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Setoff and Bankruptcy

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SETOFF AND BANKRUPTCY

LAWRENCE KALEVITCH

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I. INTRODUCTION

"[Setoff] is grounded on the absurdity of making A pay B when B owes
A."

Studley v. Boylston National Bank, 229 U.S. 523, 528 (1913)

Traditional bankruptcy has honored\(^2\) setoff\(^3\) even though this has the effect
of conferring a priority on holders of setoff rights. Yet courts and commentators

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\(^2\) See Barkley Clark, Bank Exercise of Setoff: Avoiding the Pitfalls, 98 BANKING L.J. 196 (1981); Carmelita Hammon, Note, Setoff In Bankruptcy: Is the Creditor Preferred or Secured, 50 COLO. L. REV. 511, 517 (1979); Harold A. Justman, Comments on the Bank's Right of
Setoff Under the Proposed Bankruptcy Act of 1973, 31 BUS. LAW. 1607 (1976); Philip T. Lacy,
Setoff and the Principle of Creditor Equality, 43 S.C. L. REV. 951 (1992); Ephraim K.
Leibowitz, Banks' Right to Setoff in Bankruptcy: "From Erosion To Extinction," 94 BANKING
L.J. 796 (1977); John C. McCoid II, Setoff: Why Bankruptcy Priority?, 75 VA. L. REV. 15
(1989); John Teshelle, Banker's Right of Setoff—Banker Beware, 34 OKLA. L. REV. 66

\(^3\) 311 U.S.C. § 553 (1988):
(a) Except as otherwise provided in this section and in sections 362 and
363 of this title, this title does not affect any right of a creditor to offset a
mutual debt owing by such creditor to the debtor that arose before com-
mencement of the case under this title against a claim of such creditor
against the debtor that arose before commencement of the case, except to
the extent that—
   (1) the claim of such creditor . . . is disallowed other than under section
502(b)(3) of this title
   (2) such claim was transferred, by an entity other than the debtor, to
such creditor—
      (A) after the commencement of the case; or
      (B)(i) after 90 days before the date of the filing of the petition; and
         (ii) while the debtor was insolvent; or
   (3) the debt owed to the debtor by such creditor was incurred by such creditor—
      (A) after 90 days before the date of the filing of the petition;
      (B) while the debtor was insolvent; and
have for many years worried about the policy of giving priority to setoff holders in bankruptcy. The text of the Bankruptcy Code has presented priority for qualifying setoffs.

One qualification for priority of setoffs has received little attention because of a focus on the limitations on setoff expressed in § 553. The focus on these § 553 limitations on setoff has perpetuated the traditional precode canon that setoffs enjoy priority in bankruptcy. Setoff rights come from nonbankruptcy law, usually state law but also federal nonbankruptcy law. But nonbankruptcy law no more obviously grants priority rights to setoff than it generally grants any creditor rights of priority. Indeed, it is much easier to suppose what nonbankruptcy law does than to state plausibly what nonbankruptcy law does.

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(C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 365(h)(2), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.


Bankruptcy Act § 68 (Bankruptcy Act of 1898 as amended, 11 U.S.C § 108(a)-(b) (repealed 1979):

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

b. A setoff or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under section 93 of this title; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

4 See infra notes 28-30.

5 See infra note 75.

6 One theory of bankruptcy holds that state law should provide the norms of bankruptcy distributions. Thomas Jackson, The Logic and Limits of Bankruptcy Law (1986). One might object to this view on the grounds that state law is too indeterminate on distributive issues created by insolvent debtors to provide distributive norms. For example, in applying state law to constructive trusts, analysis of Jackson's theory reveals that it is neither constructive nor trustworthy as Dean Philip T. Lacy has similarly applied the same theory to support priority for setoffs in bankruptcy. Dean Lacy's recent
Bankruptcy has adopted nonbankruptcy law as generally conclusive on the validity of a setoff as well as almost all other questions of whether a claim of a creditor is valid. Bankruptcy need not also adopt any particular treatment which nonbankruptcy law might give to setoffs or any other valid nonbankruptcy claim. For example, bankruptcy generally recognizes the contract rights of a debtor’s promisees and the tort claims of a debtor’s victims. Yet bankruptcy does not guarantee promisees or victims that they will receive treatment in a bankruptcy proceeding in the face amount of their claims. The face amount of a creditor’s claim represents the same thing in bankruptcy as it

rejoinder counters Professor John C. McCoid’s conclusions by showing that some setoff rights, for example, those acquired while the debtor was solvent, do not offend the principle of equality among creditors as framed under preference law. Lacy, supra note 2; McCoid, supra note 2.

These examples suggest what may be true generally about the usefulness of a state law theory. State law may require an elaborate interpretive dance to determine what priorities it commends. Jackson seems to assume that a constructive trust claimant would win the race to a debtor’s assets under state law and so deserves bankruptcy protection. Lacy assumes a holder of setoff rights would win the same race.

Each may believe that these parties have a significantly higher likelihood of collecting their claims against an insolvent debtor than average creditors of the same debtor. But state law presents no obvious or uniform schedule of probable debt collectibility for any setoff or other claim.

Of course, if probable debt collectibility were the measure for bankruptcy priority, as it sometimes is, (see infra note 14) bankruptcy could conveniently choose to impose priority to all claims of a certain kind while recognizing that only the mean or median of such claims truly holds a higher than average collectibility rate. In this article I suggest that the code requires a case-by-case assessment of a setoff claim for priority based on a sufficiently high likelihood of collectibility under state law to merit priority in bankruptcy. But, the very different text of the former Bankruptcy Act presumed a high likelihood of collectibility, although the courts completely honored that text only in liquidations (which ironically had the least of any other policy basis). See infra Part IV. Currently, bankruptcy does not even indulge liens with any greater presumption of greater collectibility.


7§ 502(b)(1).

8Major exceptions to this rule are the limitations on recoverable damages in bankruptcy of lessors and employees (§ 502(b)(6)-(7)) who receive perhaps compensating alternative abstract bankruptcy rights under other bankruptcy sections.
does under state law: An abstract right to a judgment establishing the validity of a claim.

From one significant point of view, every creditor deserves to receive 100 cents on each dollar it is owed. We often talk as though state law provides for the collection of debt of 100 cents on a dollar. This cannot be the view of state law when the debtor is insolvent. State law has never guaranteed that the debt it makes enforceable will be collectible in its face amount. Rather, state law has provided creditors with the abstract legal rights to enforce and collect debts. In view of this legal machinery, one might illogically equate the proposition of what is a valid claim to what is a collectible claim. But state law generally does not, and of course generally cannot, actually enforce the precept that debts should be paid in full. That every creditor deserves full payment is thus a proposition states might adopt for solvent debtors. State law permits the legal enforcement of this proposition when the debtor is solvent.

Bankruptcy law, on the other hand, deals with the problem of insolvency in which alternative moral imperatives might support widely different bankruptcy approaches. A number of alternative moral imperatives could direct the essential task of converting prebankruptcy abstract legal rights of creditors into concrete bankruptcy rights, or in determining who gets the debtor’s assets.

9This statement must exclude the class of debtors who are insolvent only by the exclusion of exempt property. Unlike other debtors (for example, corporations), individual debtors (oxygen-breathers) for certain purposes are insolvent even though they have assets of a value greater than their liabilities or revenues sufficient to meet current debt obligations under the law of exempt property. For example, excluding exempt property, pursuant to fraudulent transfer law, debt obligations may leave an individual debtor with liabilities exceeding assets or current obligations exceeding revenues. See Uniform Fraudulent Transfer Act §§ 1-2. Bankruptcy is quite unsettled about the proper treatment of individual debtors solvent when exempt property is included in the calculation and insolvent when exempt property is excluded. Prebankruptcy planning presents the individual debtor the opportunity to exempt property. Some prebankruptcy planning is permissible and some not. So far a so-called "pig rule" provides an ad hoc bankruptcy limitation on prebankruptcy planning. E.g., NCNB Nat'l Bank v. Bowyer (In re Bowyer), 916 F.2d 1056, 1059 (5th Cir. 1990); Northwest Bank v. Tveten, 848 F.2d 871 (8th Cir. 1988); see also Fla. Stat. § 222.30 (1993)(invalidating exemptions created by conversion of nonexempt into exempt property with intent to hinder creditors).

10For example, bankruptcy law might distinguish among the claims of creditors by validating certain claims and invalidating others. Bankruptcy could strive to pay as much as possible to all those claims which are more deserving than others.

Or, bankruptcy could create a comprehensive hierarchical ladder of creditor claims. If payment in full of the most deserving creditor claims was the guiding norm, bankruptcy could pay only the top rung(s) to the extent of the value of the bankruptcy estate. In this scheme no claims valid under state law would need de jure invalidation, although most would receive de facto invalidation.

Though the latter bankruptcy scheme seems more like traditional and present bankruptcy law, elements of the former also manifest themselves in our bankruptcy law. Bankruptcy law has a rather short hierarchical list of the priority claims which often
The present Bankruptcy Code adopts an imperative with respect to claims in bankruptcy which rests on applicable nonbankruptcy law. The code leaves to nonbankruptcy law the largely unfettered function of identifying the validity and the amount of the claims of creditors. Bankruptcy uses these abstract prebankruptcy legal rights to determine the validity and the amount of the claims of creditors. This determination results in a conversion of prebankruptcy rights into abstract bankruptcy rights.

Creditors who achieve the best or better positions in debt-collection in bankruptcy proceedings are typically those who had priority over less well-positioned creditors before bankruptcy proceedings. As a result, the prebankruptcy calculus of the collectibility of any particular claim against a debtor comes to light in bankruptcy. For example, when a bank has a valid lien against an asset of an insolvent debtor, state law informs bankruptcy law about the relative collectibility of the bank's claim as against the other claims against debtor.

De facto invalidates unsecured claims excluded from the list. The list begins with secured claims and continues with the unsecured claims expressly granted priority in § 507.

Identifying claims valid in bankruptcy is the function of the bankruptcy concept of allowable claims, which generally proceeds under § 502. However, an allowable claim in a bankruptcy assures a creditor only an abstract bankruptcy right to compensation from the assets of the bankruptcy estate. Like state law, bankruptcy makes no guarantees of the present monetary value of allowable claims. Instead, such claims are rights to participate either in the asset distribution of a liquidation or in the bargaining (including voting) of a reorganization.

This may lead to the idea that state law may play an informative role, with respect to the different legal questions of how to convert abstract bankruptcy rights into concrete rights. For example, because state law has norms which identify the validity and amounts of claims, one might expect it to have norms regarding how to rank such claims. However, state law does not obviously rank the priority of claims, despite longstanding suppositions to the contrary. One priority principle from state law stands out: First in time is first in right. Although this "race" idea often appears in state law, it applies to priority disputes among lien or ownership claimants and it typically ranks lien or new owners above the claims of former owners' unsecured creditors. Among unsecured claims, state law has no priority rule. Generally, state law presents unsecured creditors a ratability rule under which last counts as much as first. This ratability rule combines with the priority rule of "first in time" to offer creditors an opportunity: claimants who first acquire payment or a lien securing payment typically have the better rights to the property with which the debtor made or secured payment.

Perhaps the soundest characterization of state law is opportunity. Every creditor has the opportunity to take a lien and acquire a higher priority than unsecured creditors. For the conversion of abstract legal rights to concrete legal rights, state law provides every creditor an equal opportunity to vindicate its abstract right. Thus, among abstract rights, state law presents a normative message of equal creditor opportunity. Nevertheless, by the time a debtor files bankruptcy, creditors will have begun to avail themselves of the state law debt-collection opportunities.

Bankruptcy might find this information interesting or irrelevant. Whatever normative force comes from the relative collectibility of the various claims against a
Bankruptcy thus uses relative collectibility to determine distributional priorities as in the case of liens.\textsuperscript{15} Bankruptcy also uses considerations apart from collectibility to determine bankruptcy priority. Employees receive priority for certain claims even though they may not have been well-positioned in any race for a debtor’s assets outside of a bankruptcy proceeding.\textsuperscript{16} Unsecured claims enjoying no specific code priority share proportionately, or ratably, according to the amounts of their allowed claims in whatever remains in the bankruptcy estate.\textsuperscript{17} The nature of the treatment of the different kinds of claim is sometimes not easily comprehended. Some claims seem to enjoy priority rather than mere ratability, although neither relative collectibility nor distinct bankruptcy aims seem to support their priority. Setoffs are an example of the latter.

Setoffs appear to enjoy priority in the code. However, no present bankruptcy aim justifies a general priority for setoffs.\textsuperscript{18} Relative collectibility also does not support a general priority for setoffs.\textsuperscript{19} Arguably, a different bankruptcy code might need to give general priority to setoffs.\textsuperscript{20} The Bankruptcy Code has no

debtor depends on the forcefulness of relative collectibility as a criterion for distributive bankruptcy issues.

Bankruptcy should never accept an \textit{a priori} normative force of relative collectibility unless it wishes to reward those who were equally favored under state law but who more vigorously engaged in debt-collection. One mistaken reason for rewarding the more vigorous debt-collectors would be the assumption that "rewarding" follows state priority law. This reasoning, however, transforms a state principle of equal opportunity into a state priority policy. A state might adopt a pure opportunity priority system because it wishes to avoid making these distributive decisions. If this were true, bankruptcy would have more reason to give normative force to state neutrality than to the priorities which happened to arise from neutrality. Honoring what is no more than the probability of debt-collectibility as a priority would require a different justification.

On the other hand, bankruptcy could make a commitment to relative collectibility for a number of reasons. Bankruptcy might wish to: 1) damage prebankruptcy creditor expectations as little as possible and honor vigorous debt-collectors as holding higher expectations; 2) minimize manipulative forum-shopping which may injure legitimate claims; and 3) have no independent reason to favor any creditor over others. In addition, bankruptcy might choose relative collectibility because it is an inexpensive priority scheme or one so expensive or uncertain that it forces creditors to bargain among themselves regarding how a bankruptcy estate shall be distributed. Bankruptcy might shirk relative collectibility and prefer pure ratability, or it might shirk collectibility for other priority schemes which serve other purposes.

\textsuperscript{15}\S\S \textit{506(a), 724(b)(1), 1129(b)(2)(A).}
\textsuperscript{16}\S \textit{507(a)(3)-(4).}
\textsuperscript{17}\S \textit{726(a)(1).}
\textsuperscript{18}McCoid has laid the foundation for this assertion on which Part III builds. \textit{See} McCoid, \textit{supra} note 2.
\textsuperscript{19}\textit{Id.}
\textsuperscript{20}Granting priority to setoff in bankruptcy may have the effect of encouraging holders of setoff rights to refrain from exercising those rights before a bankruptcy case commences. If true, this may provide a debtor in bankruptcy the opportunity to use
need to provide such priority to setoffs. Relative collectibility does favor certain
setoffs, but it does not confer a general priority to setoffs inasmuch as the
collectibility probability of setoffs seems no more than average.

Thus, it is not surprising that a careful examination of the code shows that
setoffs may receive priority in bankruptcy. Setoffs, however, do not, and should
not, obtain bankruptcy priority simply because they are valid under state law.
This article explains why any priority for setoff in bankruptcy is more
complicated than usually assumed. The validity of an abstract legal right prior
to bankruptcy is only the first step in the process of obtaining priority in
bankruptcy. When the code validates setoff, it merely accepts the abstract legal
right of the setoff. In order to have priority, a setoff must pass a relative
collectibility test, commonly known as valuation under § 506(a).21

Bankruptcy traditionally treats the rights of a setoff holder against an
insolvent bankruptcy estate as though the estate were solvent. The tradition of
fully recognizing setoff in these insolvency proceedings has continued
primarily due to a policy favoring the reorganization of distressed businesses.
The policy of protecting setoff for the purpose of providing reorganizing
businesses with needed operating funds became anachronistic with the
enactment of the Bankruptcy Code.22

Setoff holders are given secured claims under the code.23 The secured claim
is a feat of legal imagination because claims are abstract rights against someone
and secured claims are abstract rights against something. A setoff holder has a
claim against the debtor in bankruptcy and is also subject to liability on a claim
of a debtor in bankruptcy. As compared to other creditors holding in personam
funds in a bank account during a bankruptcy proceeding. A policy favoring
reorganization would permit this use, as does the code. See infra Part III. But that
reorganization policy need not be implemented by a setoff priority.

Section 68 of the Bankruptcy Act granted priority to setoff rights which survived
despite criticism perhaps because, absent these rights, the reorganizing debtor would
lack the funds to operate the business while restructuring its finances and operations.
The Bankruptcy Code has no such reason to grant setoff priority because it directly
creates the opportunity to use funds subject to setoff. Nor does the code obviously grant
setoff priority independent of relative collectibility.

21 The Senate Judiciary Committee Report on the Bankruptcy Reform Act of 1978
shows that the legislature recognized that setoffs might be subject to valuation under
§ 506(a): "The subsection [506(a)] also provides for the valuation of claims which involve
setoffs under section 553." S.R. No. 989, 95th Cong., 2d Sess. 68 (1978), reprinted in 1978
U.S.C.C.A.N. 5854. (note that the comparable provision of the House Committee Report,
95-595, lacks this precise statement. See infra note 23).

22 See infra Part III.

23 § 506(a). The legislative history shows appreciation for the similarity of liens and
setoffs which led to merging the two as code secured claims.

"[T]he analogy between a deposit or debt that may be offset and a
security interest is not complete. Nevertheless, it is adequate to justify
giving an offsetting creditor the same protection as the bill gives secured
creditors generally."

claims against a bankrupt debtor, a setoff holder is indistinguishable from the other creditors. Yet a setoff holder effectively manages to enjoy a priority over other creditors in bankruptcy by effectively receiving payment on its claim by a setoff rate rather than a pro rata figure. In other words, a setoff holder is distinguished from other creditors on the grounds that the setoff holder owes money to the estate. An unsecured creditor may become a secured claimant because it owes as much to the estate as the estate owes it.

A mistake supports the imagination behind this idea of setoff. The mistake is found in the assumption that equal face-amount debts owed to a bankruptcy estate and by a bankruptcy estate are balanced. Bankruptcy takes the Wonderland view by concluding that these mutual claims have equivalent value. The purpose of this counterfactual assumption (how can a claim against an insolvent have the same value as a claim in same amount against a solvent?) eventually became an incentive to banks from setting off, so that a reorganizable debtor might have the use of its bank account to continue business operations. No longer necessary for that blunt purpose, the setoff seems to live on. 24

When parties simultaneously owe each other money, which is presently payable, they agree 25 to net-out the claims or debts out and the net debtor will

24 See infra Part III.

25 Like other agreements under the objective theory of contract law, neither party need actually or subjectively assent to the netting out of the claims. Parties with frequent common dealings as debtor and as creditor often do provide for setoff in their express agreements or through their course of dealings. Even without such overt behavior, the law accords each the right of setoff to the extent it is a creditor. Some setoff rights may thus arise without either party's manifesting assent at all. In these contexts quasi-contract may more accurately ground the right of setoff. "Setoff is a creature of equity, and arises without the aid of a special contract between the bank and depositor." See Clark, supra note 2, at 233. Seen as a cure for unjust enrichment outside of bankruptcy as between two parties each of whom is debtor and creditor, setoff in bankruptcy affects other parties and may conversely unjustly enrich a setoff holder.

The right of setoff as a state law creation may aim only at the two-party relationship as opposed to the exercise of setoff under which state law may recognize the exercise of a right of setoff as a priority. E.g., U.C.C. § 4-303 (1990). A right of setoff at bankruptcy resembles an un adjudicated claim of a constructive trust. Bankruptcy law has struggled with claims of the latter. See supra note 6.

The leading cases tend to involve an ownership claim to property of the estate frequently deriving from state constructive trust law. This has become the most controversial setting for determining whether a claimant owns the property or whether the claimant is just another unsecured creditor of the estate. Cases supportive of the nonbankrupt party's claim of ownership include: Sanyo Elec., Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.), 874 F.2d 88 (2d Cir. 1989); City Nat'l Bank of Miami v. General Coffee Corp. (In re General Coffee Corp.), 828 F.2d 699 (11th Cir. 1987), cert. denied, 485 U.S. 1007 (1988); Vineyard v. McKenzie (In re Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985) (approving in theory and not on the facts presented). Cases rejecting the nonbankrupt party's claim of ownership include: First Capital Mortg. Loan Corp. v. Research-Planning, Inc. (In re First Capital Mortg. Loan Corp.), 917 F.2d 424 (10th Cir. 1990); Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989); Torres v. Eastlick (In re North Am. Coin & Currency, Ltd.), 767 F.2d 1573 (9th Cir. 1985) (refusing to apply constructive trust ownership theory absent fraud).
pay the other the balance owing. This simple process is the origin of setoff and remains the legal basis for setoff. Although untroubling when it occurs between solvent parties, setoff may become troubling when one party is insolvent. In a bankruptcy proceeding, the domicile of the insolvent, setoff raises positive and normative questions.

Bankruptcy law never fully respected setoffs and setoff rights.\textsuperscript{26} Setoffs have remained controversial under the Bankruptcy Code\textsuperscript{27} as they had been under the repealed Bankruptcy Act.\textsuperscript{28}

Bankruptcy may have conflicts to resolve which state law does not address. That appears to be true for constructive trust claims in bankruptcy, which move a simple two-party constructive trust issue into a multi-party context. Likewise, a claim of a setoff right in bankruptcy may ask for a priority over other creditors based on state law authority which addresses only two-party disputes—the setoff holder and its depositor/debtor. In multi-party contexts, such as distributional disputes among creditors, the state law validating setoff may rest primarily on the premise that a debtor’s creditors may have to bear the cost of finding further assets of a debtor, which will have satisfaction from a ready asset such as a bank account. State debtor-creditor law, a body of law which is almost entirely ancient, may have been formed without any view that the debtor is insolvent.

\textsuperscript{26}See supra note 3, for text of § 553. The bankruptcy code creates the distinction between setoffs exercised prior to bankruptcy and those that are not. The few rules provided by the code distinguish setoff rights held at the time a bankruptcy case begins (§ 553(a)) from setoffs exercised prior to bankruptcy (§ 553(b)). The magic of legal imagination permits such fantastic distinctions. One legally clear occurrence of the exercise of a setoff right seems to be the moment a court orders one debt to offset another. Yet, so many setoffs are held by banks or other depository institutions that, by the customs of such institutions, setoff occurs when some customary procedure is followed by which a deposit account is "seized." This has led to a second perhaps clear legal instance of setoff: setoff occurs when such setoff rights holders say so.

As with the first example, whether the setoff was valid often depends on whether a court eventually will agree with the setoff holder's action. But, the time at which a court rules that a setoff right is valid may no more be the time at which a party offsets than would a contract occur when a court rules a contract to be valid. Surely there are contract rights and setoff rights antedating judicial rulings. The model of bank setoff suggests that setoff occurs when one debtor, such as a bank, refuses the demand for payment by another debtor, its depositor. In nonbank contexts it is the apparent insignificance of a rejected demand for payment, the absence of a customary materiality, that leads to the belief that at bankruptcy the code might separate exercised or actual setoffs from setoff rights which have not been acted on. Thus, § 553 breaks into two different categories the question of setoffs in bankruptcy as though the real world supported the idea that some setoffs have not occurred before bankruptcy and others have. This reasoning rests on the groundless belief that prior to bankruptcy demands and refusals to pay have not occurred between the eventual debtor in bankruptcy and its debtors and creditors.


\textsuperscript{28}Hitherto, the controversy about setoff has rested on principle: does the code priority for setoff violate a fundamental bankruptcy principle, such as a principle of creditor equality? This question was recently asked and answered affirmatively by Professor John C. McCoid. McCoid, supra note 2. Dean Philip T. Lacy's recent rejoinder counters McCoid's conclusions by showing that some setoff rights, those acquired while the debtor was solvent, do not offend the principle of equality among creditors as framed
Cases and commentary have questioned the normative wisdom of the code's validation of setoff rights. In addition, the code provisions regarding setoff are less plain than practice books suggest.

under preference law. Lacy, supra note 2. This article takes a different view than their template of preference law to assess the proper scope of setoff rights in bankruptcy. See infra note 39. This paper questions the conventional code reading adopted or assumed by McCoid and Lacy, and apparently, by everyone else.

