Time-barred claims can be considered for recoupment when they arise out of the same factually related transaction as the plaintiff’s claim. It is settled law throughout the U.S. and in Delaware that a statute of limitations does not apply to recoupment, either as an affirmative defense or affirmative counterclaim<sup>20</sup> — a principle that the U.S. Supreme Court has reiterated many times.<sup>21</sup> The reasoning behind the idea of letting parties assert recoupment at any time is that statutes of limitations are supposed to keep out stale litigation, and that purpose “would be distorted if the statute were applied to bar an otherwise legitimate defense to a timely lawsuit, for limitation statutes are aimed at lawsuits, not at the consideration of particular issues in lawsuits.”<sup>22</sup>

## **Finger Lakes Capital Partners LLC v. Honeoye Lake Acquisition LLC**

In *Finger Lakes*, Zubin Mehta and Gregory Shalov formed Finger Lakes Capital Partners as an investment vehicle to own several operating companies. They contacted Lyrical Partners LP to serve as the money partner, with Mehta and Shalov managing the investments. Finger Lakes held each of its portfolio companies as separate limited liability companies (LLCs) with separate operating agreements. The LLCs holding each portfolio company paid management fees to Finger Lakes. The parties (Mehta, Shalov and Lyrical) each signed a term sheet requiring them to split the management fees at the Finger Lakes’ level in an amount dependent on the source of the fees.

Over the course of a decade, the portfolio companies did not perform well. As Finger Lakes needed additional capital from Lyrical, the parties agreed to allow Lyrical to “claw back” its investment money as added protection for continuing to invest. All but one of the investments failed; the one successful investment generated a substantial return when it was sold. The parties disagreed about how the proceeds should be distributed; Mehta and Shalov sued Lyrical in the Delaware Court of Chancery.<sup>23</sup> Lyrical filed a counterclaim

seeking to recover both its share of management fees due within the three years before filing its Aug. 15, 2014, counterclaim and also management fees that were due more than three years before Lyrical filed its counterclaim (called the “earlier amounts”).

The chancery court held that the proceeds should be distributed first in accordance with the operating agreement governing the investment in the profitable portfolio company. Then the term sheet and the clawback agreement would be applied to reallocate the distribution on the terms of those agreements. As a result, most of the profits from the one successful portfolio company were to be distributed to Lyrical. Finger Lakes argued that *laches* barred recovery of the earlier amounts, but the chancery court disagreed, holding that Lyrical could rely on the earlier amounts — totaling more than \$2.5 million — to support its affirmative defenses of recoupment and setoff, to which *laches* did not apply. The chancery court reasoned that the statute of limitations did not apply to those affirmative defenses. Finger Lakes appealed.

On appeal, the Delaware Supreme Court affirmed in part and reversed in part. First, it held that the chancery court had correctly interpreted and applied the applicable operating agreements, term sheet and clawback agreement for how to distribute and allocate the proceeds. Second, and more relevant for this article, the court ruled that the chancery court was wrong when it held that Lyrical could use setoff or recoupment to recover the time-barred management fees (*i.e.*, the earlier amounts more than three years before its counterclaim).

Lyrical could not rely on setoff because Delaware statutory law precludes setoff for amounts owed outside the three-year statute of limitations, so the earlier amounts outside the three-year period before Lyrical’s Aug. 15, 2014, counterclaim could not be used for setoff. The court reasoned that “[t]his makes sense, as a claim unrelated to the suit brought by the plaintiff should not gain new life from the happenstance of the plaintiff having sued the defendant on an unrelated matter.”<sup>24</sup>

The court also held that Lyrical could not rely on recoupment because its defensive claims did not arise from the same transaction as Finger Lakes’ claims. Although Lyrical did not raise recoupment as an affirmative defense, the court nonetheless also analyzed that option and held that Delaware law requires “the transactional nexus requirement under recoupment to be tightly constrained.”<sup>25</sup> The court quoted from a 2004 Delaware Chancery Court<sup>26</sup> decision to help explain why “great care” is needed before allowing a party to assert stale claims as a basis to reduce its liability for a judgment in a suit brought by a party asserting timely claims.<sup>27</sup> In essence, allowing recoupment as a defense on a factually unrelated transaction permits defendants to avoid statutes of limitations by creative pleading and turns what is otherwise supposed to be a narrow equitable doctrine into a “wide-ranging license to revive a relationship’s worth of stale grievances, which long predate the fresh dispute that brings the parties before the court.”<sup>28</sup>

17 *Id.* (quoting *Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992)).

18 *Id.*

19 *Finger Lakes*, 2016 WL 6678445, at \*2 (quoting 1 Victor B. Woolley, *Practice in Civil Actions and Proceedings in the Law Courts of the State of Delaware* § 503 (1906)).

20 See, e.g., *TFID III-X LLC v. Fruehauf Prod. Co. LLC*, 883 A.2d 854, 859 (Del. Ch. 2004).

21 See *Beach v. Ocwen Fed. Bank*, 523 U.S. 410, 415 (1998) (“[A] defendant’s right to plead recoupment ... survives the expiration of the period provided by the statute of limitations that would otherwise bar the recoupment claim as an independent cause of action.”).

22 *Id.* at 415-16 (citations and quotations omitted).

23 *Finger Lakes*, 2016 WL 6678445, at \*1.

24 *Id.* at \*2.

25 *Id.* at \*3.

26 *TFID III-X LLC v. Fruehauf Prod. Co. LLC*, 883 A.2d 854 (Del. Ch. 2004).

27 *Finger Lakes*, 2016 WL 6678445, at \*3.

28 *Id.* (quoting *TFID III-X LLC*, 883 A.2d at 865).

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Applying this analysis, the court held that Lyrical's defense of using the earlier amounts arising from management was not factually related to Finger Lakes' claim for distribution of the proceeds from the sale of the portfolio company because the profit-distribution dispute under the specific operating agreement, term sheet and clawback agreement was not factually related to Lyrical's failure to receive management fees owed to it under the term sheet. As a result, Lyrical could not assert as a defense the earlier amounts as a setoff (because those were time-barred under the statute of limitations) or as a recoupment (because they were not factually related to Finger Lakes' claims).<sup>29</sup>

### Conclusion

The *Finger Lakes* decision is a helpful pronouncement under Delaware law that defines the scope and limitations of two important affirmative defenses that are frequently asserted in bankruptcy cases in a variety of contexts. Going forward, litigants and restructuring professionals on both sides of a dispute will need to evaluate a setoff defense not only for the typical requirements for setoff under § 553 (e.g., a claim, a debt and mutuality), but also from a timing perspective to determine whether the basis for the setoff

is being "used to raise from the dead"<sup>30</sup> old counterclaims that occurred beyond three years from the dispute if under Delaware law.

In addition, parties will need to evaluate whether equitable recoupment is available as an additional defense in light of the tightly constrained "transactional nexus" that is required under Delaware law. Litigants cannot use recoupment to net out every claim or debt in long-running, complex business relationships that have produced multiple agreements intended for different purposes over the years. Evaluation of each transaction is key, and this evaluation will require a careful review of the facts underlying the affirmative causes of action and the counterclaims that a defendant might assert under the recoupment umbrella. Moreover, although setoff and recoupment are similar, they have important procedural differences in bankruptcy. The automatic stay in bankruptcy prohibits creditors from exercising setoff rights without first getting court approval, but there is no express automatic stay limitation for recoupment. As a result, creditors should consider incorporating language into their contracts permitting them to recoup amounts owed, which could strengthen a recoupment argument if the other contracting party ever files for bankruptcy. **abi**

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<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at \*2.