The significant interpretive difficulty on setoff has concerned the dispute about the effect of the automatic stay on setoff rights including whether a bank's administrative freeze of an account violates the stay. Compare Daniel Keating, Offensive Uses of the Automatic Stay, 45 VAND. L. REV. 71 (1992) (automatic stay enables bankruptcy court review of setoff validity) and B.F. Goodrich Employees Fed. Credit Union v. Patterson (In re Patterson), 967 F.2d 505 (11th Cir. 1992) (a credit union's freeze of deposit without relief from stay violates automatic stay) with Jack F. Williams, Application of the Cash Collateral Paradigm to the Preservation of the Right Setoff in Bankruptcy, 7 BANKR. DEV. J. 27 (1990) (freeze should not violate stay provision because cash collateral under § 363(c)(2) requires adequate protection of setoff holder's rights).

In addition, setoff under the Bankruptcy Act was often questioned. Indeed, the Supreme Court ruled that setoffs needn't be recognized in railroad reorganization under former § 77 because of the policy favoring railroad reorganization. Lowden v. Northwestern Nat'l Bank & Trust Co., 298 U.S. 160 (1936); Baker v. Gold Seal Liquors, Inc., 417 U.S. 467 (1974). Other bankruptcy courts had likewise suggested under the Act that setoff is merely permissive and is a notion which has recurred under the code. See infra Part III.

29 E.g., Elcona Homes Corp. v. Green Tree Acceptance, Inc. (In re Elcona Homes Corp.), 863 F.2d 483 (7th Cir. 1988) (presenting objections to bankruptcy's apparent favoring of setoff holders); McCoid, supra note 2 (setoff conflicts with the principle of creditor equality); Lacy, supra note 2 (challenging McCoid's analysis as to setoff rights inter alia obtained while the debtor was solvent as no violation of the equality principle). Lacy's defense against the claim that setoff is a misguided preference uses the law of preference to show some setoffs are not preferences. In this he assumes that the immunization of transfers prior to a preference period or while a debtor was solvent, is sound bankruptcy law. That is questionable. Second, the timing of the right to setoff may not be the appropriate focal point for comparative analysis with preference law. Thus, if a setoff right accrued while the debtor was solvent, but setoff was exercised only after the debtor became insolvent, the latter event seems the better analogue of a preferential transfer.

The creditor who has not setoff by the date of bankruptcy, as with the creditor who has done so on the eve of bankruptcy, might have the setoff avoided or affected in bankruptcy under a principle of creditor equality. Similarly, Lacy suggests that his quarrel with McCoid is principally that the latter fails to evaluate his anti-setoff views with the bankruptcy theory of Baird and Jackson. Lacy, supra note 2, at 953 n.13. Baird and Jackson's theories largely advocate bankruptcy's recognition of creditor's nonbankruptcy entitlements. DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY (1992); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986). Lacy argues that creditor's nonbankruptcy entitlements recognized in bankruptcy include setoff rights.

But this overstates the issues between the "state's rights" and the "bankruptcy policy" groups. Jackson has emphasized that a major task of bankruptcy law is the proper translation of substantive nonbankruptcy rights in the bankruptcy context rather than resting bankruptcy analysis on whatever label a state might formally use. The setoff question is a preeminent example of the problem about which people might disagree as to the correct bankruptcy translation. No one seems to maintain a strong view of
Setoffs may offend a notion of equality among creditors because the setoff holder, when conceived as an unsecured creditor, receives better treatment than other unsecured creditors.32 Honoring setoff in bankruptcy may pay a setoff holder more than that paid to other unsecured creditors. On the other hand, some setoff holders, along with other creditors (such as liens), may deserve priority in bankruptcy as "secured claims".33 The Bankruptcy Code has seemingly taken the latter view in providing a "secured claim" to setoff holders.34 Like liens, setoffs may enjoy better treatment in bankruptcy than claims of unsecured creditors.35 Legitimate doubts about the analogy of setoffs to liens remain, as does traditional bankruptcy hostility to liens and other priority treatments of any creditor in a bankruptcy proceeding.

either state rights in bankruptcy or of bankruptcy policy. For example, the bankruptcy policy view does not suggest that nonbankruptcy entitlements should be ignored in developing bankruptcy law; nor has the pro-entitlements view taken the opposite position. The conflict remains relatively mild and theoretically undefined with abundant examples of disagreement but no broad view by which to comprehend why it isn't all ad hoc. See also David G. Carlson, Bankruptcy Philosophy, 85 Mich. L. Rev. 1341 (1987).

30Commentary supporting setoff in bankruptcy: Hammon, supra note 2; Lacy, supra note 2; Leibowitz, supra note 2. Contra McCoid, supra note 2; D.E. Murray, Bank Versus Creditors of Their Customers: Set-offs Against Customers' Accounts, 82 COM. L.J. 449 (1977).

31Because the parties to a setoff relationship are both creditors and both debtors, I use debtor when referring to the debtor in bankruptcy and setoff holder or setoff claimant in referring to the nonbankrupt party. Two reported cases posed a setoff relationship while each was a debtor in bankruptcy. There I resort to proper names. See infra at notes 212-36.

Under § 553 a right of setoff is recognized with the following limits: (1) the body of § 553(a) does not create a right of setoff which was not valid prior to the bankruptcy of the debtor against whom a setoff right is asserted; (2) § 553(a)(1) bars setoff based on a disallowed claim against a debtor, and this is very significant as the text will explain; (3) § 553(a)(2) bars setoff based on a claim against a debtor transferred by an entity other than the debtor either after commencement of the bankruptcy case, or within 90 days before the date of the filing of the petition; (4) § 553(a)(3) bars setoff through a claim against the debtor acquired for the purpose of obtaining a setoff right within 90 days of the filing of the petition and while debtor was insolvent; (5) § 553(b) recaptures a setoff right exercised prior to the date of the filing of the petition to the extent creditor has reduced the insufficiency between its claim and the debtor's claim between either 90 days before the filing or the first date there is an insufficiency and the date of the exercise of the setoff right. In addition the code bars the exercise of a setoff right by a claim that arose against the debtor before the commencement of the case under § 362(a)(7) though relief from this stay may be granted. § 362(d).

Other than these limitations on setoff rights in bankruptcy, one further unnoticed limitation is the thesis of this article: under § 506(a) the court may value the setoff right at less than its face value. See infra Part I.

32See McCoid, supra note 2.

33See Lacy, supra note 2.

34§ 506(a).

35§ 553.
Full recognition of liens in bankruptcy only follows from bankruptcy tests to which setoffs are generally immune. Although setoffs must pass their own tests under the code, setoffs share another basic test with liens for their qualification as a secured claim under §506(a). This test, valuation, limits the priority of liens and setoffs in bankruptcy. While the valuation of liens in bankruptcy is as common and notorious as debt in bankruptcy, valuation of setoff rights in bankruptcy is unknown. The thesis presented here holds that valuation of setoff rights is no less appropriate than lien valuation, and further, that the text of the code readily accepts such an unconventional reading.

Setoff overcompensates the holder of a claim against the debtor whenever its face value exceeds the real value of that claim. Setoff in bankruptcy has

36 The preface to §553(a) provides the setoff immunity from the trustee's strong arm power under §544(a), which avoids liens (and other transfers of the debtor) unperfected at bankruptcy.

37 Section 553 imposes five tests for recognizing setoffs in bankruptcy. See supra note 31. The first requires that the setoff be valid under nonbankruptcy law. The other four are independent bankruptcy tests: §§553(a)(1)-(3), 553(b).

38 I presume here the normative probity of lien valuation and traditional lien priority in bankruptcy. My thesis merely follows from acceptance of that premise, the code text and sundry comparisons of similarity and difference between bankruptcy treatments of creditors. Until I find time to repair my broken normativity machine, I shall have to endure drawing normative conclusions based on the general lines of treatment that bankruptcy gives to various creditors. I leave to others their own broken normativity machines and invite them to limit the normative appeal of their speculations in this way. Even though one may derive no final 'ought' from swinging at the often dizzying 'is' of the Bankruptcy Code, it does cut down strikeouts and may yield an attainable hit for justice by treating equals the same.

39 Permitting a creditor to offset its debt to a bankruptcy estate in the full face amount of the debt owed by the debtor offends the norm of fraudulent transfer law. Face amount valuation of setoff preserves a principle of reciprocity between a setoff holder and its debtor. As between these two parties alone, their contractually-based rights demand full setoff valuation. On the other hand, bankruptcy places the reciprocal rights of creditors against the bankruptcy estate and imposes fraudulent transfer and preference law to limit any individual entity's rights in or against property of a bankruptcy estate or property which ought to be in an estate. Fraudulent transfer law cuts deeper than preference law which is, in principle, simply an aspect of the overcompensation aspect of fraudulent transfer law.

The highly technical preference law (§547(b)) forces the sharing with other creditors of certain prebankruptcy transfers of a debtor's property, when made: 1) on account of an antecedent debt; and 2) within the preference period; and 3) while debtor was insolvent. This yields the creditor more than she would have received in a liquidation. §547(b)(1)-(5). Preference law is taken to implement a policy of equality among creditors. It is perhaps disputable that the preference law should be taken to ground a principle of equality. Another justification for preference law is the chilling of premature collection activity by creditors which may preclude a debtor's business turnaround. Perhaps another argument in support of preference law is the maintenance of the debtor's assets as a business unit which may produce a greater yield for creditors in bankruptcy.
None of these reasons should persuade anyone that bankruptcy needs present preference law. All these preference law justifications are apologies for an embarrassing tradition since preference recoveries cannot produce ratable equality in a code which itself has less equality than inequality in its favoring so many different claimants (e.g., §§ 506-507) who frequently take much if not most of every bankruptcy estate. No more than the society at large in which equality is more a dream than a reality, may bankruptcy implement a principle of equality among creditors. Chilling premature collections through preference law, or maintaining the business as a more valuable unit through preference law is hardly the feat of preference law in a bankruptcy code which permits creditors and debtors to file bankruptcy and obtain an automatic stay without so much as a judicial fare-thee-well. The power to file and invoke the automatic stay protects against premature collections and preserves the "common pool." Preference law deters no one from prebankruptcy collection.

Fraudulent transfer is the normative basis by which bankruptcy should measure setoff. The thesis here is that the positive basis for setoff—the code—doesn't require the traditional or conventional priority for setoff. Reading the code as suggested in this article would permit bankruptcy treatment of setoff consistent with the principles of fraudulent transfer by compensating setoff with its real value.

The real value of a general claim against an insolvent is the face amount of a claim discounted by the odds and time of its collection. This approach theoretically differs from previous suggestions. See McCoid, supra note 2, at 1-6. McCoid's proof of the violation of the principle of equality rests on contrasting setoff protection with preference law and suffers under Dean Lacy's criticism. See Lacy, supra note 2. Yet, the many histories, purposes and immunities within preference law leave little case for it.

The vicious preference clock, telling either Creditor Savings Time or Creditor Immunity Time, cannot itself be explained by any sound principle of equality among creditors when the problematical aspect of preference law remains proximity to bankruptcy rather than just insolvency. But this needs a few words of explanation: a transfer which otherwise qualifies for preference avoidance under § 547(b) is not voidable as a preference if effectively made prior to the preference period. Yet a debtor might have been insolvent, or as insolvent, prior to the preference period when the transfer was made. That creditor may be overcompensated for its claim if bankruptcy law permits its retention. Preference law tolerates the retention. Fraudulent transfer law should not tolerate the retention, but the issue there of "reasonably equivalent value" is problematical. "Value" includes satisfaction of antecedent debt. § 548(d)(2)(A). If the real value of the debt or claim for which payment is made prior to the preference period is less than the payment, then the creditor may have received more than the reasonably equivalent value of its claim. To that extent it is theoretically a fraudulent transfer. § 548(a)(2)(A)-(B). Fraudulent transfer law articulates the overcompensation principle, if never perfectly, and is the proper theoretical basis for understanding setoff in bankruptcy.

Some might still insist that the principle of equality grounds the overcompensation test as implemented in fraudulent transfer law. But that is wrong because the overcompensation principle may benefit third parties or debtors independent of their creditors. For example, the rights to avoid transfers on exempt property (§§ 522(d)-(i)) benefit debtors, not creditors. I don't think § 522(f), for example, is necessarily wise to the extent the courts have applied it to cases in which a debtor has chosen or been restricted to the state exemptions, because the overcompensation principle is there infringed by overcompensating debtors who may thereby gain greater exemption rights than outside bankruptcy. See Owen v. Owen, 111 S. Ct. 1833 (1991); Lawrence Kalevitch, Lien Avoidance on Exemptions Property: The False Controversy About Opt-out, 44 OKLA. L. REV. 443 (1991); C. Robert Morris, Bankruptcy Fantasy: The Site of Missing Words and The Order of Illusory Events, 45 ARK. L. REV. 265 (1992).
traditionally provided the setoff holder with a right to cancel its liability to the bankrupt estate by the face amount of the setoff holder’s claim against the estate. Although the code defines setoff as a secured claim, the implication of including setoffs within the concept of secured claims has not been addressed.

The code treats liens and setoffs as secured claims. A lienor under § 506 receives a secured claim in the face amount of the debt secured only if the collateral has at least that value. Section 506(a) requires collateral valuation to determine the amount of the secured claim. Setoff in the face amount of a creditor’s claim likewise requires valuation. Part II discusses § 506(a) and § 553 and how they may limit, in appropriate cases, the setoff right to less than the face amount of a creditor’s claim. Part II shows that this reading of the Bankruptcy Code is not only consistent with § 553, but also readily accepted under § 553. Part II continues with a more detailed examination and analysis of § 553. Part III compares the different kinds of setoffs with liens and other creditors’ rights and shows that certain setoffs compare well with creditors who enjoy no special bankruptcy treatment, even though these creditors were well-positioned until bankruptcy. Part IV continues the theme of the positive analysis of Part II, and the comparative analysis of Part III, to set forth an

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41 E.g., Lacy, supra note 2, at 959; McCoid, supra note 2, at 15-16, 27-39; Baird, supra note 29, at 206; Frank Kennedy, Secured Creditors Under the Bankruptcy Reform Act, 15 IND. L. REV. 477, 487 (1982).

Professor Kennedy also explained the purpose of § 553(b)’s limitation on setoff as perhaps different from the principle of equality among creditors: "The application of this [§ 553(b)] test only to pre-petition setoffs is intended to deter them in the interest of enhancing the chances that debtors in distress may survive financial crises as a result of the exercise of restraint by their bank creditors." Kennedy, supra, at 491 n.89. Yet, Professor Kennedy might have thought the equality principle so implicit that he might assume no one would think his identification of a policy of deterrence behind § 553(b) as exclusive. See also supra note 20.

A policy of deterring prebankruptcy setoffs by bank creditors has some effectiveness under § 553(b) because a bank creditor can setoff almost instantly. So its collections by setoff are different from the typical unsecured creditor whom only the mythology of preference law could deter. Bank setoff may be the only effective creditor collection which can disempower the general timing power bankruptcy gives debtors (or groups of creditors). Professor Kennedy’s statement of the purpose of § 553(b) provides an incentive to creditors, including banks, against offsetting during the 90 days before bankruptcy, presumably by protecting the right of setoff for those creditors who don’t setoff until after bankruptcy (and by leave of court—§ 362(a)(7)). Part III addresses this "reward" justification of setoff, and the theses of Part I and II may diminish the bankruptcy value of a setoff right even for those who wait.

42 Other requirements for this conclusion include that the debt be allowable under § 502.

43 § 506(a).

44 Infra note 49.

45 Infra note 92.
explanation of why the intuitions regarding the preferential aspect of setoffs were curbed by a policy goal which has become anachronistic.46

Part V discusses valuation of setoff rights in bankruptcy. This discussion may disappoint anyone predisposed to thinking that valuation of setoff rights might be simple or quick. However, no one familiar with the valuation process of collateral in bankruptcy should be surprised. Still, this may discourage appreciation of the theses presented, and may strengthen the tradition of valuing setoffs in the face amount of the creditor’s claim. Consistency and integrity would require performing the same valuation for the same valuation for secured claims which are liens.47 Part VI addresses postbankruptcy setoff rights and inquires as to the effects of exempt property, debt discharge and confirmation on setoff rights.48

Some setoffs deserve validation in full in bankruptcy proceedings, even after bankruptcy proceedings have come to discharge or confirmation. Others deserve treatment no different than gifts by insolvents. The remaining setoff claims require careful handling.

II. SETOFF AND THE CODE TEXT

The voluntary exchange of something relatively worthless for something relatively valuable may be permissible between the immediate parties as a valid contract but it is a voidable fraudulent transfer when the party who received something relatively worthless was or thereby became insolvent.49 Such exchanges impair the rights of third-parties, the creditors of the insolvent. The general principle supporting bankruptcy’s compensation of creditors derives from fraudulent transfer law. No one should take from a debtor more than its fair share. Some transferees, including creditors, will take more than others because their rights were relatively more valuable before bankruptcy.50 Some creditors will take more because specific federal bankruptcy policies define their fair share, regardless of their relative prebankruptcy value.51 No federal bankruptcy policy supports an indiscriminate priority in bankruptcy for a holder of a setoff claim.52 Thus, any priority for setoff in bankruptcy must derive from the relative value of a setoff before bankruptcy. Some setoff claims have no more relative value than some creditors have sufficient collateral to back their claims. Under such circumstances, bankruptcy’s recognition of setoff

46 Infra note 158.
47 Infra note 195.
48 Infra note 205.
49 E.g., Uniform Fraudulent Transfer Act § 5(a).
50 § 502.
51 E.g., § 507.
52 Section 553(a) rather neutrally permits recognition of setoffs in bankruptcy to the extent setoffs are recognized outside of bankruptcy.
in the face amount of a creditor's claim confers a gift on the setoff holder and violates the fraudulent transfer principle.

A. Section 506(a)

The code treats a setoff just like a secured claim. Under § 506(a), the code may determine that a setoff right is a secured claim. When a traditional lienor under real or personal property law has a secured claim under § 506(a), the amount of the secured claim is the value of the collateral.\(^{53}\) Section 506(a) grants a valid\(^{54}\) setoff holder "a secured claim . . . to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent . . . the amount so subject to setoff is less than the amount of such allowed claim."\(^{55}\)

Conventional analysis reads the "amount subject to setoff, as the case may be" as the face amount of the creditor's claim against the estate.\(^{56}\) Under this analysis, the amount of the secured claim a setoff holder receives under § 506(a) follows from the allowed claim of the creditor under § 502.\(^{57}\) This reading of the code permits overcompensation and relative favoring of setoff holders in bankruptcy and begs the question of whether the code does give setoff holders priority. The previously quoted code text and § 553 suggest a different analysis, which, although more complicated, is responsive to the distributive fairness

\(^{53}\)§ 506(a).

\(^{54}\)Section 553 must recognize that a setoff is valid before § 506(a) applies. The latter incorporates the former. Interestingly, this is also true conversely. § 553(a)(1).

\(^{55}\)Id.

\(^{56}\)See supra note 39.

\(^{57}\)E.g., GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 169 (1986), which refers only to disallowed under § 502. Another commentator attributes the inclusion of setoff as a secured claim under § 506(a) as necessary to § 553(b): "Without section 506(b)'s [506(a)] inclusion of a right of setoff in its definition of secured claim, every pre-bankruptcy setoff would result in an improvement in position. With section 506(b) [506(a)], it is necessary to look to section 553(b) to determine which setoffs result in an impermissible pre-bankruptcy improvement in position." DAVID C. EPSTEIN ET AL., DEBTORS AND CREDITORS 945-46 (3d ed. 1987).

But, § 553(b) alone suffices for the calculation of any improvement in position due to a setoff taken within 90 days before bankruptcy. Under that provision the critical term is "insufficiency" which is defined therein as the "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." § 553(b)(2). A court compares the insufficiencies at two specified dates and thereby determines any recoverable improvement-in-position. No recourse to § 506 enters this separate § 553(b) analysis. However, the amount by which the setoff did not improve the holder's position may remain for valuation as a secured claim under § 506(a) if the trustee or debtor obtains the use of such funds under § 363(c)(2). See infra notes 171, 194. Otherwise, no issue of any "secured claim" may arise from the setoff.
issues which trouble judges like Richard Posner\textsuperscript{58} and scholars like John McCoid.\textsuperscript{59}

The quoted text of the Bankruptcy Code does not expressly provide the computation of the "amount subject to setoff, as the case may be".\textsuperscript{60} What the section teaches is that the amount subject to setoff is the allowed secured claim of the setoff holder.\textsuperscript{61} For the case-by-case determination ("as the case may be") of the "amount subject to setoff," setoff claimants may undergo valuation, as do lien claimants, to determine the allowed secured claims.\textsuperscript{62} In lien cases, bankruptcy determines the value of the collateral in order to determine the allowed secured claim.\textsuperscript{63} Likewise, bankruptcy determines the value of the amount subject to setoff. When the setoff right has a lesser value than the face-amount of the creditor's claim against the debtor, § 506(a) may limit the setoff in bankruptcy, just as it limits a lien to the extent that the debt exceeds the determined value of the collateral.

Section 506(a) permits real valuation of setoff rights in bankruptcy. "An allowed claim"\textsuperscript{64}, begins § 506(a), is "a secured claim to the extent of the amount subject to setoff... and is an unsecured claim to the extent that... the amount so subject to setoff is less than the amount of such allowed claim." Determination of "the amount subject to setoff" is critical to this definition of the "secured claim" that the section bestows upon any setoff claimant. What is the "the amount subject to setoff"? Readers of this sparse language need to know the meaning of this critical expression in order to determine what is the secured claim of a setoff holder.

In the traditional setoff formula, DC\textsuperscript{65} - CC\textsuperscript{66} or CC - DC, the amount subject to setoff is either DC or CC. The setoff amount which any creditor has is the amount of its claim reduced to the extent to which its own claim exceeds the claim against which setoff may be taken. From the point of view of the creditor who has not filed bankruptcy, its setoff right is CC - DC. CC may be taken to

\textsuperscript{58}Elcona Homes Corp. v. Green Tree Acceptance, Inc. (In re Elcona Homes Corp.), 863 F.2d 483 (7th Cir. 1988).

\textsuperscript{59}See supra notes 28-30.

\textsuperscript{60}§ 506(a).

\textsuperscript{61}Determination of a secured claim is the purpose of § 506.

\textsuperscript{62}"Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." § 506(a). See supra note 37.


\textsuperscript{64}"An allowed claim," the phrase with which § 506(a) begins, means a claim which § 502 deems valid against a bankruptcy estate.

\textsuperscript{65}DC equals the bankruptcy debtor's claim.

\textsuperscript{66}CC equals the creditor's claim.
equal the allowed unsecured claim of the setoff claimant, or the latter discounted to true value. The former interpretation supports the conventional face-value treatment of setoff; the latter supports the real value interpretation suggested here. Under the statutory text CC may equal either; thus, § 506(a) permits bankruptcy courts to determine the amount subject to setoff to be the real value of the creditor’s claim, CC. This is the consequence of the drafters’ use of the expression "the amount subject to setoff" without defining or further explaining that expression. This consequence does not necessarily reflect the intention of the drafters.

Using face-value figures in the setoff formula assumes that the critical expression, "the amount subject to setoff," may be derived directly from the amounts of the prebankruptcy claims of each party. Arguably, this derivation is consistent with the drafters’ expectations, that the traditional netting out of mutual claims followed setoff analysis. The net result is an amount subject to setoff, at face-valuation of the setoff claimant’s setoff right, which may well be appropriate when the unsecured claim is able to be satisfied in full. When, in a bankruptcy proceeding, that cannot be accomplished, devaluing setoff rights may be more appropriate under the code text.

Section 506(a) refers to § 553, which is conventionally read as the critical code provision on setoff. In general, § 553 does not conclude its work until § 506(a) has allowed or disallowed the setoff right.67 This follows not from the fact that § 506 precedes § 553 in the code, but rather because § 553 incorporates § 506 and requires setoff determination under § 506(a). If the latter permits setoff valuation as here suggested, § 553 does as well.

B. Section 553

Prefatorily, § 553 teaches that "[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor . . . against a claim of such creditor against the debtor. . . ."68 Setoff is a "right of a creditor to offset a mutual debt." Whatever right to offset that a creditor may have to offset in bankruptcy cannot exceed its nonbankruptcy right. Whether a creditor has any such nonbankruptcy right is far more complex than typically addressed in bankruptcy discussions. To the bankruptcy writer, the right may be assumed. If a creditor would be denied setoff outside of bankruptcy, in

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67Section 553(a)(1) specifically makes this point, although it does not expressly relate its use of the term "disallowed" to § 506(a). Section 553(a)(1) does present the idea that a setoff right might be disallowed for its purposes, such as limiting setoff rights in bankruptcy, for any disallowing reason other than § 502(b)(3). See infra text accompanying note 55.

68§ 553(a).
whole or part, then to that extent there is no bankruptcy right protected by § 553.69

Those debts which are mutual are the subject of a long and frequently troubling history in bankruptcy and debtor-creditor law. The doctrine of mutuality of debts requires that, on some scale of parallel planes, each debt must have arisen more or less on the same plane for setoff to be permitted.70 Thus, where the bank holds a loan claim for money against D and D has a deposit account with that bank, the debts are mutual; and where the bank has the monetary claim but holds money in trust for D, the debts are not mutual, as the bank is a trustee, not a debtor. Preoccupation with the mutuality doctrine has obscured the question of the amount of the setoff. The reference to the nonbankruptcy right of setoff in § 553(a) may suggest that the code is incorporating nonbankruptcy law to provide the amount of the setoff right. However, the reference to nonbankruptcy law may only determine the abstract question of whether a setoff claimant has any setoff right and may leave for bankruptcy determination the amount of the setoff right under §§ 553 or 506.71

69Section 553(a)(1) requires that the setoff right asserted must not be disallowed. It may be disallowed under § 502(b)(1), like any other claim, to the extent it is unenforceable outside of bankruptcy. See Murray, supra note 30.


The recent rash of insolvencies of bank institutions, generally outside of Title 11 bankruptcy proceedings, has produced interesting setoff decisions on the mutuality of debt issue. See, e.g., Grady Properties Co. v. FDIC, 927 F.2d 528 (10th Cir. 1991) (holding that setoff is barred where bank's debtor acquired claim against bank from third party arising from a separate and unrelated commercial transaction).

71Recognition of abstract nonbankruptcy rights without automatic recognition of their nonbankruptcy values is the rule, not the exception, in bankruptcy. The determination of a secured claim in bankruptcy may determine the final distributional value of a secured claim in a bankruptcy proceeding. However, bankruptcy takes a two-step process for unsecured claims: (1) nonbankruptcy law determines (for the most part) the allowance of unsecured claims; (2) bankruptcy law determines how much of the estate each unsecured claim will receive. E.g., §§ 502, 726, 1129. Because lien
Setoff between solvent parties is a common law and common sense expedient. There it would be "absurd" to make each party pay the other.\footnote{Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913).} Setoff operates between solvent parties by the cancellation of X's and Y's debts when they are equivalent or to the extent they are equivalent. What the right result is when X or Y is insolvent is a question that rarely arises outside of bankruptcy or other proceedings.\footnote{A related question may arise in the context of an assignment of rights in which an account debtor is also a creditor of the assignor and the assignor is insolvent. Here, as elsewhere, under state law, the Uniform Commercial Code imposes the risk of a party's insolvency (the assignor here) on the account debtor or the assignee, on the principle of notice or knowledge. U.C.C. § 9-318(1) provides that "the rights of an assignee are subject to . . . (b) [any] claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment." Cf. Artoc Bank & Trust, Ltd. v. Apex Oil Co. (In re Apex Oil Co.), 975 F.2d 1365, 1369 (5th Cir. 1992)(standing for the proposition that an account debtor holding setoff rights may have sufficient notification as diligent inquiry would disclose on knowledge of debtor's creating security interest in accounts "[a]t least where millions of dollars are at stake.")} The nonbankruptcy idea of setoff assumes that the face amounts of each debt are determinative because the real value of such mutual claims is the face amount when both debtors are solvent. The thesis that § 506(a) permits courts to limit setoff, whenever the setoff would overcompensate the holder's secured claim rectifies the distributional inequity some setoffs may effect.

Under § 553(a) creditors do retain the abstract right of setoff under Title 11 that they have outside of bankruptcy. The conventional reading of this text assumes that bankruptcy must value that abstract right just as it would have outside of Title 11 if the debtor were solvent at every material moment. That is compensatorily inconsistent with bankruptcy's general approach to creditors valuation under § 506(a) is the analogy to this second distributional step, it is easy to miss the first step: no lien may be a secured claim unless a claim secured by a lien is allowed under § 502. Bankruptcy may recognize the abstract claim secured by a lien without automatically granting secured claim status. The distributional rule based on collateral valuation specifies the bankruptcy value of the lien. The decision of Johnson v. Home State Bank, 111 S. Ct. 2150 (1991) does not upset this analysis. That a lienor may have a claim in a bankruptcy though it has only a lien and no in personam claim against the debtor still requires a bankruptcy determination of that lien as a secured claim. Fixing the amount of the secured claim requires analysis of the amount of the claim and valuation of the collateral, regardless of whether a nonrecourse lien arose because of a prior bankruptcy proceeding discharging what had previously been a recourse lien or a nonrecourse lien had been the parties' original agreement. In the latter case, one must look to that agreement; and in the former case, one must regard the discharged debt. In either event outside of chapter 11 and the notorious § 1111(b) election, the secured claim cannot exceed the value of the collateral.

\footnote{Overcompensating a creditor's right of setoff, however, might be justified on other grounds. If the sole purpose of § 553(b) were to deter the exercise of prebankruptcy setoff rights, protecting a setoff in the full face amount of a creditor's claim may be a reward for preserving the bankruptcy estate analogous to a postpetition administrative expense. § 503(b)(1)(A). Were this true, it would leave perhaps inconsistent any differential treatment of liens which had not been foreclosed before bankruptcy.}
which must because of the insolvency appropriately convert all the abstract prebankruptcy rights of creditors into concrete bankruptcy rights. Granting any creditor a concrete bankruptcy right identical to its abstract prebankruptcy right requires either that a prebankruptcy right was immune from the problem of insolvency or that considerations extrinsic to the problem of insolvency merited the extraordinary treatment of a creditor. For either of these reasons, the conventional reading of the code supposes that setoff holders receive this extraordinary treatment. However, under § 553(a)(1),75 which limits setoff claims by normal bankruptcy rules of claims allowance, a setoff claim receives no more bankruptcy recognition under § 502 than any other claim. The body of § 553(a) requires bankruptcy to protect the setoff right subject to the exceptions which follow, such as § 553(a)(1).

Section 553(a)(1) does not indicate expressly what might disallow a setoff claim. The reference to the exclusion of § 502(b)(3) from this exception to the body of § 553(a)'s recognition of setoff indicates that the drafters expected readers to understand "disallowed" as at least a reference to § 502, the code's most general provision on allowance of claims. The reference of disallowed is not confined to § 502 and may include any section which might provide for the disallowance of a setoff, such as § 506(a). Section 553(a)(1) may limit the setoff right granted under the body of § 553(a) through § 506(a), which limits the secured claim as recognized in various code provisions to the value of the collateral.

The overcompensation problem requires the same setoff determination as a secured claim for purposes of § 553 as is ordinarily undertaken to determine what lienors hold as secured claims in bankruptcy. It is not merely good or parallel policy to do so. The code does not grant priority to the setoff automatically in the face amount of the creditor's claim. Sections 553 and 506 are compatible and require case-by-case valuation of the creditor's claim to a setoff right. Using the face amount of the creditor's claim against the estate may be correct, but only if that is the real value of the setoff right. As in the matter

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Whether liens would thereby be differentially treated depends on a number of complex issues and perhaps ultimately on whether liens or setoffs meaningfully survive bankruptcy. For example, a lien on collateral may be valued for one or another purpose. ("Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with a hearing on such disposition or use or on a plan affecting such creditor's interest." § 506(a).) This seems to mean collateral may be valued more than once, perhaps even again after bankruptcy was apparently over. See generally David G. Carlson, Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral, 6 BANK. DEV. J. 253 (1989). For example, perhaps a setoff claim that is lost early in a bankruptcy proceeding under § 553(b) (because the setoff holder improved its position during the 90 days before bankruptcy by offsetting mutual debts) may receive recognition at a later stage in a complex proceeding, such as a reorganization, if the point of the deterrence aim has abated.

75"[T]his title does not affect any right of a creditor to offset . . . except to the extent that — (1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title;" § 553(a)(1).
of liens, any difference between the face amount of the creditor's claim and its value as an offset constitutes an unsecured claim against the estate, that is, a deficiency claim in the vocabulary of liens.

C. Section 553 Setoff Limitations

As previously noted, § 553 states five limitations on setoff in bankruptcy. Those limitations have been widely understood to validate setoff outside the scope of that section. To proclaim any further limitation on setoff, as by the previously suggested interpretation of § 506(a), may appear to contradict the validation of setoff accomplished by the general principle of § 553. Were § 506(a) to limit further the setoff beyond the proscriptions of § 553, some indication of that limitation should appear in the code. As previously noted,76 § 553(a)(1) does precisely that.

Nevertheless, the purely77 bankruptcy limitations on setoff in § 553 may be thought to conflict with the reading taken here under the valuation principle of § 506(a). To appreciate this objection, recall that § 553 invalidates any nonbankruptcy setoff taken or obtained within 90 days before bankruptcy in either of three events: (1) where the setoff right was acquired from another entity while the debtor was insolvent;78 (2) where the debt, against which a setoff right was exercised, was incurred by the setoff holder while the debtor was insolvent;79 (3) where the setoff improved the holder's position because there had been an insufficiency between the holder's claim and debt prior to setoff and during the 90 days before bankruptcy.80

A setoff claimant may not fall under any of the outlined substantive § 553 limitations and, yet, may have a claim of setoff rejected. A putative setoff right may be invalid for a number of reasons. For example, the claim against the debtor in bankruptcy may be entirely invalid outside of bankruptcy, as where the latter's promise lacked consideration. When this is true, § 553(a)(1) incorporates § 502(b)(1) and disallows such a setoff claim in bankruptcy.

Any objection to the reading of setoff under the code as taken here cannot rest on a bald premise that only § 553 limits setoff. Other provisions of the code arrive in § 553 by its express invitation including, as previously discussed, § 502 and § 506(a).

The objection to the thesis that § 506(a) affects setoffs might arguably rely on a softer criticism, namely that the other limitations on setoff in § 553 conflict with setoff valuation under § 506(a). That objection would suppose that the purposes or effects of the other rules in § 553 conflict with setoff valuation.

76See supra text accompanying note 67.

77Sections 553(a)(2)-(3) and 553(b) apply only in bankruptcy but § 553(a)(1) operates in bankruptcy the same as any invalid setoff claim would operate outside of bankruptcy.

78§ 553(a)(2).

79§ 553(a)(3).

80§ 553(b).
under § 506(a). These setoff-invalidating rules, however, fit with setoff valuation. Each will be discussed in turn.

1. Setoffs Based on Claims Obtained From Another Creditor: § 553(a)(2)

A claim against a debtor obtained from another entity while a debtor was insolvent and within 90 days before bankruptcy is invalid in bankruptcy for the purpose of offsetting a claim of the debtor against the creditor.81 This kind of invalid setoff has an aim similar to the setoff analysis presented here. A setoff so obtained under the analysis taken here has a real value almost certainly below face value because of the element that the debtor has been insolvent at the time. If the code invalidates such a setoff in whole, the objection would argue against the reading taken here which would validate the setoff to the extent of its real value. Thus, § 553(a)(2) and this thesis conflict. But the former directs its aim only at setoff rights obtained from another entity. These are illegitimate in that respect under the code even though they might be less objectionable when reduced to their likely lesser real value. Yet one might wish to discourage prebankruptcy trading in claims against a troubled debtor as a problem which § 506(a) valuation might not sufficiently deter.82 As well, one might wish to avoid the costliness and uncertainties of valuation hearings in bankruptcy for any interests so generally unlikely to bear any significant real value. Claims bought from another creditor shortly before bankruptcy while a debtor is insolvent may come very cheaply. The objection to the thesis taken here essentially rests on the idea that setoffs outside the proscription of § 553(a)(2), those obtained from another entity prior to 90 days before bankruptcy, are automatically valid in bankruptcy and also immunized from any valuation; they are per se valid in face amounts in bankruptcy. But immunizing liens from per se avoidance under comparable lien avoiding provisions is distinct from the valuation of liens.83 So too are setoffs.

81 Note that § 553(a)(2) addresses only claims obtained from others during the stated time period. It is inapplicable to the transfer of setoff rights. Omitted in the text is the further limitation on setoffs—that setoffs obtained postpetition from another entity are invalid. § 553(a)(2)(A). Postpetition trading in claims, for setoffs or for investment, may present distinct problems which valuation cannot resolve. Postpetition trading in claims may disrupt the bankruptcy process by creating costly delay or conflict. Similarly, as the following text explains, valuation of setoffs is consistent with an independent policy barring setoffs obtained from other entities which may incite avoidable bankruptcies.

82 A stronger objection would form to the present thesis if a setoff obtained while the debtor was insolvent was invalidated by the code. However, that is not true. Even were it true, one might regard the valuation of setoff as consistent with such a provision as a hedge against finding the debtor was solvent at the time the setoff was obtained and the almost certain finding that debtor was insolvent at bankruptcy.

83 For example, a lien may be avoided under the bankruptcy avoidance powers. §§ 544-549. Yet the unavoidability of any lien thereunder does not also have the effect of guaranteeing that a lien will receive valuation exceeding the value of the collateral. The bankruptcy limitations on setoffs free setoffs from the generally applicable bank-
2. Debts Incurred to Debtor for the Purpose of Obtaining Setoff: § 553(a)(3)

Another setoff which is per se invalid under the code is the setoff created when a creditor of the debtor incurs a debt to the debtor during the 90 days before bankruptcy and while debtor was insolvent, and the debt was incurred for the purpose of obtaining a setoff. Finding a debtor extending credit to anyone during its prebankruptcy days of despair is suspicious. When this suspicious circumstance combines with its suspiciously benefitting a preexisting or soon-to-be creditor, outlawing such a setoff enforces a larger fraudulent transfer policy. That is the element of purpose required for the voidability of such a setoff. As with fraudulent transfer principles under which transferees who lack good faith get no credit for what they gave the debtor, the provision voids the setoff in full. Again, limiting the setoff to real value may not sufficiently enforce the fraudulent transfer of the setoff right except in cases in which a § 506(a) valuation found the setoff worthless.

3. Prebankruptcy Setoff (Improving Setoff Rights): § 553(b)

The complicated limitation on setoff imposed by § 553(b) likewise fits with the valuation of setoff. Mechanically, § 553(b) limits the prebankruptcy exercise of a setoff right to a certain amount, the extent to which the first insufficiency is reduced by the time the setoff was taken if it were taken within 90 days before the bankruptcy. To that extent the setoff is per se void in bankruptcy. The rule invalidates certain buildups of bank accounts which enable a setoff holder to improve its position during the presumptively troubled 90 days before bankruptcy. The target is the improvement of the setoff holder's position—that improvement in the setoff value during the 90 days

ruptency avoidance powers. But valuation becomes necessary to honor liens and setoffs in bankruptcy only if they are not avoided in the bankruptcy.

84Section 553(a)(3) literally applies regardless of the timing of the order in which the mutual debts are incurred. It does not say that the setoff holder must have been a creditor before it also became a debtor. Arguably, one cannot have a purpose of obtaining a setoff unless one is already a creditor at the time one becomes indebted. One might have the purpose of obtaining a setoff right by incurring a debt, even if the setoff right does not accrue until the later time when one acquires a claim against its creditor. Nevertheless, the circumstances are too suspicious no matter how the parties order the debts.

85§ 548(c).

86Cf. Braniff Airways, Inc. v. Exxon Co., 814 F.2d 1030, 1040 n.11 (5th Cir. 1987) (stating that "The fact that a setoff never actually took place does not affect the analysis. The issue is whether Exxon hypothetically had the right to a setoff, and because of this right it was secured and therefore the payment received from Braniff was not a voidable preference.") (emphasis added).

87§ 553(b)(1)(B).

88"Insufficiency" is the "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." § 553(b)(2).

89§ 553(b)(1).
before bankruptcy which is fully recaptured by § 553(b). As above, the improvement of a bank’s setoff rights during this troubled period invokes the avoidance policy of fraudulent transfer law. Correctly or not, building up funds in a bank account, for example, during the 90 days before bankruptcy is taken as behavior too suspicious to treat more softly than by invalidation. Valuation may consistently target what the aim and text of § 553(b) leave unaffected. 90

In sum, the thesis that setoffs are subject to valuation under § 506(a) does not conflict with the texts or policies of the substantive limits on setoff under § 553. The conventional assumption that only § 553 should limit setoff backs the objection which has been considered. That assumption does not find support in the text of the setoff limitations which all follow concordant policies which have the effect of invalidating certain setoffs even if these setoffs would have survived valuation to any extent. Those setoffs which survive these setoff avoiding rules still require valuation to accomplish the separate purpose of fairly compensating (avoiding overcompensation of) secured claims. That the invalidation also cures overcompensation is true, but it is only true of those especially troublesome and particular setoffs to which § 553 directly speaks. Given the error of the bald argument that § 553 validates the face amount of setoffs which are not particularly invalidated under § 553, 91 one may conclude that the objection to setoff valuation rests on the no less bald a proposition than that legislation which invalidates some, validates the rest. But, were invalidation the purpose of valuation, the objection would not so widely miss its target.

III. LIENS, WELL-POSITIONED UNSECURED CREDITORS AND SETOFFS

The analysis thus far finds that setoffs in bankruptcy may receive similar treatment to liens under § 506(a). Nevertheless, examining the important differences between liens and setoffs may help to explain why bankruptcy has struggled with setoffs. 92 First, setoffs have traditionally received face amount valuation in bankruptcy because of the claims allowance rules in bankruptcy.

90 A contentious view of § 553(b) holds that a prebankruptcy exercise of setoff under § 553(b) may trigger a recovery by the trustee of an “otherwise unavoidable right. The provision is clearly at odds with the notion that the enforcement of a nonpreferential security interest does not constitute a preference... A creditor who receives a preference that a trustee avoids under section 547, is, with the exception of litigation expenses, in no worse shape than it would have been had it not received the preferential transfer. In contrast, under section 553(b) a creditor who exercises a a right of setoff... may well be in worse shape than if it had refrained from exercising its right.” Lacy, supra note 2, at 975. If true, this statement assumes that setoff holders have secured claims in bankruptcy in the face amount of their claims. In the rare instance when § 506(a) valuation will produce such values, § 553(b) operates to disgorge the improvement in the bank’s position effected by the setoff. Arguably, only the least real value of the setoff will receive recognition under § 553(a). The excess which the bank also took by setoff will expose the offsetting creditor to the trustee’s avoiding powers such as a preferential transfer.

91 See supra text accompanying notes 55, 67.

92 Bankruptcy has struggled with liens as well for different reasons.
Secondly, and derivatively, setoffs have been provided a "legal preference" because of an illusory analogy to liens. The difference between a lien and a setoff is the apparent ease of valuation of a setoff as a bankruptcy secured claim. "How much did debtor owe this creditor" swiftly sets the figure by which creditor may offset the claim of the debtor's trustee in bankruptcy. But a lien is a secured claim to the extent of the value of the property in the bankruptcy estate which prior to bankruptcy had been subjected to the lien. So long as prior to bankruptcy or in bankruptcy the lien is valid and not subject to a superior interest, the lien is a secured claim in the value of the collateral. What the value of the collateral is presents a hard question unlike the illusory clarity of setoff.

A. Allowance and Distributive Rights: Abstract and Concrete Rights in Bankruptcy

A setoff right arises from a claim against another party and not from the claim of that other party. Even though bankers and lawyers customarily look to the amount on deposit to determine the amount of a bank setoff, this is elliptical from the point of view of a bank as a creditor and appropriate rather when asking about setoff from the bank's status as debtor. As a defendant debtor, a bank can determine the amount by which it may offset its creditor's claim by the amount on deposit. As a plaintiff creditor, a bank has no setoff rights but may be subject to its debtor defendant's right of setoff in the amount bank owes its debtor/depositor. If a bank's claim against a debtor is invalid or otherwise unenforceable, as a defendant against a debtor's claim it has no setoff right. In bankruptcy such a bank should have no greater right because § 553 merely recognizes the nonbankruptcy setoff right. If such a right does not exist outside bankruptcy, bankruptcy disallows the claim.

Disallowance also concerns valid claims and extravagant claims. The validity of a claim and the monetary value of a claim may be distinguished. In matters of setoff, by tradition there has been no devaluation of a face amount of a claim against a bankruptcy by the factor of its real value, as Part II suggests. The reason for that treatment is the similarity of treatment of setoff creditors with general unsecured creditors. Generally, unsecured creditors have their claims against a bankrupt estate determined as if the estate were solvent. The claims allowance process differs from the asset distribution process in this

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93 Bankruptcy does not validate all liens. The bankruptcy avoiding powers limit the effect of vulnerable prebankruptcy liens in bankruptcy. §§ 544-550.


95 So long as a bank is owed more than it owes, setting off against what it owes may not be troublesome.

96 An important exception concerns the postpetition period in a bankruptcy proceeding during which mutual claims may arise from postpetition dealings. In said instance, the applicable law would appear to be federal bankruptcy law, which would govern rising postpetition setoffs.
respect, although the bankruptcy process could perform this task under distribution provisions or allowance provisions. Bankruptcy creates an illusion in "allowing" claims at full face value since insolvent estates cannot compensate at such values in the eventual distribution of assets. Yet the traditional separation of allowance and distribution is very practical in permitting the administration of claims prior to the final determination of the value of the estate available for distribution. Practical and harmless generally, the separation of claim allowance and distribution perpetuates the illusion that the value of a setoff is the face value of the holder’s claim against the estate.

Comparing the setoff right holder with the lien holder clarifies this obscurity. Granting the full face value to the claim against the debtor is the equivalent of granting the full face value of the debt to the lien holder. Traditional treatment pretends that the setoff right which a bank has against a claim held by the bankruptcy estate of its depositor is the face value of bank’s claim against the estate. When a bank’s claim is allowable in bankruptcy at its face value as an unsecured claim, that figure has traditionally determined the value of bank’s setoff right in bankruptcy. Allowability is not the equivalent of value as the distinction in bankruptcy between the face amount or allowable claim and the distributional value of such a claim marks.

To illustrate, suppose that if an unsecured claim of a lien holder were valued at distributional rates, then one might want to limit a lien holder’s interest in collateral to this measure of true value. Thus, if the collateral and debt are worth $100 at face value, but the bankruptcy distribution on an unsecured claim would amount to 50%, then on this view the lien might have in bankruptcy a value only of 50%. This would result in a lien for 50% of the value of the collateral, amounting here to $50. Yet, the lien creditor would here also receive $50 on distribution as well as payment of $50 from the sale of the collateral or a continuing $50 lien on the collateral. Either the traditional recognition of a secured claim of $100 or this analytical expression of the same distributional return, $50 in cash from the estate and $50 of lien generally leads to the same distributional value of the total rights of the lien creditor.

In contrast, using this analytical expression of rights for setoff, if bank owes $100 to debtor who also owes bank $100, the bank’s claim has a distributional value of $50 on the same 50% dividend. The debtor’s claim against the bank, assuming bank’s solvency, has a value of $100. The amount of the bank’s secured claim in bankruptcy is $50. Thus far, then, the bank is in exactly the

97Section 502 determines whether a claim is "allowable" in bankruptcy and, with a few exceptions, treats the amount of a claim as it would be determined under nonbankruptcy law. Bankruptcy payment of claims in money or rights will follow from further determinations so that claims determined to be allowable set the maximum which may be paid on bankruptcy claims. As most bankruptcy estates cannot pay claims in full, the figure set by the allowance process of § 502 necessarily sets the stage for the pro rata determinations of a creditor's share in an insolvent estate.

98Omitted here is a discussion regarding the treatment of secured claims in reorganizations.
same position as the lien creditor of the previous paragraph. Each has a $50 secured claim in debtor’s bankruptcy. However, a lien creditor received its distribution of $50 from the estate and retained a lien on the collateral in the amount of $50 which matches the conventional bankruptcy expression of lien rights; a setoff holder’s rights do not so correspond to conventional analysis.

Bank cashed in its setoff right of $50 in exchange for its secured claim. That setoff right arose from the distributional value of its unsecured claim against the estate. Its allowable $100 unsecured claim would receive a 50% distribution. In lieu of the distribution, bank chose to retain the real value of its right not to have to pay the estate the $100 it held which belonged to the debtor. The real value of that right was the distributional value of the right: $50. The bank has nothing left and must fork over the balance of its $100 debt to the estate, or $50.

Again, a lien holder would not similarly exhaust its claim of $100 against the estate when it exchanged its unsecured claim for $100 for distribution payment of $50. Along with a setoff holder in conventional analysis, a lienor would retain its lien even after accepting the $50 distribution. That payment does not discharge the lien, but reduces the amount secured by the lien. To be sure, lien and setoff rights in bankruptcy may differ in an important (if logically unnecessary) manner on the question of debt discharge. A discharge of a $100 debt may occur regardless of the amount an estate distributes to creditors.99 But a discharge of debts may not affect a lien.100

B. Setoff Holders as Well-Positioned Prebankruptcy Creditors

The treatment bankruptcy traditionally gives holders of setoff rights presumes that setoff holders are, like careful lienors, particularly well-positioned prebankruptcy creditors or other risk-free transferees of the debtor. One inspiration for traditionally protecting careful lienors and certain other parties with whom the debtor had dealt before bankruptcy comes from the distribution of rights among the parties existing at the time, more or less, of filing bankruptcy. At that time there will usually be other particularly well-positioned creditors. These creditors share a stronger expectation of successful debt-collection than other creditors. At least this is often true until a bankruptcy case begins. Whether or not bankruptcy should always or usually follow the relative positioning of creditors, it often has. Yet in so doing, the law of bankruptcy may mistake for a creditor who is particularly well-positioned, a creditor whose odds of debt-collection are no more than average. Were there no other policy beyond recognizing the real value of entitlements existing before bankruptcy for awarding priorities in the bankruptcy estate, as of course there are,101 a mistaken and even longstanding special treatment by

99 A debt may be discharged by payment or under §§ 727(b), 1141(d), 1228, and 1328, which discharge debt bankruptcy for selected debtors. Some prebankruptcy debts are excepted from bankruptcy discharge under the cited sections. E.g., § 523(a).

100 See infra Part VI.

101 E.g., § 507.
bankruptcy might change. In the matter of setoff in bankruptcy other policies do inspire the present limitations borne by § 553. These limitations may set the proper balance between the prebankruptcy rights of a setoff holder and what other goals bankruptcy law may have. Yet this may be soundly doubted. Instead of a sound analysis of the prebankruptcy positioning of setoff holders, the present code may have arisen from an assumption, perhaps mistaken, of what that position is. The heavy scales of tradition make rather than measure such assumptions. It is more than likely that the present bankruptcy law receives assumptions about setoff’s proper bankruptcy status from a past less affected by reason than politics.

Whether bankruptcy is mistaken about setoff when it uses the face value of a setoff holder’s claim initially depends on an evaluation of a setoff holder’s rights prior to the bankruptcy proceeding. What setoff holders have done before bankruptcy or might otherwise have done to protect themselves, and what they have not done prior to bankruptcy, sets the framework for the evaluation. How "well-positioned"\textsuperscript{102} are creditors with setoff rights? Are all setoff holders so well-positioned that they deserve face valuation of the setoff rights?

One may compare setoff holders with other creditors who are generally accorded or denied special protection in bankruptcy. The latter include contract promisees accorded no priority in bankruptcy. A comparison of setoffs to liens and other well-positioned prebankruptcy creditors may furnish the appropriate basis for evaluating whether holders of setoffs or setoff rights merit special bankruptcy treatment. Yet comparing setoffs to liens also requires an account of the differentiation among liens made by both nonbankruptcy and bankruptcy law. Lien creditors do not automatically obtain special treatment in bankruptcy. Done rightly, liens do, however, generally receive better treatment than other creditor claims. Where liens are not rightly done, they are inchoate or, more contemporarily, unperfected. The several kinds of liens include statutory, judicial and consensual liens. Examples of unperfected or inchoate liens of each kind abound. A shared quality making these liens unperfected or inchoate is an element of incompleteness. Mechanics liens, for example, may be unperfected because some public notice or judicial action has not occurred. Judgment creditors, for example, may have liens merely inchoate before levy is made. Consensual liens most typically are or become unperfected because of a failure to file public notice or because of an expiration of such a notice.

\textsuperscript{102}Well-positioned prebankruptcy creditors include lien creditors and unsecured creditors who, but for the filing of bankruptcy, had a higher probability of successfully collecting on their claims against the debtor. The chief strength in the argument for treating setoff holders with bankruptcy priority is that setoff holders would have successfully collected their claim by offsetting it against the debtor’s claim. This proposition is false. But, even if it is true under certain circumstances, setoffs are protectible in bankruptcy without protecting every setoff. The valuation interpretation for setoffs presented in Part I, \textit{supra}, would discriminate between priority setoffs and others.
Bankruptcy ignores such inchoate or unperfected mechanics lienors, judgment creditors or consensual lien creditors, even though each of these parties has a typically stronger prebankruptcy position than do unsecured creditors. Often, each is only a small step or slip away from perfecting its superior rights and its far better position than that of unsecured creditors. Such parties acquire the special priority bankruptcy traditionally bestows on liens when they have achieved a choate or perfected lien at a time sufficiently prior to bankruptcy. These broad notions, and the details they demand or assume, provide a basis for comparison with setoffs. Perhaps not surprisingly, some but not all setoffs fare well in the comparison. Some setoff holders are particularly well-positioned and others are doubtful.

Preliminarily, it goes (almost) without saying that setoff holders may take advantage of the protection bankruptcy gives to perfected liens. If one were to conclude that holders of setoff rights which have not been exercised at the time of bankruptcy filing are no more well-positioned than a judgment creditor about to levy or a mortgagee about to record, both of whom receive no special protection in bankruptcy, then holders of setoff rights may still achieve lien rights in a bankruptcy by appropriate behavior. Were such a course necessary but uninviting because of inconvenience and expense, it may be sufficient to note that bankruptcy generally puts lien holders to such inconvenience and expense. That such costs may fall on debtors is perhaps only to note that borrowers generally may be thought to bear these costs. After posing a simple example of how banks, the most common setoff holders, might achieve a lien, or lien-like right, some contrasts between such an arrangement and generally recognized setoff rights are set forth below.

Assume that long before bankruptcy the setoff holder has required the eventual bankrupt to deposit a sum of money, which the borrower may not use for any purpose, into the bank or another bank. Assume that this was done in a manner which was fair to both the bank and its borrower: in the event of

103§ 545.

104Because a judgment does not usually create any lien until some further recording or docketing, a judgment creditor is an unsecured creditor in bankruptcy unless it has obtained a judicial lien prior to the commencement of bankruptcy. Judicial liens obtained shortly before bankruptcy may be avoidable as preferential transfers. § 547(b).

105§ 544(a).

106The applicable preference period is 90 days for non-insider creditors and one year for insider creditors. § 547(b)(4).


108Under the derivative title rule governing rights of judgment creditors, a judgment creditor may seize from another party only what the judgment debtor may seize. Thus, an arrangement disabling a borrower from enjoying property also limits its creditors. A creditor who receives special advantage from such an arrangement is by definition a well-positioned creditor.
insolvency of either party, the other would by their contract be likely to have priority to the deposit over other creditors. A bank and its borrower/depositor could enter into this agreement so that the bank did not hold the funds in a general deposit account. Suppose the funds were placed in a special account, some kind of trust or escrow account pursuant to the parties' contract that upon the borrower's insolvency or bankruptcy, the bank would have the right to the funds to pay the balance of the debt. If the bank might validly be both trustee and beneficiary, such an arrangement would closely resemble a perfected security interest. The bank would there have done enough to assure both that the creditors of its debtor and its own creditors would have no claim to the funds on deposit. If valid, such an arrangement would have effectively put the funds on deposit out of the use or control of either party as if the bank and its borrower had hired an escrow to hold the funds until the escrow terms had been satisfied. By such devices the parties would transform themselves relatively more clearly from being each other's unsecured creditor to secured creditor status.

But doubts about bank setoff arise because the claim against the bankruptcy estate may be conceived to be an unsecured claim. Were, as suggested above, a valid trust created from the borrower's funds in the hands of an independent trustee or escrowee per a bank and borrower contract, the estate would have no claim to the funds except as there may be excess over the balance owed the lender. The debtor's interest in the trust funds would have previously been transformed into whatever the parties had previously agreed. An escrow or trust alters the legal relationship of lender and borrower under an unsecured or undersecured loan accompanied by a general deposit account. The general deposit account leaves open the possibility that the debtor might obtain the use of the funds prior to bankruptcy. If the bank were to hold a valid setoff right, certain problems would arise. If the bank were to permit the debtor the use of such funds prior to bankruptcy, the setoff right would be lost. The bank might claim both that the funds were on general deposit but that the depositor had no access to that account. Whether this is a hypocritical assertion or whether debating this assertion is hypercritical may lie at the heart of setoff's place in bankruptcy.

But an escrow or trust relationship makes the deposited funds unavailable for the general use of either party until the trust conditions are met. Under a general deposit account relationship of debtor and creditor, a depositor is legally free to use whatever funds are in the account so long as the bank as creditor does not freeze the account. It may be that a bank has designated in its

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109See Teshelle supra, note 2, at 46-49.

110Such a creditor bank holds a perfected security interest. However, under UCC § 9-104(1), terming the bank's interest as a "security interest" may be misleading. Older terminology suggests that the transfer of an interest in a deposit account is an assignment for security. The validity of such assignments depends on whether they defraud other creditors in the creation and designation of special accounts which take a debtor's funds out of its control.
computer system that the account may not be debited below a certain balance amount but is otherwise freely available to the debtor or its payees. Or the bank may at some temporal point freeze the account. General state law generously permits banks to make these decisions after payment orders are received from debtors or their would-be transferees. Nevertheless, the volume of litigation concerning whether such depositary banks effectively made these kinds of after-the-fact decisions raises questions about such internal and clandestine processes. Watchfulness, holds or freezes of accounts have remained de facto pre-setoff practices under the state law governing the relative priority of account transferees or garnishors because nonbankruptcy law allows setoff against such parties after notice of such claims comes to the bank. Whether there is any legal effect to an account under watch, hold or freeze under this priority law is immaterial. What matters is whether the bank has set off within the time frame for such action. Yet determining how well-positioned a bank which had not exercised a setoff right at bankruptcy should take into account the difference between a bank with a right of setoff which had done nothing at all and a bank which had administratively limited the debtor's opportunity to withdraw funds. A high account balance at bankruptcy may reflect only some apparent good fortune for the bank. Such a bank might insist that had bankruptcy not occurred, it was so much better positioned than an average unsecured creditor, that its odds are too high to deny it special treatment in bankruptcy. Yet that is also the case with inchoate or unperfected lien creditors. Properly or not, bankruptcy generally accords treatment to lien creditors who have completed the actions necessary for their special treatment rather than accord priority on the basis of which creditors would have won the collection race if there had been no bankruptcy.

Even if a bank could show that 95% of the time a depositor situated as the debtor in bankruptcy could not have successfully removed the funds in the account, bankruptcy has not generally accepted such rationales in particular cases. A comparable holder of a security interest might try to show that it would have perfected its security interest 95% of the time before lien creditors or transferees would have taken the collateral. But one expects that comes to naught in a bankruptcy proceeding. To suggest that in a bankruptcy case the secured party should receive a discounted secured claim when it had before bankruptcy perfected might stir excitement among trustees faced with perfected security interests. Or, suppose that a pawn shop or securities holding bank or brokerage could be shown to erroneously release possessory collateral 5% of the time: that would not affect those instances in which such lenders had not made such errors just because they happened to be bankruptcy cases.

1. Probabilities

What bankruptcy should do to a setoff right or a lien should depend upon what did happen in a particular case and not what might have happened in

111 U.C.C. § 4-303.
such cases. A lienor may have released its lien and permitted its debtor to sell the collateral free of the lien. When it does so, it should suffer the consequences, but not when it has not done so.

Lien analogies help to understand the doubts surrounding the setoff. They show that the law of secured transactions and mortgages provides rights effective in bankruptcy upon compliance with prescribed acts and the presence of collateral in the bankruptcy. The lienor’s right to foreclose is respected in the bankruptcy. Comparably, a bank with a setoff right might continue its right of setoff in bankruptcy so long as funds remain on deposit at bankruptcy.\textsuperscript{112} Nevertheless, taking the setoff right at face value clearly provides the holder who refrained from exercising that right in any manner with an opportunity surpassing lien protection. A lienor who could have foreclosed and recovered any deficiency from other assets of a debtor while the debtor was solvent does not have that lost opportunity revitalized at bankruptcy when debtor is insolvent. Nor will a lienor whose collateral once had a sufficient value, as when debtor was solvent, receive priority in bankruptcy above the remaining collateral or its value. To permit the equivalent treatment of the unexercised setoff right as well as such treatment for a creditor who never held a setoff right while its debtor was solvent rests on probabilities which bankruptcy otherwise eschews for the facts of particular cases.

\textsuperscript{112} Even after bankruptcy, it is provided that a bank may pay items until the bank receives actual notice or knowledge. § 542(c). Nevertheless, the payee or other transferee may be subject to liability for receipt of a postpetition transfer under §§ 549-550. Whether such a payee, or its collecting bank (if the latter was an "initial transferee" under § 550(a)(1)), against whom a depository bank may have recourse, is free of a trustee’s postpetition claim is an issue that has not arisen. The question is prompted by the difference between a depository with setoff desires and a depository without setoff desires. In the latter, the revocation restores the asset to the estate. In the former, the asset is affected by the depository’s setoff.

Suppose the depository bank has a right to revoke against the payee or its agent, such as a collecting bank. Assume that the depository does revoke. Also assume that a bankruptcy trustee brings action to recover the transfer from either the depository or the collecting bank or the payee. In order to make this hypothetical truly interesting with respect to setoff issues, assume further that the depository bank claims setoff against the trustee based on the transfer it properly revoked as against the collecting bank and the payee. If the revocation is immaterial to the postpetition transfer liability of the collecting bank and its principal (the payee), success by the trustee against such parties will presumably double their claim against the estate and enrich other creditors. The very broad code definition of transfer does not expressly include a revoked transfer. Intuitively, a revoked transfer of the property of the estate should generally not be recapturable by the estate inasmuch as the revocation would have already restored the transfer to the estate.

In the instant hypothetical, the revoking depository bank has a claim against the estate. As the depository of estate funds, the bank is motivated to setoff against any liability it has to the estate. On revocation, this bank does defend against the trustee’s claim to the funds with its offsetting claim. The depository may have done after bankruptcy what would not have been permissible prior to bankruptcy: it acquired a debt to the debtor while the debtor was insolvent for the purpose of obtaining a right of setoff. § 553(a)(3). Or the revocation means the transfer never happened and the setoff is otherwise permissible.

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Providing all setoffs in bankruptcy full face value recognition would justify recognizing priorities among unsecured creditors depending on the probabilities of their having won the race to a debtor's assets had there been no bankruptcy. Not even the well-positioned unsecured creditor, ready to levy on assets of the debtor pursuant to judgment, who perhaps deserves priority for its nonbankruptcy opportunities, has a reasonably certain claim at the filing of bankruptcy. Bankruptcy is typically filed by a distressed debtor to avoid seizure by a well-positioned judgment creditor. The effect of that filing is the automatic stay. Bankruptcy recognizes no monetary claim for the stoppage of the creditor's judgment enforcement. Whether the well-positioned unsecured creditor should receive compensation for its having been stopped from enforcing its state law rights because of the automatic stay is another question. But if bankruptcy has correctly viewed these state law rights or opportunities as unprotectible, more similarity than difference comes to comparison of the well-positioned unsecured creditor as judgment creditor and the setoff holder who has yet to exercise setoff at bankruptcy.

The appropriate focus of this comparison lies in what happens to each of these differently but well-positioned creditors in a liquidation, typically under chapter 7. There (as well as in chapter 11) the filing of the petition invokes the automatic stay. Though one cannot say that every insolvent business enterprise will take chapter 7 (or 11), experience shows that if an effective extra-bankruptcy liquidation (as through assignment for the benefit of creditors) cannot be accomplished, then bankruptcy liquidation will likely be chosen. The corporate debtor typically takes no benefit from the chapter 7 other than perhaps some good feeling from the less well-positioned unsecured creditors who likely urged the step to protect themselves against the well-positioned unsecured creditor. Chapter 7 does thus serve some creditors of an enterprise by stifling the opportunity the well-positioned unsecured creditors had under the typical state law rule of first in time, first in right.

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113 § 362.


115 Assignments for the benefit of creditors are codified in some states and judicially sanctioned in others. The assignment is usually thought more efficient than bankruptcy liquidation when the number of creditors is relatively small and thus manageable. Typically, the assignment law will provide for a termination of individual creditor actions replaced by claims recognition and estate administration provisions in the assignee. Unfortunately, few of the assignment processes among the states have received modern attention. This lack of modern attention is largely due to the fact that bankruptcy law has filled gaps that the assignment statutes or decisional law have left open. Nevertheless, there would be little controversy among creditors charged with drafting a new state assignment law that some form of stay of individual creditor rights should terminate at or shortly after the creation of the assignment.

116 The point of an organized liquidation of a business corporation may be preservation of the common pool of assets so that all creditors of the same class (the
The well-positioned unsecured creditor has no right to more than other creditors under state law. State law does not need to provide this because bankruptcy law already addresses it. As a result the well-positioned unsecured creditor is not disappointed in any legitimate expectation which can amount to a loss cognizable in a bankruptcy case. Its claim that but for the filing and the effect of the automatic stay halting its levy or sale, it would have collected the debt is an assertion based solely on the higher probabilities its position opportuned. Yet the effect and perhaps purpose of the automatic stay of chapter 7 precluding its levy nullifies any appeal to probabilities.

This seems true also of the holder of a setoff right who has yet to exercise that right prior to the bankruptcy filing. Setoff holders who have taken their setoff prior to the bankruptcy filing are in this respect remarkably distinguishable from setoff holders whose rights remain unexercised. The holder of an unexercised setoff right resembles the well-positioned unsecured creditor qua judgment creditor; those who have offset the mutual debts before bankruptcy resemble the judgment creditor qua lien creditor. 117

If a judgment creditor cannot appeal to the higher probabilities that it would have won the race to the debtor’s assets had bankruptcy not interrupted its leading position, then treating holders of setoff rights and completed setoffs the same upon bankruptcy risks treating differently positioned creditors similarly. Were this the appropriate comparison, it becomes evident that setoff holders as a class receive the protection of a probability denied to others. 118 In this analysis setoffs taken before bankruptcy, especially before insolvency, 119 are differentiated from setoffs which were available but not taken.

unsecured) will take only their fair pro rata share. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, ch. 1 (1986). But, what any creditor’s fair share is, is problematical. One need not adopt Jackson’s theory that state rights should determine what is a fair share. Bankruptcy often eschews that view, as in the case of a well-positioned (yet unsecured) creditor.

117 Although those who offset before bankruptcy are analogous to judgment creditors who levied before bankruptcy, that should not conclusively establish that the setoff should be recognized in its face value. Because bankruptcy routinely recaptures judicial liens as preferences when the elements of § 547(b) are met, a prebankruptcy setoff taken during the 90 days before bankruptcy, or the longer insider preference period, would not ordinarily have occurred while the debtor was solvent. Thus, valuation even of prebankruptcy setoffs may lead to substantial discounting.

118 Once more, note that bankruptcy policy might be justified in generally approving setoffs without differentiation between setoffs exercised and those not before bankruptcy. The textual observations simply point out that some comparisons between similarly positioned prebankruptcy creditors suggest similarity of treatment, all other factors being equal. Excluded from that analysis are perhaps sound policy factors encouraging undifferentiated bankruptcy protection of setoffs on the ground that stimulating prebankruptcy setoffs would effect more bankruptcies and lesser protection of poorly positioned creditors. As to that, see supra note 115.

119 See supra note 117.
2. Foreclosure Rights

Another inter-creditor comparison may seem to support an undifferentiated protection of setoff in bankruptcy. A bank with a right to setoff resembles a secured creditor with a right to foreclose its collateral. Bankruptcy does not devalue the latter's right to special bankruptcy treatment because it had not foreclosed before bankruptcy. If unexercised setoff rights are merely foreclosure rights, then bankruptcy has no more reason to treat the two setoff positions any differently than it treats the two secured creditor positions differently. Yet, examples of how bankruptcy may treat the secured creditor differently may be suggestive of overprotection of the unexercised setoff right.

A secured creditor who foreclosed before bankruptcy may not incur the risks of valuation and delay that bankruptcy imposes on secured creditors who have not foreclosed before bankruptcy. Its foreclosure sale will have realized its opportunity to maximize the value of the collateral. The foreclosing secured creditor controls the sale of the collateral, and that control permits it to receive in a more favorable time-frame the best available price. The fact that pre-foreclosure secured creditors resent bankruptcy also suggests the greater costs of bankruptcy to the unforeclosed lien.

Thus, in terms of value there is likely to be more difference than similarity between a setoff and a foreclosed lien than between a setoff and an unforeclosed lien. If bankruptcy effectively differentiates lienors in this way, comparing setoff rights as merely akin to foreclosure rights may point to a different conclusion. Yet from the point of view of delay alone, setoff rights and lien foreclosure rights may be more similar in bankruptcy. Each suffers from the automatic stay and each appears subject to the same tests for relief from stay. Whichever, value or delay, should be the focus of the comparison therefore may lead to different conclusions about how unexercised setoff rights emerge from the analogy to lien foreclosure rights.

3. Transferability and Setoff

An independent difficulty with always accepting setoff rights at face value in bankruptcy concerns the previously mentioned and apparent opportunity a debtor has to liquidate a general deposit account prior to bankruptcy. If certain probabilities may be taken to favor the setoff rights' holder, the probabilities or opportunities that debtors may have to reduce the bank account before bankruptcy should receive some due in providing similar treatment of similar prebankruptcy rights in bankruptcy. This will be addressed in two ways: (1) I shall assume that the debtor has free access to a bank account

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120 The text assumes completion of the foreclosure through sale of the collateral.

121 Note that a foreclosing creditor may realize this opportunity without actually obtaining on foreclosure the maximum value available. Cf. Durett v. Washington Nat'l. Ins. Co., 621 F.2d 201 (5th Cir. 1980) (concluding that foreclosures may be fraudulent transfers when too little foreclosure value is obtained).

122 § 362(d).
up to the moment before bankruptcy. When this is true, if ever, protecting any mere right of setoff is spurious. (2) I later drop this dubious assumption to observe a more refined idea about setoffs which are exercised before bankruptcy.

A setoff right in a deposit account to which a debtor enjoys the ability to withdraw in full disturbs fundamental fraudulent transfer principles. Like Twyne's sheep\textsuperscript{123} or Ratner's accounts receivables,\textsuperscript{124} the bank account seems to be the debtor's to do with as it pleases. Should debtor do so, its transferees will suffer no claim of the setoff holding bank once it honors the debtor's orders. For that reason, others may feel safe in extending credit to the debtor based on its representation of sufficient funds in the account to cover the debt. Whether creditors should be so comforted is another question which may depend on evaluation of particular facts of particular cases, including the extent to which a bank misled an inquiring creditor as to the susceptibility of a deposit account to its or others' claims.\textsuperscript{125}

The paradox of a debtor's enjoying full access to its bank account simultaneously with bank's setoff right betrays fundamental bankruptcy premises beyond the principles of fraudulent transfer.\textsuperscript{126} Property to which a debtor may enjoy an unrestricted right prior to bankruptcy will pass to the bankruptcy estate free of any claims.\textsuperscript{127} Yet a right to setoff under nonbankruptcy law has traditionally meant that a debtor lacks the power to transfer its bank account subject to setoff to its bankruptcy estate free of the setoff right. Yet a debtor would seem to pass to the estate any funds which it has withdrawn prior to bankruptcy free of the setoff claim. Nor may a setoff holder succeed in regaining funds transferred to a third party though some such transferees may suffer recapture by the estate as a preference or fraudulent transfer.

As a result, a debtor with the actual freedom to withdraw from the account may have prebankruptcy creditors who may not be likely to wrest the account from the bank.\textsuperscript{128} A garnishment summons will be likely to have two effects:

\begin{itemize}
  \item \textsuperscript{123}Twyne's Case, 76 Eng. Rep. 809 (1601).
  \item \textsuperscript{124}Benedict v. Ratner, 268 U.S. 353 (1925).
  \item \textsuperscript{125}The priorities on garnishment of a bank account, which typically permit a garnishee bank to offset and take priority over the garnishing creditor, rest on a different analysis: That rule applies to cases in which the garnishing creditor makes no claim that it was misled by the general deposit account or another act of the garnishee into extending credit to one who is insolvent.
  \item \textsuperscript{126}Perhaps both ironically and suggestively, however, the same is not true for a debtor's creditors who are unlikely to succeed in garnishing a distressed debtor's bank account. Garnishment will almost certainly be met by a successful exercise of setoff by the creditor if it holds a sufficient claim which will generally take priority over the lien by garnishment.
  \item \textsuperscript{127}\textsuperscript{541}.
  \item \textsuperscript{128}See Clark, supra note 2, at 206-13 (stating that "It is fundamental law that a bank may not exercise setoff against a customer's account unless the customer's debt to the
First, the bank as creditor will exercise whatever rights of setoff it holds unless its depositor-debtor provides it protection for its debt or an adequate explanation of the garnishment. A garnishment will signal the bank of its debtor’s financial difficulties. Even if the bank had not taken any previous action, it could setoff after receiving the garnishment order and subordinate the garnishor’s claim to its own.\textsuperscript{129} Second, the garnishment is likely to lead to a new understanding between the parties.\textsuperscript{130}

The depositary’s favorable priority against a garnishing judgment creditor may have contributed to bankruptcy’s illusions about setoffs because of the powerful imagery this priority evokes in bankruptcy sensibilities. If setoffs take before garnishing creditors before bankruptcy, \textit{a fortiori} they take priority over such creditors in bankruptcy. This imagery flows from older ideas about what is property of the bankruptcy estate and the modern perpetuation of that meta-concept in the trustee in bankruptcy’s strong-arm power. Under the Bankruptcy Act, two ideas chiefly bounded what property came into the estate.\textsuperscript{131} The first idea was property which a debtor at the moment it filed bankruptcy might transfer. The second idea, providing a powerful and obscuring image about setoffs, held that property owned by a debtor at the moment of filing bankruptcy came into the estate if a judgment creditor could levy on that property.

The priority rule favoring setoff holders over garnishing creditors suggested but did not support the conclusion that a debtor’s bank account did not come into the bankruptcy estate. For, the alternate test of transferability by the debtor would bring the account into bankruptcy if setoff had not occurred prior to the filing of bankruptcy. Yet another powerful bankruptcy image is the trustee’s power to bring into the estate property formerly belonging to the debtor when its transferee would be subordinate to a judicial lien creditor on the date of bankruptcy.\textsuperscript{132}

The state priority rule which generally favors offsetting creditors conflicting with garnishors affords an incomplete absorption of the state law background to setoffs in bankruptcy. A bank account in which the debtor at the time of filing enjoyed the right of withdrawal is per se property of the estate under the old law because the debtor had the right to withdraw and transfer the funds. That right rested on the rule which used the test of transferability as creating bankruptcy property.

\textsuperscript{129}Id.

\textsuperscript{130}However, the garnishee bank must effect its setoff or jeopardize its priority over the garnishor. Teshelle, \textit{supra} note 2, at 62.

\textsuperscript{131}Bankruptcy Act, § 70(a)(5)(repealed 1979).

\textsuperscript{132}§ 544(a).
The bankruptcy property test was and is (though in more general language) the abstract transferability idea. Thus, seductive as it is, the fact that a debtor has not depleted a bank account before bankruptcy is immaterial to the property of the estate issue, as is the question of whether a garnishing creditor might have successfully wrested the account from the holder of setoff rights. The seductive image of the account remaining at bankruptcy, along with a state law priority rule suggesting that a bankruptcy trustee’s strong-arm power cannot defeat the setoff right, obscures the other material fact that we have assumed: that up to bankruptcy, debtor could draw down the account as it pleased.

A debtor’s ability to use the funds on deposit absent a setoff or setoff-like act of the bank not only satisfies derivative-title legal tests for including a deposit account in a bankruptcy estate, but it also clouds the traditional supposition that setoff rights merit special treatment in bankruptcy. In such circumstances the holder of a setoff right may claim the state law background to bankruptcy shows it to have superior rights to the account as against other creditors under the setoff-favoring garnishment rule. However, the debtor’s ability to draw the account down means that it might pay other creditors from the account as it wished. Setting the state law background to bankruptcy under one but not another of these rules identifies the prebankruptcy position of such a holder of setoff rights incompletely. Had bankruptcy not intervened, a contention that setoff would have happened before debtor withdrew the funds may be as unconvincing as an unperfected secured party’s contention that it would have perfected its rights before a levy on its collateral.

Liberal modern rules protecting security interests even though use and control of collateral remains in a debtor may not significantly improve the claim for bankruptcy priority of a holder of a setoff right. The floating lien of an inventory or accounts financer permits the debtor significant control and perhaps suggests that banks with setoff rights might fit this financing pattern. If bankruptcy permits such control in the debtor without jeopardizing a nonpossessory security interest, then the same permissiveness might support the setoff right.

But differences outweigh the similarities in this comparison under the different powers of transfer available in these two situations. The use and control over the actual goods in inventory financing does not permit a debtor

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133§ 541(a)(1) passes to the estate "all legal or equitable interests of the debtor in property...."

134Such an unperfected bankruptcy security interest generally falls under the trustee’s strong arm power. § 544(a); U.C.C. § 9-301(1)(b).

135U.C.C. § 9-207.

136Generally, the bankruptcy code does protect the inventory or receivables security interest by immunizing transfers during the preference period, so long as a secured party meets certain qualifications, including no improvement of its position during the preference period. § 547(c)(5).
to dispose of inventory as it wishes free of the security interest. Most transferees of inventory would under the U.C.C. take subject to the claim of a perfected secured party. Only buyers in the ordinary course\textsuperscript{137} take free of the security interest.\textsuperscript{138} No other creditor may receive the goods in payment free of the security interest.\textsuperscript{139} No judgment creditor may seize or sell the goods free of the lien of the perfected inventory financer. Yet, once they are withdrawn, the debtor may transfer funds previously subject to setoff to setoff to anyone it wishes free of any further setoff claim of the bank. Likewise, the perfected receivables financer who receives protection of its interest in bankruptcy is also completely protected under the commercial code because no transferee of its rights in accounts may take free of the security interest. Yet the situation with respect to both the setoff right holder and the secured party may be identical to the extent that cash proceeds\textsuperscript{140} of either the security interest or the bank account may be transferred free of the setoff or secured party's claim.

If the setoff right is not justifiable on the same grounds as an inventory lien because of the limited power of real transferability of the latter, the setoff is also dissimilar to its most common lien analogy when the funds are freely available to the debtor. The pledge or possessory security interest requires the debtor to pay the debt before it may withdraw possession from the pledgee-secured party. Debtors under pledge have neither a right nor real opportunity to take the collateral. Few transferees of a released pledge will take subject to the pledgee's claim.\textsuperscript{141}

Comparing setoff rights with other well-positioned creditors shows that special treatment in a bankruptcy need not follow from traditional setoff rights outside of bankruptcy. Here, as elsewhere, having some advantage over other creditors when bankruptcy occurs does not suffice for priority. Like lienors of every kind, all of whom have some claim to bankruptcy to priority, setoff rights holders may convincingly claim such treatment when they have specially positioned themselves as by exercising setoff sufficiently prior to bankruptcy\textsuperscript{142} in circumstances such that run-of-the-mill unsecured creditors have no sound claim to reversal of the setoff holder's priority position. Absent an exercise of setoff rights before bankruptcy, and outside legal proscriptions based on other policies, a setoff right is indistinguishable from other creditors who lead in the collection race but who enjoy no bankruptcy priority. What is

\textsuperscript{137}U.C.C. § 1-201(9).
\textsuperscript{138}U.C.C. § 9-307(1).
\textsuperscript{139}U.C.C. §§ 9-201, 9-307(1).
\textsuperscript{140}U.C.C. § 9-306(1).
\textsuperscript{141}U.C.C. § 9-301(1).
\textsuperscript{142}If holders of setoff rights were subject to the same tests as general creditors, the law of preferences could recapture setoffs taken prior to bankruptcy when all of the elements of a voidable preference applied. § 547(b). This would differ from the present law under which § 553(b) recaptures improvements in the setoff rights holder's position during the 90 days before bankruptcy.
an exercise of setoff rights must rest on an analysis of what opportunities the holder of setoff rights foreclosed to the debtor. However labeled (e.g., setoff, freeze or hold), the legal principle measures the prebankruptcy termination of a debtor's transfer rights in an account by a creditor's decision not to pay. Bankers and other account debtors who are also creditors of the same party may make important distinctions by these and other labels. Some bankruptcy courts have ruled that a freeze or a hold is not a setoff barred by the automatic stay. Others disagree. If parties to such setoff opportunities also discriminate between various labels, then revealing those understandings should inform the principle of when appropriate action justifies special treatment in bankruptcy of a setoff holder.

143 E.g., In re New York City Shoes, Inc., 78 B.R. 426 (Bankr. E.D. Pa. 1987) (imposing "administrative freeze" on debtor's account which constitutes a setoff under state law. We also fail to see how the "banker's dilemma" is so difficult to resolve. The Bank can protect itself from the consequences of Marin by placing something akin to a "do not pay hold" on a debtor's accounts. If withdrawals were cleared with the debtor, the bank could then pay them and protect itself from liability. As we indicated at pages 427-28, supra, we see significant distinctions between the "do not pay hold," which the Debtor could loosen at will, and the deep "administrative freeze" imposed by the Bank here upon its becoming aware of the Debtor's bankruptcy filing. Id. at 431. See also In re Cusanno, 17 B.R. 879 (Bankr. E.D. Pa. 1982), aff'd sub nom. Cusanno v. Fidelity Bank, 29 B.R. 810 (E.D. Pa. 1983), vacated, 734 F.2d 3 (3d Cir. 1984).

144 E.g., In re Quality Interiors, Inc., 127 B.R. 391, 393 (Bankr. N.D. Ohio 1991) ("therefore, in this Circuit an administrative hold alone does not constitute a setoff and is not prohibited by § 362(a)(7)"); In re Learn, 95 B.R. 495 (Bankr. N.D. Ohio 1989) (treating freeze and hold synonymously).

145 Some courts hold that a setoff consists of three elements. Whether banks and other creditors share the following distinctions is doubtful: (1) a decision to setoff; (2) an overt act; (3) a record indicating that a setoff has occurred. E.g., Baker v. National City Bank, 511 F.2d 1016 (6th Cir. 1975); In re Flynn, 143 B.R. 798 (Bankr. D.R.I. 1992).

146 E.g., In re New York City Shoes, Inc, 78 B.R. 426 (Bankr. E.D. Pa. 1987) (imposing "administrative freeze" on debtor's account not violation of stay at least until debtor provided setoff holder adequate protection); Bank of Am. v. Edgins (In re Edgins), 36 B.R. 480 (Bankr. 9th Cir. 1984); Kenney's Franchise Corp. v. Central Fidelity Bank (In re Kenney's Franchise Corp.), 22 B.R. 747 (Bankr. W.D. Va. 1982).

4. Setoff and Executory Contracts

Though comparisons with liens help to understand various forms of setoff claims, setoff might fall under bankruptcy's treatment of executory contracts (as might liens, of course).\textsuperscript{148} The rights of parties to executory contracts also seem to change\textsuperscript{149} upon bankruptcy regardless in general of how well-positioned a debtor's promisee had been theretofore. Although the policy is presently in controversy, traditionally parties to contracts as to which material performance on the part of the debtor as promisor remained could but need not be performed after bankruptcy.\textsuperscript{150} In general, a cost-savings to the estate grounds the principle. If debtor had at bankruptcy filing more expensive promises to perform than had its promisee, the debtor or trustee may withhold performance or "reject" the contract, leaving a promisee to make an unsecured claim against the estate in the amount of its contract damages.\textsuperscript{151}

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\textsuperscript{149}Under the real value analysis submitted previously, like setoff rights, contract rights do not change in value in bankruptcy. Only by positing a counter-factual solvent debtor may a promisee of an insolvent debtor in bankruptcy see the value of its rights change. Thus, the analysis nowadays tendered in discussions of promisees of executory contracts having their nonbankruptcy face value rights converted into diminished bankruptcy bucks on the filing of a bankruptcy petition is misleading. The promisee of an insolvent promisor has only a (low) probability of receiving or collecting the face value of its rights. Insolvency affects value even before bankruptcy proceedings commence.

\textsuperscript{150}Again, it is not bankruptcy proceedings which disturb the promisee's expectation but rather insolvency. Insolvency does not create a problem for a debtor's profitable contracts.

\textsuperscript{151}Correlatively, the debtor or trustee may opt to perform its promise, "assume" the contract, where its entitlement to a more valuable return promise will enhance the bankruptcy estate.

The Fourth Circuit's decision of Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), \textit{cert. denied}, 475 U.S. 1057 (1986), sparked controversy about whether the power of a debtor or trustee to reject an executory contract entailed also the recapture of prebankruptcy benefits conferred on the nonbankrupt party. \textit{Lubrizol} permitted a debtor to recapture intellectual property rights. Congress amended the code to protect intellectual property licensees such as Lubrizol Enterprises. § 365(n). This legislative development, along with previous such specific protections for land purchasers and lessees (§§ 365 (h)-(j)), has encouraged the view that rejection under § 365 does not constitute a right of recapture or avoidance. \textit{E.g.}, Michael Andrew, \textit{Executory Contracts in Bankruptcy: Understanding "Rejection"}, \textit{59 U. COLO. L. REV.} 846 (1988); Jay L. Westbrook, \textit{A Functional Analysis of Executory Contract}, \textit{74 MINN. L. REV.} 227 (1989); \textit{DAVID G. EPSTEIN, ET AL., BANKRUPTCY} 241 (1993).

However sound this view may be, courts may persist in following the principle of \textit{Lubrizol} outside the specific protections granted by the code, on the interpretive canon that specific anti-recapture protections would be legislatively granted only if recapture of prebankruptcy contract benefits were permissible in general. Until Congress enacts a legislative expression against recapturing benefits, the matter may not rest.

It is altogether unfortunate that an explanation of why abstract contracts rights are never recaptured under executory contract rejection could not prevent the recapture or
Bankruptcy thus recognizes "rejected" prebankruptcy contracts as unsecured claims against the estate. Although the rejection power recognizes the prebankruptcy contract rights, those contract rights against the estate will receive the same two-step valuation which comes to all nonpriority unsecured claims. Because rejection will typically constitute a breach of the contract, the promisee's rights start as a claim for damages calculated generally under applicable contract law. This damages figure constitutes the promisee's claim against the estate. Second, the promisee's pro rata distribution (or chapter 11 voting) rights will come from these damages.

The pro rata distribution or voting rights for which a contract promisee involuntarily converts its prebankruptcy contract rights measures the real value of the promisee's contract claim. Treatment at such a real value figure is no different than what bankruptcy does to contract rights which have been fully earned by a creditor before bankruptcy. The accounts receivable that a creditor earned before bankruptcy follows the same two-step valuation procedure. The face value of the insolvent debtor's accounts payable cannot be paid. Bankruptcy thus converts face value contract rights to the real value of those rights in the particular bankruptcy proceeding.

The same two-step treatment or conversion of the face value of contract rights against the estate might be accorded setoff or certain rights of setoff. One might regard executory contract rejection and conversion as though this were a unique problem of bankruptcy law separate from other contractually transferred prebankruptcy rights such as setoff rights. Yet, when bankruptcy converts contract promises' rights from face value to real value, bankruptcy may have an apt model for setoffs. What happens to executory contracts might happen more generally in bankruptcy. Tradition and labels separate executory contracts from setoffs in bankruptcy, not natural or inherent differentiating features. Sound policy aims might justify the differentiation. But giving special avoidance cases from emerging. A proper explanation precludes the suggestion taken by Lubrizol and other cases. That explanation embodies an analysis which would show why prebankruptcy contract rights are never avoided or recaptured in any case. Unfortunately, the view remains that prior to bankruptcy a contract promisee has the right to full payment or performance and that bankruptcy proceedings disrupt this right. Under the real value analysis suggested here, as well as the construct of the well-positioned creditor, contract promisees receive in bankruptcy substantially (i.e., discounted by priorities created by bankruptcy) what they would have obtained outside of bankruptcy—the real value of a promise given by an insolvent. Under this view, any abstract claims held by a contract promisee are honored in bankruptcy (not avoided), substantially dollar for dollar of real value. When applicable, § 365 merely permits rejection of the contract so that a debtor or trustee may choose to create a damages claim rather than perform a prebankruptcy promise to make a property transfer.

So long as one thinks of the prebankruptcy contract promise as having a face value rather than a real value, the choice to create a damages claim rather than to perform after bankruptcy will inevitably appear as an avoidance or recapture. But mere claims against insolvent estates which cannot pay face value have only real values.

152§ 365(g).
153§ 502.
treatment in bankruptcy to setoffs, even setoff rights for which no
prebankruptcy action took place, would suggest similar protection of contract
promisees. Instead, the real and not the face value of the executory contract
promisee receives bankruptcy protection. The policy of granting an inchoate
setoff holder better bankruptcy protection than executory contract promisees
cannot stand on analysis of their respective prebankruptcy positions. That
preferential treatment might stand on some other bankruptcy policy but that
would need separate explanation.

The legal arrangements which give rise to setoff rights typically stem from
contract. Setoff rests on contractual principles and articulates what contractual
analysis would have adduced.154 The right to setoff arises from the express or
implied agreement of the mutual debtors. When at bankruptcy a debtor has a
general bank account on which no setoff has yet been exercised, the parties’
contractual relationship permits the bank to setoff, which is no more perhaps
than a right to demand performance of any executory promise. The debtor had
promised the bank that it might take the funds in the account and apply them
to its debt to the bank. If no setoff had occurred before bankruptcy, the debtor’s
promise remains unperformed. The automatic stay prevents the bank from
helping itself to the funds in accordance with the prebankruptcy promise, just
as a promisee loses any prebankruptcy right to enforce a prebankruptcy
promises in the manner that an agreement or legal processes provides.

Some promisees may have control over property transferred by a debtor
pursuant to an uncompleted prebankruptcy contract. Such promisees may
retain such property against the bankruptcy estate by the wide repudiation of
the idea that executory contract doctrine bestows a recapture or avoidance
power.155 Comparable setoffs would receive sustenance from this view of
executory contracts: Those setoffs under which the holder did actually have
control over the property subject to setoff. Other setoff holders may not so
qualify when before bankruptcy the debtor had control over the property
subject to setoff as where a bank account had no withdrawal restrictions.

These comparisons show that a holder of a setoff right who permits a debtor
free access to funds supporting the setoff right is positioned no better than
ordinary contract promisees and is significantly worse than careful lien
creditors. Treating such holders of setoff rights specially in bankruptcy may be
understood as traditional, but it is nevertheless unjustifiable except on some
independent policy basis. The next section discusses the apparent policy
favoring setoffs, even unexercised setoff rights.

154 This analysis was the basis for the Court’s decision that a statute codifying
commercial understandings, contracts, was not state action for purposes of the

155 E.g., EPSTEIN, supra note 151, at 241.
C. Why Funds Remain in Bank Accounts at the Time of Bankruptcy

Given the illusory nature of mere setoff rights, why substantial funds so often seem to remain at bankruptcy needs explanation. The presence of such accounts at bankruptcy may per se support the difference between setoff holders and other well-positioned prebankruptcy creditors who do not receive special treatment in bankruptcy. Given the risks to the bank in permitting a debtor access to funds, it seems odd that funds should remain in any general account at bankruptcy. That oddity disappears upon the realization that setoff holding banks are unlikely to permit their insolvent debtor-depositors this free funds availability.

A setoff holding bank may occupy either of two prebankruptcy positions. Either it knows of its debtor-depositor’s financial distress, or it is surprised by the bankruptcy. If bank has known for a long period of time of the debtor’s precarious position, exercising setoff will be likely to prompt a bankruptcy sooner rather than later. Protecting setoff rights in bankruptcy may thus delay the commencement of bankruptcy proceedings. A bank’s forbearing setoff may permit the debtor to have the funds he needs to continue operating. This benefit, which is perhaps one of the benefits sought by setoff policy, would come no less from a setoff holder who deliberately refrained from offsetting than from one who unintentionally or negligently passed up the opportunity to setoff.

This is an independent justification of protecting setoff rights in bankruptcy. It may be a well-founded policy justification, though that seems doubtful. Clearly it is an optimistic policy because it ultimately rests on the economic premise that debtors will succeed in climbing out of financial distress more often than not if they are permitted to continue operations. Refraining from setoff in this situation merits special recognition by according the setoff holder a secured claim in a bankruptcy. Yet a pessimist can believe that encouraging delay in exercising setoff will permit a debtor and a holder of setoff rights to manipulate the debtor’s assets so that if bankruptcy becomes necessary, the setoff holder will occupy a safe position. Whether the encouraging of delayed setoffs benefits the creditor group by producing a more valuable debtor or bankruptcy estate is open to question. A laissez-faire economist might propose that this result will occur because encouraging forbearance by the setoff holder will lead to voluntary new arrangements among the interested creditor group which, in turn, will maximize the value of the assets for the creditor group. Yet that suggestion also argues for purifying the voluntary arrangements to maximize their value, perhaps by removing any legal protection of the setoff in bankruptcy. Perhaps protecting a setoff right in the event of bankruptcy corrupts rather than facilitates any value-adding voluntary bargaining before bankruptcy. Protecting setoff rights in bankruptcy encourages a bank to participate in bankruptcy-avoiding efforts. Whether such efforts will be successful, or whether they will be fair if they are successful, depends on far more than mere opportunity. Such opportunities may waste or secrete assets as often as they preserve or produce value.

As a result, accepting face value bankruptcy protection of setoff rights on a policy of setoff delay and opportunity may be no more plausible than implausible. Second, that policy should in theory extend to any party with the
power to shut a debtor down, and thus may go too far. The prebankruptcy opportunity apparently afforded by that policy would justify extending similar protection to any creditor so well-positioned that it too might close the debtor's operations down. A policy of delay and opportunity would also protect a judgment creditor about to levy on a critical asset who temporarily forbears that right to provide debtor an opportunity to turn a corner. But, the judgment creditor does not obtain special treatment in bankruptcy. Such a judgment creditor may well refrain from levy only if it receives something in exchange, such as a partial payment or security interest. Yet its right to retain such a payment will become doubtful under preference analysis if the bankruptcy should occur within ninety days later. An unperfected or a late perfected secured party who forbears repossession of a critical asset to provide debtor such an opportunity to work out its troubles does not get special bankruptcy treatment as a result of that restraint. Perhaps these creditors should get the same bankruptcy treatment traditionally accorded setoff holders. If they were to, the setoff holder's traditional place in bankruptcy would have a firmer basis.

Finally, even if setoff policy rests on encouraging continued operations which may result in a debtor's assets improving in value, that policy is anachronistic in a bankruptcy world which has dramatically changed since the dawn of setoff when bankruptcy meant only liquidation. The rise of bankruptcy reorganization law largely eliminates the power of setoff holders and other creditors and interests from unilaterally forcing a debtor's liquidation. The early days of bankruptcy reorganization saw a struggle over setoffs which might throttle the effort at reorganization. That struggle clearly ended with the passage of the Bankruptcy Code, which provides a debtor who might feasibly reorganize (and perhaps too many others) the opportunity to use funds subject to setoff. Current reorganization law provides the policy which precludes the disastrous effect that a prebankruptcy setoff once might have had. Part IV discusses setoff and reorganization.

IV. SETOFF AND REORGANIZATION

Case law has long suggested that permitting setoff rests in the sound discretion of the bankruptcy court. Under either the conventional view of setoff or the true value view tendered above, the setoff provisions of the bankruptcy code lack any additional discretionary judgment. If the code recognizes setoff to some extent based on nonbankruptcy law, discretion might derive from nonbankruptcy law. Were that body of law discretionary, presumably the law of the state creating the right of setoff in the creditor, the bankruptcy courts might parcel off setoff rights on whatever discretionary

156 The courts have generally ruled that creditor forbearances do not constitute new value. Thus, forbearing to levy in exchange for a payment would not be a contemporaneous exchange free of preference challenge. Id. at 318.

157 See infra notes 160-63.
basis nonbankruptcy law expressed. No such nonbankruptcy approach stirs the lingering rhetoric about permitting setoff in bankruptcy.

A. Setoff Protection as a Reorganization Policy

The once discretionary basis of setoff did not stem from nonbankruptcy setoff law. Rather, the vague norm of discretion arose as part of the new bankruptcy reorganization culture. The leading modern case for the

158Ironically, the modern cracks in the setoff stronghold began with the Supreme Court's decisions concerning whether the bankruptcy setoff rule of § 68(a) applied in railroad reorganization under section 77 of the Bankruptcy Act of 1898, as amended. Baker v. Gold Seal Liquors, Inc., 417 U.S. 467 (1974); Lowden v. Northwestern Nat'l Bank & Trust Co., 298 U.S. 160 (1936); Harold Justman, Comments on the Bank's Right of Setoff under the Proposed Bankruptcy Act of 1973, 31 BUS. LAW. 1607 (1976). See also CJI Industries, Inc. v. Reading Co. (In re Reading Co.), 838 F.2d 686 (3d Cir. 1988); cf. Boston & Maine Corp. v. Chicago Pac. Corp. (In re Chicago Pac. Corp.), 785 F.2d 562 (7th Cir. 1986). Technically, the provisions of chapter 7 of the Bankruptcy Act, including the rule of § 68(a) on setoff, only applied in Section 77 (railroad reorganization) to the extent that they were consistent with Section 77.


Ironically, setoff began to crumble in these cases and later fostered the discretionary or permissive rhetoric in business reorganization. Under one view of setoff, it is more appropriate in certain cases than in liquidation bankruptcies. Liquidations surrender to the immediate circumstances of insolvency, and reorganizations try to convert the debtor's financial and ownership structure so that it may at some point emerge as a solvent enterprise. Awarding the setoff holder a stronger voice in the reorganization might recognize the relatively higher value setoff might hold, assuming successful reorganization and solvency. However, the reorganization culture focused on the immediate issue of working capital to which setoff may be so devastating; and it understandably lost sight of the alternative manner by which setoff might receive fair compensation under a plan.

Courts have appreciated the difference between, on the one hand, permitting setoff by way of counterclaim to an action by a reorganizing debtor when the setoff poses no imminent threat to the reorganization, and on the other hand, the alternative of postponement of the setoff. E.g., IRS v. Norton, 717 F.2d 767 (3d Cir. 1983); Niagara Mohawk Power Corp. v. Utica Floor Maintenance, Inc.(In re Utica Floor Maintenance, Inc.), 41 B.R. 941 (Bankr. N.D. N.Y. 1984); Western Land Planning Co. v. Midland Nat'l Bank, 434 F. Supp 616 (E.D. Wis. 1977); In re Williams, 422 F. Supp. 342 (N.D. Ga. 1976)(postponing setoff in chapter 13); Preferred Surfacing, Inc. v. Gwinnett Bank & Trust Co., 400 F. Supp. 280 (N.D. Ga. 1975)(postponing setoff in chapter 11).

Even under the code, the more controversial setoff issues are the analogous motions by banks and debtors to get the funds that are in the account subject to setoff. See supra notes 148-52. The other setoff-like "priority" claims needn't be paid early in a
discretionary or permissive view of setoff in bankruptcy is Borden Company v. Bohack (In re Bohack).\textsuperscript{159} Ironically, the case granted a creditor the opportunity to setoff its claim, which was the right to assert a counterclaim to the debtor's complaint for antitrust violations.\textsuperscript{160} The theory behind the court's discretion dictum concerns the difference between ordinary bankruptcy, or liquidation of the nonexempt assets of a debtor, and a reorganization proceeding.\textsuperscript{161} "An 

bankruptcy proceeding. Thus, asking any reorganization court to deny setoff because the debtor needs the funds to maintain operations may be treated distinctly from whether a setoff holder has a greater voice in the reorganization through voting power or through a plan provision. Discretion to deny a setoff was originally meant to deny the exercise of setoff when that would seriously imperil the incipient reorganization. However, many thought that this denial thus doomed the setoff entirely, particularly if reorganization failed and left too meager assets. The concept of adequate protection has the purpose of offsetting the likelihood of the latter possibility. § 361. See also §§ 362(d), 363(c)(2).

159599 F.2d 1160 (2d Cir. 1979).
160 The court first expressed the conventional view of the history and function of setoff in and out of bankruptcy:

The doctrine of setoff has long occupied a favored position in our history of jurisprudence. It originated in the antiquity of Roman law and was later adopted into the English legal system. See Loyd, The Development of Setoff, 64 U. PA. L. REV. 541 (1916). It was incorporated into the English bankruptcy scheme in 1705 and became a recognized doctrine of American bankruptcy law with the passage of the Act of 1800. 4 COLLIER ON BANKRUPTCY ¶ 68.01 (14th Ed. 1975). Today, the doctrine of setoff is preserved in § 68 of the Act which provides as follows: "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

Although proceedings in bankruptcy are equitable in nature, the dominant impulse of § 68 is inequality among creditors." In re Applied Logic Corp., 576 F.2d 952 (2d Cir. 1978). A setoff has the effect of paying one creditor more than another. Despite the preferential advantages bestowed upon certain creditors by virtue of § 68, setoffs are accepted and approved because they are based upon long-recognized rights of mutual debtors. Although § 68 is permissive rather than mandatory, the Supreme Court has held that when the statutory provision is relied upon by a creditor, it should be enforced by the court. Cumberland Glass Manufacturing Company v. DeWitt and Company, 237 U.S. 447, 455 (1915). 599 F.2d at 1164-65.

161 Allowance or disallowance of a setoff is a decision which ultimately rests in the sound discretion of the bankruptcy court. This circuit, however, has repeatedly favored the allowance of setoffs. In In re Applied Logic Corp., a bank was permitted to exercise its right to set off a debt owed it by the bankrupt against deposits and certificates of deposit held by the bank. Judge Friendly commented therein that (t)he rule allowing setoff, both before and after bankruptcy, is not one that courts are free to ignore when they think application would be 'unjust'. It is a rule that has been embodied
unqualified right of setoff in a chapter 11 proceeding might conceivably defeat the purpose of the arrangement. A setoff could deprive the debtor of all or a large part of its current assets at a time when it needs them most."162 The purpose behind the discretionary view of setoff in reorganization cases prior to the code came from the sensible concern that setoff could defeat or impede a reorganization.163 Under even the conventional view of setoff under the code, a debtor or trustee in chapter 11 may have to recognize a setoff, but that recognition does not entail immediate satisfaction of setoff rights. Even if a bank account is subject to setoff, a debtor may use the account under the code, though the prevailing view164 requires that the debtor provide adequate protection165 to the setoff holder.

The mechanics of the code authorizing a debtor's use of an account which is subject to setoff settles the precode doubts about whether setoffs may generally impede reorganization. These mechanics permit alternative treatments for holders of setoff rights. To whatever extent courts putatively had

in every bankruptcy act the nation has had, and creditors ... have long acted in reliance upon it.

576 F.2d at 957-58.

In an earlier case Judge Friendly described an injunction against a setoff as "strong medicine." In re Lehigh and Hudson River Ry. Co., 468 F.2d 430, 434 (2d Cir. 1972). See also Tyler v. Marine Midland Trust Co. of New York, 128 F.2d 927 (2d Cir. 1942). The policy of the Bankruptcy Act is to allow setoffs and counterclaims. Western Land Planning Co. v. Midland Nat'l Bank, 434 F. Supp. 616 (E.D.Wis.1977). This court is reluctant to disturb this policy unless compelling circumstances require it. A decision disallowing a setoff must not be made cavalierly. The statutory remedy of set off should be enforced unless the court finds after due reflection that allowance would not be consistent with the provisions and purposes of the Bankruptcy Act as a whole... [W]ere this ordinary bankruptcy, no question of the propriety of the setoff would arise. 599 F.2d at 1165-66.

162 Id. at 1165. The debtor's argument in Bohack arose from two Supreme Court precedents in railroad reorganization cases in which the Bohack court noticed that the setoff provision of the Bankruptcy Act did not expressly control, as it contrarily ruled in chapter 11 cases like Bohack. Lowden v. Northwestern Nat'l Bank & Trust Co., 298 U.S. 160 (1936) and Baker v. Gold Seal Liquors, Inc., 417 U.S. 467 (1974). The court in Bohack said:

Section 302 of the Act, 11 U.S.C. § 702, explicitly provides that specified portions of the Act, including § 68, are applicable in Chapter XI proceedings insofar as they are not inconsistent with or in conflict with the provisions of the chapter. To the contrary, no express approval of setoffs under § 68 appears in the statute governing § 77 reorganizations. 599 F.2d at 1166 (citation omitted).


164 See infra notes 178-82; cf. Epstein supra note 151.

165§ 361. See infra note 179.
broad discretion to deny a right of setoff to facilitate reorganization, the code supplants that general notion with a particular process which accounts for that concern as well as others, including protection for the setoff holder from the risks of a debtor's use of an account subject to setoff.

166 The Bohack court held that the Bankruptcy Act absorbed the statutory rules of ordinary bankruptcy into chapter 11, "insofar as they are not inconsistent with or in conflict with the provisions of this chapter." 599 F.2d 1160, 1166 (2d Cir. 1979). Bankruptcy Act, § 302 (repealed). This guided the application of the setoff rule. Bankruptcy Act § 68(a) (repealed). Unlike the present code, in which the rules of chapter 5 (bearing the setoff provisions, §§ 506, 553) are said to apply to all chapters without any qualifying principle (§ 103(a)), the Act may be seen as creating discretion to permit setoff under the former § 302 consistency principle. It is unclear whether this means that deciding under the consistency principle leaves room for differences of opinion, or whether this truly grants discretion to decide whether to permit setoff. The court in Bohack propounded that the review standard was an abuse of discretion, which may suggest the latter and broader view rather than a legal error standard as under the former.

Some courts to continue to propound a discretionary standard. E.g., DuVoisin v. Foster (In re Southern Indus. Banking Corp.), 809 F.2d 329, 332 (6th Cir. 1987)("[t]he application of setoff, however, is permissive and lies within the equitable discretion of the trial court."). See also IRS v. Norton, 717 F.2d 767 (3d Cir. 1983); In re Davies, 27 B.R. 898 (Bankr. E.D.N.Y. 1983); Tradex, Inc. v. United States (In re IML Freight, Inc.), 65 B.R. 788, 793 (Bankr. D. Utah 1986). Even in chapter 11, this is erroneous under the Bankruptcy Code, given the plain statutory mandate to apply chapter 5 (including § 553) to every operative chapter of the code. § 103(a).

For railroad reorganizations, the courts had carved under the Bankruptcy Act a true discretion rule for setoff. See supra note 162. Under § 1161 of current railroad reorganization law, several code provisions are stated to be inapplicable in a case concerning a railroad. Whether the exclusion from this list is meant to reverse the discretionary setoff rule of previous bankruptcy practice is unclear. That rule may continue under § 1171(b), by which the railroad reorganization court has broad discretion to determine whether any unsecured claim is entitled to priority treatment. However, the discretionary view of setoff spread from former section 77 railroad reorganization into nonrailroad business reorganization inasmuch as the latter cases routinely cite to the Supreme Court's railroad cases.

The Bohack case rested on a different statutory direction which left room for deciding whether setoff was consistent with chapter 11. No such judgment may be made under the code. Nevertheless, the absence of true discretion to permit setoff in reorganization does not mean that setoff is, in any sense, automatic in reorganization. Aside from the mandated valuation issue under § 506(a), as previously discussed, the purpose and timing of setoff remains an important, critical concern in a reorganization. The purpose behind the discretionary view of setoff in reorganization cases prior to the code came from the sensible concern that setoff could defeat or impede a reorganization. Even under the conventional view of setoff under the code, a debtor or trustee in chapter 11 may have to recognize a setoff, but that recognition does not force immediate satisfaction of setoff rights. Even if a bank account is subject to setoff, a debtor may use the account under the code, and the prevailing view requires that the debtor provide adequate protection to the setoff holder.
Under the code a setoff holder has lost the power to defeat a reorganization effort which might be successful. Whether setoff is taken before or sought after a chapter 11 filing, a debtor may obtain the use of the funds in an account. In this reorganization context the previously noted pro-setoff policy has become an anachronism. The driving force of that policy was the inducement of banks and other major setoff holders to forbear setoff. For banks had the power to obstruct a reorganization by exercising their setoff rights. Bankruptcy held out the carrot and stick of asking few questions about the legitimacy of a right of setoff in the bankruptcy proceeding even though generations had acknowledged that setoff was at best a legal preference. Continuing to recognize setoffs in bankruptcy with few questions asked, and never looking beyond the face value of setoff rights, no doubt affected the hold-out power of setoff holders.

Nevertheless, the bankruptcy code substantially eliminated that hold-out power by providing that chapter 11 debtors might obtain the use of funds subject to setoff. The legal preference came to setoff holders to induce their willing forbearance so that reorganization might proceed. The reorganizing creditors no longer need to overcompensate a setoff holder in order to obtain the use of funds. Protecting all setoff holders in the face value of their setoff rights may once have had the salutary effect sought, but continuing that practice under the code lacks any purpose and will only stir controversy about why other similarly situated creditors do not merit similar bankruptcy treatment.

167 A recent treatise takes a different view:

The issue of the bank's right to setoff the debtor's account might arise another way that also implicates section 553. Suppose that the bank did not have time to effect the setoff before the debtor filed bankruptcy. The automatic stay now prevents the bank from acting unilaterally to offset the debtor's account. Thus, the bank seeks relief from automatic stay to effect the setoff, and the trustee responds by resisting the relief and seeking a turnover of the funds in the debtor's account pursuant to section 542(b), which requires an entity owing a debt that is property of the estate to pay such debt to the trustee.

The bank will prevail against the trustee. It will be permitted to make the postpetition setoff if its right of setoff is protected by section 553. The obligation under section 542 to pay the account to the estate does not apply to the bank to the extent that the account may be offset under section 553. Epstein, supra note 151, at 361 (footnotes omitted). Surely this account assumes that the trustee or debtor has failed to offer or satisfactorily provide adequate protection. Section 553 expressly subordinates the setoff to the debtor's use of property subject to setoff under § 363. See Collier, infra notes 175-79.

To the extent that an account exceeds the real value of the bank's claim against the debtor, turnover lies in favor of trustee. As suggested in Part II and III, the code implants a further valuation test on setoff under § 506(a) to which § 553(a)(1) directs. To reject turnover under § 542(b) a court must find the whole of a debtor's account subject to setoff. Fundamentally no difference arises on the right of turnover where the bank has no setoff right or a setoff right amounting to 50% of the account.
B. Use of Setoff Funds

The mechanics provided by the code for the use of funds or accounts subject to setoff begin with a debtor or trustee's right to seek turnover of the funds pursuant to § 542(b). In exchange, so to speak, a setoff holder may move for adequate protection of the setoff right which should ordinarily follow any request for turnover by a debtor of the property, including funds or bank accounts, within the possession or control of the creditor or for a court order permitting relief from stay to effect a setoff. As well, the recognition of a setoff right may come before a bankruptcy court in the context of a plan confirmation hearing in which a creditor or other interested parties might object to the treatment of the creditor, and its setoff claim, under a plan.

One might hold a valid setoff right which nevertheless does not entitle the creditor to adequate and protection and, depending on the case, does not entitle the creditor to relief from stay to setoff, nor provides any proper ground for objecting to confirmation of a plan properly providing for the setoff right. On these matters it is imprecise if not improper to ascribe what are broad legal standards; it is wrong to suppose that some nonstatutory and precedential idea, such as Bohack's, permits a reorganization court to say that a creditor has a legal right of setoff but refuses to recognize that right in a reorganization. Some code cases appear to take that position but, nevertheless, rest on the context or timing issues.

168§ 362(d).

169For example, in Massachusetts v. Dartmouth House Nursing Home, Inc. (In re Dartmouth House Nursing Home, Inc.), 24 B.R. 256 (Bankr. D. Mass. 1982), the court properly avoided a postpetition setoff because it violated the automatic stay of § 362(a)(7). Yet, it needlessly recited the litany of Bohack:

Moreover, because an application of the setoff provisions is permissive, rather than mandatory, the Bankruptcy Court has the discretion to invalidate the privilege of setoff where setoff would frustrate a Chapter 11 debtor's ability to reorganize. Bohack v. Borden, Inc., 599 F.2d 1160 (2d Cir. 1979); In re Princess Baking Corp., 5 B.R. 587, 6 B.C.D. 842 (Bankr. S.D. Cal. 1980). In enacting Section 553, Congress recognized that:

'Treatment of setoff in a reorganization case is very different than in a liquidation case. In order to accomplish a successful reorganization it is important that business proceed as usual for the debtor. Setoff is an interruption in the conduct of the business and may have detrimental effects on the attempted reorganization.' House Report at 183.

In the present case, it is undisputed that Welfare's setoffs of the retro-payments have impaired the debtors' cash flow as debtors have been unable to satisfy monthly mortgage debt. Moreover, the element of the public interest is present in this case because patients' health and lives may be jeopardized by precarious cash flow.

Accordingly, despite the substantive merits of Welfare's entitlement to setoff the retropayments, it is my opinion that the debtor's substantial need for the funds, coupled with the public interest factor, and in view of Welfare's blatant violation of the stay in setting off post-petition requires a ruling that setoff of the retropayments on February 5, 1982 was void and of no effect.
Yet the writ of § 553 leaves a number of possible setoffs unaddressed. As to these, the code provides no express guidance, and some residue of judgment or discretion may there remain. As usual such matters may come to a boil in chapter 11.

C. Preconfirmation Use of Setoff Encumbered Funds

A debtor typically requires "hostage" setoff funds to effect its reorganization. The conventional manner by which collateral is regained by the estate is through a turnover proceeding. That section requires "an entity to deliver to the trustee property in its possession which the trustee may use, sell or lease under section 363." By acquiring possession of the property through turnover, the debtor may thereafter use the property subject to retention of the lien and payment on the secured claim under a plan. A debtor with its key property restored may succeed in reorganizing. Similarly, a cash-starved debtor with money in a bank may want the use of those funds subject to adequate protection or the indubitable equivalent of the bank's control of the funds.

But § 542(b) states that debtors of the estate must pay the debt to the trustee "except to the extent that such debt may be offset under section 553 of this title against a claim of the debtor." Assuming the offset is in the face amount of the claim against a debtor, § 542(b) seems literally to leave a court little discretion in permitting turnover even to a cash-starved debtor whose reorganization will fail, where it might have a reasonable prospect were the debtor permitted immediate use of the cash and deferred payment on the bank's secured claim. Given the fragility of cash as collateral, which the code specially treats, this special protection for the setoff holder is understandable but perhaps even more preferential than the rights of similarly situated secured claimants who hold cash collateral liens during a bankruptcy case.

24 B.R. at 265. The debtor was also told by the court to provide adequate protection for the setoff right. Id.

170 These also include setoff rights obtained after the bankruptcy case has commenced, whether in favor of prebankruptcy claims or debts, and whether held in favor of the debtor in bankruptcy or another entity. See infra Part VI.

171 § 542(a).

172 § 542(a).

173 § 542(b).

174 Debtors in chapter 11 may not use cash collateral without a court order on notice and hearing. The provision is designed to permit the lienor on cash to obtain any necessary adequate protection of its secured claim before the debtor may use the cash collateral. § 363(b).

175 Whiting Pools ordered the I.R.S. to turnover debtor's property seized before the debtor filed a chapter 11 petition. United States v. Whiting Pools, Inc., 462 U.S. 198 (1983). The text asks why a debtor may retrieve property under § 542(a) and not setoff funds under § 542(b). The policy explanation for the recapture in Whiting Pools given by the
A setoff holder is immune from turnover under the exception clause of § 542(b) which may be inapplicable to other secured claimants. COLLIER takes the position that § 542(b) does not prevent turnover of property in which the estate has an interest, such as a deposit account subject to setoff. COLLIER asserts that "turnover must be made under section 542(b) only if adequate protection is provided." The logic of this conclusion derives from a trustee's right to use, sell or lease property of the estate in the ordinary course of business. Further, the use of deposit accounts including any that are subject to setoff is an express exception to the right of setoff recognized in § 553. Thus, a trustee (and so a debtor in possession under chapter 11)

Supreme Court shows that there is no policy distinction between the two settings in which reorganization is likely to be facilitated by turnover. Some authorities claim that the procedural protections given cash collateral under § 363(c)(2) explain the express exception for setoff under § 542(b). In this view the exception assures a pre-turnover hearing in which the setoff holder may receive adequate protection of its interest. COLLIER ON BANKRUPTCY ¶ 542.03, at 542-16 (Lawrence P. King et al. eds., 15th ed. 1991). That the code contemplates use, sale or lease of setoff funds, albeit with limitations, follows from the introductory text of § 553(a): "Except as otherwise provided in this section and in sections 362 and 363 of this title . . . ."

Id. Courts have rejected turnover of funds against which an offsetting claim is properly held under § 542(b). Typically, in these cases, the debtor offers no adequate protection and inadequately relies on the automatic stay (§§ 362(a)(7); (a)(3)) as entitling turnover. The fifth circuit has held that a setoff claim valid under § 553 barred a trustee's turnover action under § 542(b) but no adequate protection was offered. Stephenson v. Duke Salisbury (In re Corland Corp.), 967 F.2d 1069, 1976 (5th Cir. 1992); cf. B.F. Goodrich Employees Fed. Credit Union v. Patterson (In re Patterson), 967 F.2d 505, 509 (11th Cir. 1992)(granting automatic stay to debtor who dropped turnover request and sought automatic stay and antidiscrimination enforcement).


Note also that the limitation to such use of cash collateral requires notice and hearing, unlike other estate property to be used in the ordinary course of business.

"Except as otherwise provided in this section and in sections 362 and 363 . . . ." § 553(a).

§ 1107(a).
may use cash collateral. Cash collateral includes deposit accounts. Thus, a
trustee may use its deposit accounts.

Notice that permitting a debtor to use its deposit accounts is the general rule
of § 363(c)(1). Deposit accounts may be free of either lien or setoff rights. When
deposit accounts are subject to a lien, they expressly fall within the expression "cash collateral." Whether the same is true when a deposit account is subject to
a right of setoff is facially unclear under § 363, but the exception in § 553 for
§ 363 could have no more likely referent. The COLLIER rendition of the
meaning of § 542(b) thus assumes that deposit accounts with setoff right-holding creditors are identical with a liened bank account. Yet code
provisions which directly address setoff do not associate the term collateral
with setoff. Because deposit accounts may be subject to either setoff or lien
rights, which the code descriptively contrasts with setoff in § 506(a), another
reading of deposit accounts as cash collateral under § 363 may be that they are
no more than accounts subject to a lien, as typically proceeds from the sale
of original collateral. That reading of § 363(a) and (c) would also harmonize the
latter's right to use deposit accounts and § 542(b)'s turnover exception for
holders of setoff rights. Under COLLIER's reading the latter exception is limited
to cases in which adequate protection is not provided to the setoff holder.

My point is not to commend turnover treatment of setoff rights which is
different from liens on a deposit account. Rather, textually the code may
permit one kind of secured claim (lien) to be subject to turnover (albeit with
likely need for adequate protection) and another (setoff) to be immune from
turnover. If there is anything profoundly objectionable to setoff under § 553 as
a preference or fraudulent transfer (if "legal"), § 542(b) facially compounds the
disparity by elevating the setoff holder to a position even above the rights and
beyond the risks normal secured claimants and lienors must bear when a court
permits turnover and an adequate protection which may nevertheless fail in
its purpose. Yet this disparity would be less true to the extent a setoff right

183§ 363(a).
184See supra note 181. See also Williams v. American Bank (In re Williams), 61 B.R. 567
185§§ 542(b), 506(a), 553.
186U.C.C. § 9-306(1).
187See EPSTEIN supra, note 151.
188See supra note 178.
189The secured claim may be sufficiently secured without the deposit account so that
no adequate protection order need be entered.
190Providing any party with adequate protection under § 361 should not fail but, of
course, it may. In the event that adequate protection does fail to provide the indubitable
equivalent of a party's interest, § 507(b) provides the party a super priority
administrative expense.

Another disparity between apparent lien treatment and setoff treatment relates to
the turnover issue. Dean Lacy takes a distinctly negative view of § 553(b). See supra note
were properly valued, as previously discussed. Indeed, face value treatment of
setoffs may force debtors to pay dearly for cash needed to reorganize under the
COLLIER view requiring adequate protection in the face amount of the bank's
claim before a court may permit use of the bank account. No reorganizing
debtor should have to provide adequate protection to the setoff holder in the
face amount of the prebankruptcy setoff claim unless a § 506(a) valuation
concludes that that is the value of the setoff in the bankruptcy.

Under the reading of setoff under § 506(a) submitted here, 191 no apparent
reason supports requiring a debtor to provide adequate protection of setoff for
the excess over the real value of the setoff claim as determined under § 506(a)
valuation. Nor, of course, upon a valuation of the setoff right below the face
value, would the exception of turnover from setoff apply to the amount
exceeding the value of the setoff. Nor should it matter for this purpose whether
a setoff right was exercised before bankruptcy or is sought by relief from stay
after bankruptcy.

D. Setoff and the Reorganization Plan

To confirm a plan under chapter 11,192 debtor must provide a secured claim
with one of three alternatives: (1) surrender of the collateral to the secured
claimant; (2) sale of the collateral with the secured claimant’s lien continuing
on the collateral or the proceeds of the collateral; (3) retention of the collateral
by the postconfirmation debtor subject to a secured claimant’s lien and
payments to the secured party of the value of the collateral under the plan.

If one regards the holder of a right of setoff as the holder of a secured claim
for these confirmation rules, as § 506(a) apparently does, it is interesting to try
to fit a setoff holder into this scheme. First, what is the analogue to the debtor’s
surrender of collateral to a lien creditor? The analogue to the setoff right is the

90. On the premise that § 553(b) has the purpose of discouraging prebankruptcy
exercises of setoff rights to facilitate reorganization, he suggests that even
prebankruptcy exercises of setoff should be subject to turnover on provision of adequate
protection. "Under existing law achieving this result is problematic because the exercise
of a setoff effectively terminates the debtor’s rights in the account prior to the
commencement of the case." Lacy, supra note 2, at 976; see also supra note 90. If this
statement is true, it appears to be inconsistent with the turnover of collateral, which has
been the subject of a transfer that has cut off the debtor’s interest. See United States v.
Whiting Pool, 462 U.S. 198, 203 (1983)("[a]lthough these statutes could be read to limit,
the estate to those ‘interests of the debtor in property’ at the time of the filing of the
petition, we view them as a definition of what is included in the estate, rather than as a
limitation.").

Setoff, turnover and § 506(a) valuation should come into every setoff taken while
the debtor was insolvent, not simply to facilitate reorganization, but more importantly
to prevent the setoff holder’s overcompensation.

191 See supra Part II.

192 § 1129(b)(2)(A). The same rule holds in chapters 12 and 13 although the power of
sale in the latter chapters is not expressly provided in the confirmation standard.
§§ 1225(a)(5), 1325(a)(5).
possessory lien creditor, say a pawn shop. A reorganizing debtor might tell the pawnshop to keep the collateral, or, if previous turnover has been obtained, the debtor might return the rolex to the pawn shop. Like the pawn shop, the bank "holding" a debtor’s money might be told by the debtor, or its plan, keep the money. Yet, again, this runs the risk of overcompensating a setoff holder.

Similarly, if one were to recognize a bank's claim to the money it "holds" in a debtor’s account under setoff rules, one could sell that account under the plan just as one might sell off a debtor’s liened accounts receivable. Because setoff rights are typically of such liquidated amounts, however, sale most commonly is the same as surrendering any claim to the funds. However, again, the real value of the debtor’s rights in the account will turn on the valuation of the setoff claim encumbering the account.

Yet the risk of overcompensation may not arise in the plan stage of reorganization. Unless there is some agreement otherwise, a debtor may have to provide the setoff holder under the plan the full face value of the setoff right. The cramdown amount required for secured claims may be the face amount of the setoff claim. Just as a setoff right in a chapter 7 liquidation of an insolvent needs to be discounted to its real value, a setoff right which has not been invalidated or otherwise concluded prior to the proposal of a plan may at that stage have a real value amounting to its face value. No less should a setoff claim enjoy the going concern value presumably held by a successfully reorganized entity. Just as there may be a difference between the value of a lien in liquidation of a business as compared to its value in an ongoing business, the value of a setoff right may likewise vary.

V. THE AMOUNT SUBJECT TO SETOFF

How a bankruptcy court might determine the real value of a setoff claim against an insolvent bankruptcy estate begins with the liquidation value of the setoff right at the time of a bankruptcy filing. The contrasting orthodox analysis begins (and ends) with the face amount of the creditor’s claim. Assuming that the debts are in an identical face amount, the conventional treatment values the claim against the estate as exactly what the value of the estate’s claim is. For a creditor of the estate who was also liable to the bankruptcy estate would never sell such a claim for less than its face amount because that would expose it to liability to the estate in the larger amount. But this begs the question, for it assumes that the value of the setoff right in bankruptcy is its face amount. Indeed, fixing the price by some artificial standard (here that bankruptcy will fully value the setoff right) ignores the debtor’s insolvency and establishes a bogus hypothetical market.

193§ 542(a).


195No one would pay face value for a claim against a debtor who was insolvent. Even a debtor of the debtor in bankruptcy would merely break even by obtaining a setoff through payment of face value. Given the risk that a claim brought for setoff purposes
Alternately, one may ask, as above, for valuation of the claim against the estate alone. The value of that claim is the value that willing buyers would pay at any particular moment. Claims have a value in such markets substantially equal to the face amount discounted for the date payable, any interest permitted, the relevant cost of money and the costs or delay in collection. Using this sort of market-formation yields low returns for sales of claims against insolvencies. Indeed, the code establishes a zero value for setoff claims acquired within the 90 days before bankruptcy from an entity other than the debtor or for the purpose of obtaining a setoff right against the debtor. Whether these absolute rules are sound may be doubted, but they suggest that a setoff right’s real value is far below its face amount.

Several objective factors permit the reasonable certainty which courts use in various valuation contexts. Dean Lacy, for example, suggests that a key factor in approving setoffs, and differentiating setoffs on the principle of creditor equality, is the setoff obtained while the debtor was solvent. Presumably a setoff obtained while a debtor was insolvent is distinguishable. That seems to be an idea behind the broad rules of §§ 553(a)(2) & (3). The setoff obtained while the debtor was insolvent has no value through the code if it is obtained within 90 days of bankruptcy. However, that does not compel the conclusion that the value of the setoff is the face amount if it had been obtained more than 90 days before bankruptcy, especially were the debtor then insolvent.

A useful initial guide for valuation of setoffs would be the face amount of any setoff right if the right was obtained when the debtor was solvent so long as the creditor did not setoff prior to the 90 day period before bankruptcy. Creditors who do setoff prior to the 90 day period should receive attention under other bankruptcy avoidance law. If such creditors or those who never

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196 § 553(a)(2).
197 § 553(a)(3).
198 These rules may rest on a policy of deterrence, or they may rest on a policy goal equality among creditors, a goal which is also accomplished by the true value thesis of setoff.
199 E.g., U.C.C. § 2-204(3) (advocating that contract damages must be reasonably certain).
200 See Lacy, supra note 2, at 954-56.
201 For example, under either § 548 or § 544(b), the setoff may be a transfer intended to defraud creditors or a transfer which has the effect of doing so. Under present law, the body of § 553(a) has been read to bar avoidance of a setoff not avoidable under § 553. This conventional reading assumes that the critical language, "this title does not affect any right to offset...", refers to cases in which no setoff has been taken before bankruptcy, and also to cases in which setoff has been taken, either prior to the 90 days before
exercised setoff rights prior to bankruptcy could show some contemporaneoussness which immunizes preferences\(^202\) the later extension of unsecured credit\(^203\) or other familiar factors which overcome the preference rules, then a court might finally value the setoff right closer to the face amount of the holder's claim against the estate. Likewise, setoffs obtained or exercised when debtors were insolvent should receive valuation scrutiny under a refined fraudulent transfer analysis.\(^204\)

VI. SETOFF AFTER BANKRUPTCY

The period after bankruptcy raises several setoff questions. The first issue is whether a claim arising after bankruptcy may offset a claim arising prior to bankruptcy. Cases routinely deny such an offset.\(^205\) The second postbankruptcy issue concerns the effect of the confirmation of a reorganization plan on preconfirmation setoff rights. Debtors have had the perhaps greedy vision that the confirmation of a reorganization plan discharges the claim of a setoff right holder but preserves the claims of debtors. None of the judicial responses to this sort of contention has shown special insight into the structure of the bankruptcy law.

A. The Timing Rule of § 553

Section 553 (a) addresses only the setoff of "mutual debt . . . that arose before the commencement of the case under this title." The latter phrase modifies both the debt owed by the setoff claimant and the debt owed by the debtor in bankruptcy. From this plain language comes the proposition that any setoff rights derived after the filing of a bankruptcy may not be recognized. In two leading appellate decisions the courts rejected setoff claims on what appear to be questionable grounds despite the plain language recited.

1. When the Claim Arose

In Cooper-Jarret, Inc. v. Central Transport, Inc. (In re Cooper Jarret, Inc.),\(^206\) the court held that a disputed prepetition claim of the debtor which had been

bankruptcy or within the 90 days, but not subject to avoidance under §§ 553(a)(2) or (3). That is a broad reading and may be justifiable by the broad language, "this title does not affect ...." If this language were intended to immunize both exercised and unexercised setoff rights, one might have the doubts McCoid expressed under the principle of creditor equality. McCoid, supra note 2. Under one aspect of that principle, one might sensibly favor those setoff rights-holders who acquired their setoffs while the debtor was solvent and refrained from setoff until bankruptcy.

\(^{202}\) E.g., § 547(c)(1).

\(^{203}\) E.g., § 547(c)(4).

\(^{204}\) See supra note 201; see also supra note 40.

\(^{205}\) Boston & Maine Corp. v. Chicago Pac. Corp. (In re Chicago Pac. Corp.), 785 F.2d 562 (7th Cir. 1986); Cooper-Jarret Inc. v. Central Transp., Inc. (In re Cooper Jarret, Inc.), 726 F.2d 93 (3d Cir. 1984).
been settled during litigation after the bankruptcy case had commenced was not a debt of the setoff claimant "that arose before the commencement of the case under this title." Although the code defines the term "debt" as "liability on a claim" and defines "claim" in the broadest possible terms, in this case the Third Circuit rested its decision on the nonbankruptcy proposition that a litigation settlement agreement creates a new legal obligation which supplants any previous liability. Thus, the debtor's debt did not qualify for setoff use under § 553 because this new obligation had arisen after bankruptcy. This same court decided the notorious Frenville case, during the same term which consistently held that a claim was not stayed by § 362 of the code because under state law the right to payment did not accrue until after the bankruptcy case was filed. As other cases and commentary reject Frenville, so too may one reject Cooper-Jarret.

2. Debtor's Use of Setoff

A more interesting though marred case is the railroad reorganization opinion of Judge Easterbrook which decided a battle of two bankrupt roads, Boston & Maine Corp. v. Chicago Pac. Corp. Boston & Maine filed its bank-
ruptcy in 1970 in Boston, and in 1979 the Court of Appeals for the First Circuit ruled that debts of the Boston & Maine for "interline balances" enjoyed no priority in its bankruptcy. The Rock Island railroad filed bankruptcy in 1975 but the Seventh Circuit in 1976 ordered that it provide priority for prebankruptcy interline balances (as well as subsequent balances). The upshot of the conflicting circuit court decisions left the Rock Island and Boston & Maine debtors in decidedly different positions, even though each was a creditor in the other’s bankruptcy. This resulted because the former had sufficient funds in the end to pay all creditors but the latter would only be able to pay 10 cents on a dollar. Thus, as Judge Easterbrook pointed out, the Boston & Maine would pay $18,000 on a 15-year old debt of $180,000 while the Rock Island would pay the Boston & Maine more than $100,000 on a more recent debt of $100,000. In these circumstances the Rock Island contended it had the right to setoff its $180,000 claim against Boston & Maine’s $100,000 claim.

Judge Easterbrook’s setoff analysis of these facts presumes without discussion the materiality of the prebankruptcy and postbankruptcy sources of the debts. Though § 553 requires that each debt arise before bankruptcy, the scope of § 553 need not extend at all to postbankruptcy setoff rights. As noted earlier, § 553 acknowledges or validates in bankruptcy some prebankruptcy setoff rights by providing that "this title does not affect any right of a creditor to offset..." Then, the setoff section qualifies the kind of setoff rights it acknowledges by excluding setoff rights deriving from certain circumstances. Interestingly, the literal effect of the rule of §§ 553(a)(1)-(3) turns out to be no more than excepting those three kinds of setoff rights from the main clause of the rule, the setoff acknowledgement. Thus, prebankruptcy setoff rights of the sort covered in the exception clause fall into something of a limbo: title 11 may affect such setoff rights although § 553 does not say what or how this will occur. This contrasts with § 553(b), which permits a trustee to

214 "Interline balances are the net amount due from one railroad to another for mutual transactions." Id. at 563.

215 Id. at 567.

216 This was the predecessor to the reorganized Chicago Pacific Corporation.


218 785 F.2d at 564.

219 The Rock Island and the Boston & Maine bankruptcies arose before the Bankruptcy Code and were governed by the Bankruptcy Act. But the court cited the code as well as § 68 of the Act for the requirement that each debt arise before bankruptcy.

220 See supra text accompanying note 66.

221 § 553(a).

222 Setoffs falling within §§ 553(a)(1)-(3) are invalid.
recover certain setoffs,223 and contrasts with the normal avoidance provisions of the code which likewise permit a trustee to avoid or recover prebankruptcy transfers.224 Setoff rights which were not exercised prior to bankruptcy are not voidable transfers by virtue of the application of §§553(a)(1)-(3). Nevertheless, such setoff rights may be affected by bankruptcy.225

223Somewhat consistently, the general recovery provision of the code, § 550, includes reference to § 553(b) but not § 553(a). The tiny difference seems to arise from liability for an "avoided transfer" under § 550, applicable only to setoffs exercised prior to bankruptcy. Setoffs which fall under § 553(a)(1)-(3) were never valid setoffs in bankruptcy and are subject to turnover under § 542(b). Cf. infra note 224.

224§§ 544, 545, 547, 548.

225Note 223, supra, suggests these § 553(a)(1)-(3) setoff rights are invalid in bankruptcy, and thus § 542(b) turnover lies as opposed to an action under § 550. Alternatively, the right of setoff is generally viewed by bankruptcy commentators as a preferential treatment of the holder of a setoff right when it is exercised prior to bankruptcy and during the preference period of § 547. Commentators describe § 553 as an exception to the preference law of § 547. E.g., GEORGE TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 169 (1987). Further, it is generally agreed that § 553(a) immunizes setoffs there recognized from preference attack.

Thus, one consequence of § 553(a)(1)-(3) may be simply to expose such nonbankruptcy setoff rights to a preference challenge under §§ 547 and 550. Setoff rights obtained during the preference period, normally 90 days (§ 547(b)(4)(A)), would, under this view, be preferences. Yet it is not easy to see how this may be so. For example, consider a setoff under § 553(a)(2) acquired from an entity other than the debtor during the preference period and while the debtor was insolvent. That is, suppose C buys a claim against D from C1 so that it might offset its own debt in a similar amount. There is no doubt at all that commentators, as well as Congress, are correct in understanding the recognition of this setoff right to result in preferential treatment for C in D's bankruptcy. However, commentators wrongly suppose that preference law is on point here.

If C's setoff right was recognized as valid in D's bankruptcy, C would not receive preferential treatment in D's bankruptcy under § 547. This is part of Dean Lacy's analysis. See Lacy supra note 2. If such a setoff right was tested under § 547, the trustee would recover nothing. Preference law requires a transfer of property of the debtor prior to bankruptcy. If C does not setoff prior to bankruptcy, but properly seeks relief from stay to setoff after bankruptcy (most likely in response to a trustee's action on the debt C owes D), C's exercise of its right of setoff cannot be a preference because of its timing. If C does exercise its right of setoff prior to bankruptcy and during the preference period, the issue becomes whether there was a "transfer of an interest in property of the debtor" under § 547(b). In the case of bank setoff it may be that imagination and hypostatization suffice for the conclusion that the debtor's interest in the general funds of the depository bank has been "transferred" by a bank's setoff. A transfer may also occur when C offsets D's claim with the claim it bought from C1. (C's purchase of C1's claim against D cannot qualify as a transfer of debtor's property.)

When D or its trustee claims C has received a preference by offsetting prior to bankruptcy, the final element of a preference action requires a showing that the challenged "transfer ... 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." In one view the estate would have to pay nothing to C if the transfer, the setoff, had not been made. The estate might setoff C's claim by its own claim against C. In that event, C's prepetition setoff would not enable C to receive more
As to setoff rights acquired postbankruptcy by a prebankruptcy creditor or a debtor of a bankrupt, § 553 says no more than the pregnant negative, that such setoff rights, as with the setoff rights borne by §§ 553(a)(1)-(3), may be affected by bankruptcy. One might suppose that if § 553 does not acknowledge or validate a setoff right, such as one acquired after bankruptcy, title 11 does affect that right by invalidating the setoff right. This in turn depends on an assumption about the style of the bankruptcy law that bankruptcy law does not recognize any claim unless it receives definite expression in the code. As applied in general this is no doubt an erroneous premise.

But as to claims of priority against the bankruptcy estate, one may expect express code statements of such priority rights such as provided in §§ 507 and 506. Section 506(a) defines setoff by expressly referring to § 553. But, as shown, the latter merely permits bankruptcy to affect setoff rights without indicating what that effect may be.

The fact that setoff grants a priority to a creditor may unravel the mystery about setoffs that lay beyond the reach of § 553. Judge Easterbrook supposed that any setoff creates an unfair priority to the holder. If, however, one takes setoff as less than a priority claim, or less than an unfair priority, then one would expect its express recognition in the code to be no more necessary than a separate listing under the definition of claim for contract, tort or statutory liabilities. If there are setoffs which do not create an unfair or any priority between the holder and other creditors, then such setoffs might be acceptable in bankruptcy even without any specific statutory mandate. Most obviously, in the case of a solvent debtor, only futility would ask the setoff holder and the trustee to exchange checks. More importantly, if it is properly valued, a setoff cannot create any unfair priority.

What other cases and setoffs might not be affected by bankruptcy derives from this understanding of what § 553 does address: those priority setoff rights and actual prebankruptcy setoffs which do provide the setoff holder with an

than C would have received in a chapter 7 case filed by D. On the other hand, if the estate did not setoff against C but rather calculated a hypothetical dividend for C, then receipt of that dividend, plus C’s setoff receipt, would result in C’s having received more than it would have received had there been no setoff transfer.

A final issue may arise which implicates the timing point once more. Perhaps a setoff right which is sought to be exercised only after the commencement of the bankruptcy case would be an invalid postpetition transfer of property of the estate under § 549. Under the previous reasoning, the estate will have had its claim against C transferred (e.g., discharged) should the setoff be taken. This postpetition transfer may be invalid. § 549. Accordingly, the postpetition taking of an invalid § 553(a) setoff would also violate postpetition transfer law and be actionable under § 550. See Tyler v. Marine Midland Trust Co., 128 F.2d 927, 928 (2d Cir. 1942).

226 The Supreme Court suggested as much in United Sav. Ass’n v. Timbers of Inwood Forest Assoc., Ltd., 484 U.S. 365, 372 (1988). There the code’s express grant of postpetition interest in § 506(b) to oversecured creditors, those whose collateral has a value exceeding the debt secured, supported the holding that undersecured creditors have no right to postpetition compensation during the interim period after bankruptcy and prior to confirmation of a chapter 11 plan.
unfair priority over other creditors. This fits the Easterbrook conception: the code must expressly provide for prebankruptcy setoff rights or actual prebankruptcy setoffs because these have the inevitable effect of giving such holders priority treatment in the bankruptcy. Postbankruptcy setoff rights receive no express attention in the code for the opposite reason. These setoff rights do not necessarily lead to any unfairness in the distribution of rights, as, for example, among the Rock Island's prebankruptcy creditors. The railroad battle exemplifies this.227 The fight between these railroads had finally nothing whatever to do with setoff under either old § 68 or its successor § 553.

The issues these bankruptcy provisions address, however fragmentarily, are the setoff rights of a party against whom the bankruptcy estate also has a claim.228 The Rock Island brouhaha concerned the setoff rights of a bankruptcy debtor. Permitting the bankruptcy estate to setoff, whether its claim derived before or after bankruptcy, does not create priority for the affected creditor over other unsecured creditors of the Rock Island, the position which Judge Easterbrook took as the policy behind the code's express limitations on setoff.229 The problem in such cases230 by a setoff by an estate implicate priority

227 The creditors were only trivially affected by the discrepant opinions of the circuit courts. The creditors would receive 100% of their claims in the Rock Island case and stood to gain only additional interest on these claims if the debtor Rock Island could setoff its claim against that of the Boston & Maine. On the other hand, the creditors of the latter railroad were to receive a mere 10% of the face value of their claims.

228 Section 553(a): [T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor..."

229 Judge Easterbrook's confusion about setoff, so common in the literature because the whole notion of setoff is so dearly abstract, may be seen in the following passage:

There is no reason why some creditors of the pre-bankruptcy firm should have their rights diminished by post-bankruptcy transactions of the firm that might create setoffs—yet that would be the result of allowing pre- and post-bankruptcy debts to cancel each other out, because a setoff would reduce the cash intake of the firm, and therefore usually reduce the funds available to satisfy competing claims.

785 F.2d at 565. The case before the court did not involve a setoff which could have reduced the funds available to the creditors. The setoff sought by the debtor in bankruptcy could only increase the funds available to its creditors by reducing the distribution to one creditor.

Further, the view taken of the benefits to be gained by transactions or events postbankruptcy with a pre-bankruptcy creditor is extremely narrow. Even if doing business with such a pre-bankruptcy creditor might create a setoff valid in bankruptcy for such a creditor, bankruptcy law does not need a legal rule as imagined by Judge Easterbrook. Unless self-interest has entirely disappeared from firm behavior, the only reason why a firm in bankruptcy should deal with a pre-bankruptcy creditor, who might thereby gain a setoff right, would be to obtain a net benefit unavailable elsewhere. If that were so, the other pre-bankruptcy creditors would have to approve such a transaction as a net benefit to them also. If the debtor was colluding with the creditor, other rules may be summoned against the setoff. § 510. Thus, to deny, by a legal rule, setoff of any postbankruptcy debt against a creditor's prebankruptcy claim will only throttle those postbankruptcy dealings which would benefit the other creditors. The equitable discretion Judge Easterbrook is so intent to deny on the wide open issue of setoffs beyond the scope of § 553, leads him to a rule which appears necessary only as
or preferential treatment concerns between the creditors of one bankruptcy estate and the creditors of another bankruptcy estate. Because there were two bankruptcy estates waging this battle of the estates, the effect of permitting one debtor in bankruptcy to setoff could produce an unfair priority for one creditor group over another creditor group. Using the real rather than face amounts of the claims of each estate would produce fairness to each creditor group.\(^{231}\) Denying setoff or permitting setoff based on face value would have the effect of favoring one group of creditors over another when the mutual debtors are both in bankruptcy whenever the real value setoff values differ. Judge Easterbrook mistook the bankruptcy setoff provisions to present an inflexible rule against setoff when one debt arose postbankruptcy and the other prebankruptcy. Second, he took that rule to apply to a setoff claim by a debtor in bankruptcy. Even so, as shown using real values of setoff rights,\(^{232}\) the decision left the parties close to the right analysis.

*Reading Company*\(^{233}\) presents a second battle of bankruptcy estates and setoff. Central Jersey’s creditors, including Reading, had received in Central Jersey’s railroad reorganization nonrecourse\(^{234}\) notes collateralized by a claim that Central Jersey held against the United States. The claim was of uncertain value. Thus, the face amount of the notes did not reflect their value. Reading sought to setoff the note in its face amount against Central Jersey’s claim in the Reading bankruptcy. Because Reading was likely to be solvent,\(^{235}\) the effect of permitting it to setoff the note of indeterminate value against Central Jersey’s claim would create a priority in favor of the other Reading creditors in the estate of the Central Jersey railroad. For by setoff these creditors would replace their rights in Central Jersey’s doubtful note with extinction of Central Jersey’s claim

...a crusade against discretion and wise only if the rule he creates does more good than harm.


**231** Boston & Maine would pay $18,000 on a 15-year old debt of $180,000 while the Rock Island would pay the Boston & Maine more than $100,000 on a more recent debt of $100,000. Because Rock Island was solvent, the real value of the Boston & Maine setoff right was its face value. The 10% dividend awaiting the Rock Island in Boston & Maine’s bankruptcy meant the latter was insolvent and using liquidation values. This gave Rock Island’s setoff right a 10% real value on its face setoff claim of $100,000 or $10,000. The effect of the court’s opinion is to require Rock Island to pay $100,000 and receive $18,000 for a net distribution of $82,000. On these real value figures, Rock Island should pay Boston & Maine $90,000 after deducting the value of its setoff right and receive the same $18,000 for a net distribution of $72,000. When the First Circuit permitted the Boston & Maine to affect setoff against Rock Island in the face amount of its claim, the eventual solvency of Rock Island justified that figure as the real value of the Boston & Maine setoff.

**232** See *supra* note 231.

**233** 838 F.2d 686 (3d Cir. 1988).

**234** *Id.* at 687.

**235** *Id.*
against Reading\textsuperscript{236}. Permitting setoff in the real value of the note would have respected the rights of the creditors of the two bankruptcy estates.

\textbf{B. Setoff Surviving Discharge or Confirmation}

The supposed special nature of setoff rights has led courts to rule that setoff rights survive a debtor's discharge of debts.\textsuperscript{237} Although this is perhaps a doubtful proposition under other provisions of the bankruptcy code,\textsuperscript{238} § 553 seems to support the proposition in its broad immunity for qualifying setoffs: "[T]his title does not affect any right of a creditor to offset..."\textsuperscript{239} Whether or not the matter is so simple as the cited courts have announced, yet another relationship of setoffs with liens is apparent in this proposition.

The principle\textsuperscript{240} of \textit{Long v. Bullard}\textsuperscript{241} persists under the code: liens may survive bankruptcy.\textsuperscript{242} Section 522(c) recognizes the rule for exempt property, and the legislative history identifies that case as its source.\textsuperscript{243} Likewise, the same language appears with reference to § 506(d), a subsection with a troubled recent history. In \textit{Dewsnup v. Timm}, the Court tentatively held that the latter subsection does not authorize lien avoidance in the form of lien-stripping in a chapter 7.\textsuperscript{244} The theme this suggests\textsuperscript{245} is the postbankruptcy survival of prebankruptcy setoff rights which, like liens, are secured claims. If bankruptcy today treats setoffs and liens as secured claims, whatever is the continuing legacy of \textit{Long v. Bullard} may include the setoff as well as the lien.

\textsuperscript{236}The court's denial of setoff presumably permits the real value of the setoff right to emerge by the eventual determination of the value of the note given the Reading Company. When that value is determinable at the time a debtor in bankruptcy seeks setoff, setoff might be granted in that amount.


\textsuperscript{238}E.g., § 524(a)(2).

\textsuperscript{239}§ 553(a).

\textsuperscript{240}Although often described as the "rule" of \textit{Long v. Bullard}, the vagueness of what this assertion means cannot justify that description. The fact that liens survive bankruptcy in view of the numerous putative effects bankruptcy may impose on liens states a general principle of law and not a rule.

\textsuperscript{241}117 U.S. 617 (1886).


\textsuperscript{244}112 S. Ct. at 776-77.

\textsuperscript{245}A forthcoming broader paper on liens and bankruptcy will provide a more thorough investigation of the issues raised.
Yet substantial doubt about how liens survive bankruptcy under *Long v. Bullard* is very real and sensible. Much of substantive bankruptcy law purports to affect liens in one manner or another, including bifurcating liens under § 506(a); avoiding liens (or subordinating in the true sense) in one or another or avoiding power such as the strong arm power or preference law; or redemption, or cramdown. If liens may be affected under so many code sections, it may be that liens as perhaps setoffs, survive a bankruptcy proceeding merely to the extent that they are specifically unaffected by bankruptcy. Or, there may be even more to liens as perhaps setoffs and less to bankruptcy than meets the eye.

One might soundly suppose, nevertheless, that liens or setoffs survive bankruptcy unless they are satisfied or avoided in bankruptcy. Liens or setoffs may survive bankruptcy only if bankruptcy does not terminate them.

This latter idea permits a broad view of what may be forever accomplished in a bankruptcy proceeding with respect to liens: *Long v. Bullard* would not threaten due arrangements made in bankruptcy. But, whatever bankruptcy may do to liens may be a feature solely of what bankruptcy is doing. Bankruptcy cases end and are closed; reorganization and rehabilitation plans are confirmed and at least some are fully performed. Other cases are converted to chapter 7. The impact of bankruptcy on debts is one model for liens or setoffs. Bankruptcy has for many years said that not only is debt generally unenforceable while the debtor is in bankruptcy, bankruptcy may well discharge the debt and forever.

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246 I deliberately use the softer term affecting liens or setoffs, rather than what often appears in bankruptcy discussions—"avoidance." Avoidance connotes a stronger meaning than effect, that a lien or a setoff no longer exists. Arguably, this may be true; but it is not logically a necessary meaning of avoidance which may have, as Carlson, supra note 6, suggests, a lesser meaning. For example, avoidance may mean temporally that C has no right against D, in terms of a present right to enforce that right; or, relationally, C may have its right avoided in the sense of present enforcement against D, but the right may be presently enforceable against D1. Many of variations on this theme may be played. The automatic stay (§ 362(a)) affects (but does not avoid in the strongest sense) the rights that the examples suggest.

247 Compare Carlson, supra note 6, at 855-62 (arguing that avoidance in the bankruptcy avoiding powers actually means subordination, although the effect may generally be the same when a debtor is insolvent) with Epstein, supra note 151, at 422 (emphasizing that "avoid" is "meaningful in itself").

248 § 544(a).

249 § 547(b).

250 § 722.

251 §§ 1129(b)(2)(B), 1225(a)(5), 1325(a)(5).

252 See, e.g., §§ 524(a), 727(a), 1141(c), 1228(a)-(c), 1328(a)-(c).
Debt discharge orders apply after bankruptcy. They provide a parallel to liens in bankruptcy which likewise may not be enforced during a proceeding without relief from stay, by leave of the bankruptcy court. Liens or setoffs may be enforced once the stay terminates under § 362(c). There is no clear lien or setoff parallel in the code to the provision that permanently enjoins actions to collect discharged debts. Further, the provisions of § 524 barring the collection of discharged debt speak only to in personam actions against the relieved debtor. Again, it bears emphasis that avoided or disallowed liens or setoffs in bankruptcy, under an expansive avoidance or disallowance notion, receive no complementary provision forever barring their enforcement after a bankruptcy case ends. Such a provision might be superfluous because enforcement of an avoided lien would be thought absurd; yet the same might also have been said about the effect of discharge.

All that may be clearly said is that the avoidance or disallowance of a lien or setoff in a bankruptcy proceeding has whatever effect bankruptcy had in mind in avoidance or disallowance. What happens, however, when the bankruptcy purposes apparently abort liquidation or a failure to confirm a proposed plan or a default with the dismissal of a chapter 7 under a plan is far from clear. For example, suppose a chapter 11 plan crammed a lien down to 50% of the debt secured and shortly thereafter the debtor defaulted on its payments to the secured claimant under the plan. Thereafter, the secured party repossessed the collateral and sold it for a price which amounted to the full amount of the debt owed. (Assume also the debtor had paid none of the

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253 § 524(a).
254 § 362(a).
255 § 362(d). But see § 362(b).
256 In the strongest sense available, a lien or setoff avoided in bankruptcy would be extinguished for all purposes.

257 A recent chapter 13 case held that a plan eliminating the lien on the debtor's residential property and retaining the lien on the debtor's business property was binding on the mortgagee upon confirmation hearing, regardless of its notification of the confirmation. Because the mortgagee knew that the debtor had filed a bankruptcy petition, the mortgagee had to pay attention to the proceedings to determine what it might want to challenge. Pacesetter Bank of Montpelier v. Pence (In re of Pence), 905 F.2d 1107 (7th Cir. 1990). The major undercurrent on the postconfirmation effects on liens or other claims in recent cases is the issue of whether the creditor bears the risk of protecting its interest, as under Pacesetter, or whether the debtor must come forward to alert the creditor of the effect of a proposed plan. See infra notes 294-313.

258 If such a heady price is too much to believe, assume that the collateral sold for more than the bankruptcy-determined value of the secured claim. Also assume that the secured claimant did not make the § 1111(b)(2) election. With respect to said election, the literature assumes that a creditor making the election guarantees its right to any surplus. Professor Carlson argues a contrary version of the text of § 1111(b), under which the electing creditor is entitled to no more than its secured claim under § 506. Carlson, supra note 74. It follows from Carlson's proposition that the electing creditor presents the same issue regarding any right to the surplus in the example.
unsecured claims under the plan.) Outside of bankruptcy and had there been no bankruptcy, the secured creditor usually has the right to these foreclosure sale proceeds. The question is whether the lien cramdown of the confirmed but defaulted chapter 11 plan has altered this nonbankruptcy right. If it has, this comports with a revised view of Long v. Bullard; otherwise, the wider and perhaps older view of Long, that liens survive bankruptcy, might yet control.

The postbankruptcy effectiveness or survival of prebankruptcy rights is a complicated issue. Here the focus is on, as in the preceding text, the lien or setoff. Yet, the abstractions of most of the code text mean that one has to regard other claims and interests, and other rights, in order to understand the postbankruptcy effect of these creatures.

First, the types of bankruptcy proceedings which postbankruptcy questions about prebankruptcy rights might address are numerous. A simple or a complex bankruptcy may have occurred. Even in a simple bankruptcy proceeding there may have been discharge as well as avoidance of claims or interests unaffected by debt discharge. Even in a complex bankruptcy proceeding there may have been no discharge but there may have been successful avoidance of particular claims or interests. So the first difficulty is the code's abstractions which leave its readers to determine what falls within these generalities; the second difficulty is the lack of a singular bankruptcy proceeding on which to gauge postbankruptcy effects.\(^\text{259}\)

\(^\text{259}\)The range of bankruptcy proceedings will startle the uninitiated. The traditional dichotomy of bankruptcy proceedings separated bankruptcy into liquidations, the surrender of assets to creditors in exchange for debt discharge or dissolution of unnatural debtors, and reorganizations, the court approved and sometimes supervised workout of debt problems of a surviving debtor. No less than three (sometimes overlapping) reorganization chapters exist in present law. Several different liquidations are available under chapter 7, including stockbrokers (§§ 741-752), commodity brokers (§§ 761-766) and everyone else who is eligible (at least seventeen different entities are ineligible) for chapter 7 (§ 109(b)).

As if this does not fill the bankruptcy plate, the occasional business enterprise which was so dismal as to require repeated bankruptcy proceedings has been turned upside down in the new age of exploration and exploitation in which creditors may: 1) breakfast with a debtor in chapter 7; 2) suffer lunch in chapter 13; and 3) find themselves at dinner in chapter 11 or 13, or any combination thereof or others. Bankruptcy hearings are more common in the morning and so these multiple proceedings pass in the trade as serial bankruptcy. One may proceed, other than by conversion, from chapter to chapter by paying a new filing fee. Numerologists may take inspiration in the newly created chapters that imaginative debtors have created, chapter 18, chapter 20, chapter 22, chapter 26, etc. One yet unaddressed legal issue in serial bankruptcies, which may concern the security interest in bankruptcy, is whether § 506, central to both liens and setoffs in bankruptcy, applies in these new chapters. The code states that chapter 5 applies in chapters 7, 11, 12 or 13 (§ 103), as though serial cases were uninvited guests at the bankruptcy version of the predators' ball! The Court in Johnson v. Home State Bank, 111 S. Ct. 2150 (1991), hid from the serial maiming outside and settled jurisprudential brooding about whether a claim is a claim. However, before trying to take strategic advantage of § 103(a)'s lapse, bear in mind that the same may be said for chapters 1 and 3. Thus, a holder of a secured claim in any chapter higher than 13 may
Second, a bankruptcy proceeding may concern prebankruptcy rights of
debtor, creditors, shareholders and even third parties. So the tendency to
assume that a bankruptcy will treat all prebankruptcy rights the same may
prove incorrect even though an a priori fairness principle supports that
expectation. Whose rights are involved may become an interesting qualification
on any answers the code may give to postbankruptcy effectiveness of
prebankruptcy rights.

The prebankruptcy rights of debtors may provide analogies or homologies
to the postbankruptcy rights of other parties, but may on the other hand be
quite immaterial to any question of the survival of others' rights. The debtor in
some bankruptcy proceedings may lose prebankruptcy rights; in others the
debtor may have prebankruptcy rights which survive. The debtor in chapter
11 presents the most curious "who" issue. First, bankruptcy lore holds that for
some purposes the prebankruptcy debtor is different from the
postbankruptcy debtor. Second, the postbankruptcy debtor is ambiguous
and may mean either the preconfirmation or postconfirmation debtor. The
preconfirmation debtor may have rights different from a postconfirmation
debtor under the view that it is a different entity, a successor to the
preconfirmation debtor with new rights and duties. When true, the
preconfirmation debtor may retain prebankruptcy rights (and perhaps duties)
to which the postconfirmation debtor does not succeed.

claim that, without the applicability of § 109, the debtor has no authority to be in chapter
13+. Perhaps regrettably, the high court took that authority for granted in Johnson.

260A third-party may be simply be a co-owner of property with the debtor. The code
permits sale of the mutually owned property. § 363. As with secured parties who seem
to be treated by the code as creditors rather than co-owners, the rights of a co-owner
may be affected in bankruptcy, but only less drastically than the prebankruptcy rights
of others, such as unsecured creditors whose prebankruptcy rights seem quite likely to
be terminated forever in many proceedings.

(concluding that a trustee, as new management of debtor, may waive attorney-client
 privilege).

262 This metaphysic is accomplished by the automatic stay of action in § 362 which
effectively avoids rights and duties to the extent they cannot be used once the
bankruptcy case commences. Thus, the stay alters the existing effective rights others
hold at bankruptcy. Arguably, one might better describe the effect of the stay and other
rights as mere suspension and not avoidance—or perhaps as avoidance (or suspension)
of the powers nonbankruptcy law presents others against the estate or debtor. In fine
legal analysis, these Hohfeldian niceties may help; but in general discourse, a distinction
between a power and a right is likely to miss the point. Bankruptcy immediately affects
the debtor-creditor and other relationships.
1. Setoff and Discharge of Debts in Liquidation

Though discharge may be irrelevant in the liquidation of a corporation, any balance remaining after setoff of the setoff holder’s claim will practically disappear after the setoff right is exercised. The liquidation of the corporate debtor will leave any unused excess over the amount setoff and the amount distributed seemingly worthless. Theoretically, though, a claim remains against the liquidating corporate debtor.

That claim may be lost against a natural debtor if there were a discharge of debts in the case. Section 524(a)(2) expressly enjoins offset through a debt discharged under any chapter of the code "as a personal liability of the debtor." A setoff right may not squarely fit the idea of a debtor’s personal liability. As a § 506(a) "secured claim," it reflects an aspect of a property right as with liens.

Almost every claim of a debtor passes at bankruptcy to the bankruptcy estate. Thereafter, an individual debtor may exempt her own claims from the estate to the extent provided by applicable exemptions law. Nonexempt claims remain as property of the estate. The effect of a bankruptcy discharge on a setoff holder’s right may depend on whether the debtor’s claim is exempt or not. If it is exempt, when the debtor makes such claim on a creditor with a right of setoff, absent a bankruptcy the creditor may have offset its claim against the debtor if the law creating the exemption and the setoff permitted. But,
even if the exemption law permitted a setoff, if the debt creating setoff was dischargeable and if the debtor’s estate were insufficient to pay the creditor’s claim, then the debtor may assert its exempt claim and contend that the otherwise offsetting claim of its creditor had disappeared because of the bankruptcy discharge. Section 524(a)(2) enjoins the collection or offset of any discharged creditor claims “as a personal liability” of the debtor. No doubt this injunction serves a debtor-protective purpose in barring a postbankruptcy assertion of the prebankruptcy setoff against the debtor. Undoubtedly this injunction bars the use of a prebankruptcy and discharged claim of a creditor from offsetting a claim by the debtor which arose after the commencement of the debtor’s bankruptcy case.

However, when the (perhaps rare) debtor’s prebankruptcy claim is exempt, § 524(a)(2) may also bar using the discharged claim as an offset against the debtor’s exempt claim. The fresh start policy of discharge might support freeing a debtor’s exempt claim from her creditor’s setoff. Yet, some would property from the coercive process of law. Bankruptcy courts have generally followed this direction and have not allowed setoff against property otherwise unreachable by creditors under the Code. In re Haffner, 12 B.R. at 372; In re Davies, 27 B.R. at 901; In re Hinson, 65 B.R. at 678; In re Terry, 7 B.R. 880, 883 (Bankr. E.D. Va. 1980); see also In re Monteith, 23 B.R. 149 601, 604, (Bankr. N.D. Ohio 1982), In re Internal Revenue Service Liabilities and Refunds In Chapter 13 Proceedings, 30 B.R. 811, 814 (M.D. Tenn. 1983). Where setoff has been allowed, the courts have recognized a more compelling policy consideration than that of debtor’s rehabilitation. For example, the state was allowed to setoff exempt tax refund monies on behalf of past due child support payments in In re Small, 18 B.R. 318, 319 (Bankr. D.Minn.1982). See also In re Haley, 41 B.R. 44, 46 (Bankr. W.D. Va. 1984) (exemption is inferior to debts arising out of criminal matters).


Debtors in a bankruptcy proceeding may choose the federal bankruptcy exemptions in the small minority of states which have not opted out of these exemptions. When the debtor chooses the federal bankruptcy exemptions, either bankruptcy law, state law, or both, may govern a claim of setoff against such exempt property. Several bankruptcy provisions might protect the exemption: (1) § 524(a)(2) could apply to bar such a setoff; (2) § 522(c) could apply to exempt such property from liability for setoff; (3) § 522(f)(1) could free the exempt property from the setoff right as it directly does for judicial liens if the mutual denomination of setoff and lien as secured claims provided a sufficient analogy. On the other hand, if the state exemption law would not shield the property from setoff, although the state exemption law would otherwise also exempt such property from creditors, a court might construe the cited bankruptcy provisions as inapplicable and permit the setoff. The interaction of the bankruptcy code and state law on what is exemptible and the effect of exemptions has produced great controversy, including two recent generally unhelpful Supreme Court adventures. Farrey v. Sanderfoot, 111 S. Ct. 1825 (1991); Owen v. Owen, 111 S. Ct. 1833 (1991). See generally Kalevitch, supra note 40; Morris, supra note 40.

269 For support of the wider interpretation of § 524(a)(2), one might also look to § 522(f), which avoids certain fresh start impairing liens on exempt property. One might reason that if certain exempt tangible property would be freed from prebankruptcy

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agree with the contention that freeing a debtor’s prebankruptcy claim from a valid setoff claim would provide a debtor with more than a fresh start, the so-called head start. 270


liens, then § 524(a)(2) simply extends that policy to exempt claims by freeing the latter from setoff.

270 One court has taken this thought to permit setoff against an exempt claim. California has protected exemptions provided to insure an income stream during times of need, such as unemployment or disability. However, it does not necessarily follow that California would be so solicitous of an exempt asset constituting an unliquidated contract claim, which could not be relied on to provide a source of income at any time in the foreseeable future. Therefore, we hold that California would recognize the right of setoff against this cause of action under the usual equitable considerations. In reaching this decision we note that in each of the California cases where setoff was not allowed against exempt property there were mutual debts but they did not arise out of the same transaction. It is obvious that the equitable balance is tipped in favor of the creditor’s right to setoff when the debts involved arose out of the same contractual dispute.

Pieri v. Lysenko (In re Pieri), 86 B.R. 208, 212 (Bankr. 9th Cir. 1988).

Some courts have addressed the issue as one of "recoupment". This tends to mute the effect of § 524(a)(2), which enjoins postbankruptcy setoff but perhaps does not enjoin recoupment. Recoupment permits the setoff of claims from the same transaction, unlike setoff, which requires only mutual claims however derived.

The justification for the recoupment doctrine is that where the creditor’s claim against the debtor arises from the same transaction as the debtor’s claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable.

Lee v. Schweiker (In re Lillie Lee), 739 F.2d 870, 875 (3d Cir. 1984). See also In re Sherman, 627 F.2d 594 (6th Cir. 1980); Waldschmidt v. CBS, 14 B.R. 309 (M.D. Tenn. 1981); In re Monongahela Rye Liquors, Inc., 141 F.2d 864 (3d Cir. 1944).

In Lee v. Schweiker, the court barred the Social Security Administration from offsetting a chapter 13 debtor’s liability for prepetition social security payments against debtor’s exempt postpetition claim for social security payments. The recoupment doctrine could not justify the offset the Social Security Administration sought because the postpetition claim of the debtor arose from a statutory entitlement instead of a contract or transaction. 739 F.2d at 875. See, e.g., In re Nevear, 674 F.2d 1201 (7th Cir. 1982); In re Hawley, 23 B.R. 236 (Bankr. E.D. Mich. 1982); Contra In re Maine, 32 B.R. 452 (Bankr. W.D. N.Y. 1983) (permitting state to recoup from postpetition unemployment benefits). Recoupment has been permitted, however, where the prebankruptcy overpayments arose out of the same health-care contract entitling debtors to postbankruptcy benefits. See In re Yonkers Hamilton Sanitarium, Inc., 22 B.R. 427 (Bankr. S.D.N.Y. 1982), aff’d 34 B.R. 385 (S.D.N.Y. 1983); In re Monsour Medical Center, 11 B.R. 1014 (W.D. Pa. 1981); In re Berger, 16 B.R. 236 (Bankr. S.D. Fla. 1981).

Several cases have held that setoff rights against the debtor’s prebankruptcy claim survive discharge.271 These cases rationalize the survival of the setoff right on a putative conflict between the general statement of § 553 that the bankruptcy code does not affect any valid setoff and the injunction against setoff of § 524(a)(2).272 Another and perhaps stronger (presenting no conflict) justification is available: § 524(a)(2) only bars setoff through discharged prebankruptcy claims against a discharged debtor’s claims which arise subsequent to the commencement of the debtor’s bankruptcy case.

The suggested resolution renders § 524(a)(2) inapplicable to the setoff of a debtor’s exempt prebankruptcy claim by a creditor’s prebankruptcy claim regardless of whether the creditor’s claim was discharged. This also accords with the general setoff valuation theory suggested above.273 The rationale for limiting a setoff in bankruptcy to its real value results from the appreciation of a setoff as a claim against the debtor and thereby according the nonbankruptcy setoff right no greater value in bankruptcy than outside bankruptcy. The concern that prompts such an analysis of setoff in bankruptcy is overcompensation of the setoff right. But, as against the debtor’s exempt claim and the creditor holding a setoff right, the real value of the setoff right was, and therefore should remain even after bankruptcy, its face value.

Although this resolution surely provides a debtor with less of a postbankruptcy start than a wider reading of § 524(a)(2), so also does the survival after bankruptcy of many liens on exempt property.274 But the reason why the Court held that liens on exempt property survive bankruptcy also applies to setoff rights. At first blush this ancient bankruptcy proposition275 sounds nonsensical. For, if property is exempt it seems to mean that creditors may not subject the property to a lien.

An exemption may render all liens on exemptible property invalid but such a wide-ranging blanket exemption is extremely rare. The common meaning of the exemption of property consists in the inability of judgment creditors to attach or levy on such property. Yet, a debtor may often subject property voluntarily to a lien. Thus, homesteads are often exempt from judgment creditors but are not exempt from purchase money mortgagees or mechanics lienors.


273See supra Parts II & III.


275Section 522(c) codifies this ancient proposition.
It would only be proper, therefore, to bar setoff against a prebankruptcy exempt claim when the exemption law barred the setoff.\textsuperscript{276} That would mean, of course, that when state law provides the exemption law in bankruptcy, which is usually the case, there never had been any right to setoff against the debtor’s exempt claim even before the bankruptcy. Broadly interpreting § 524(a)(2) to bar what would have been a valid setoff despite the exempt status of a debtor’s claim enlarges the debtor’s exemption.

When the debtor chooses the federal bankruptcy exemptions\textsuperscript{277} in the states where that option remains, one might read § 524(a)(2) as part and parcel of the § 522(d) exempt claim and understand the meaning of the exemption as free from any setoff rights. This would produce the rare blanket exemption mentioned above. In this view, whatever the law had been prior to bankruptcy, § 522(d) would create a blanket exemption extinguishing any pre-existing liens on the exempted property as well as any pre-existing setoff rights against an exempt claim. If this were true, § 522(f) would become even odder than it seemed to be in recent troublesome cases thereunder.\textsuperscript{278} If § 522(d) exemptions were so broad, the limited right a debtor would receive to avoid certain liens on such property would be superfluous.

Instead, these federal bankruptcy exemptions have been understood as the typically limited form of exemption. By exempting property within § 522(d) from the bankruptcy estate, the property is freed from the claims of a debtor’s unsecured creditors, just as under such normal exemption law the property would have been so free prior to bankruptcy had such exemptions then been in effect. Thus, judgment liens obtained by the debtor’s creditors prior to bankruptcy may be avoided under § 522(f)(1).

Yet, as to consensual liens, which setoffs resemble, only nonpossessory, nonpurchase money liens on certain goods may be avoided under § 522(f)(2). When congress so restricts that list, the message of § 524(a)(2) goes no further than to state that it protects a debtor’s claims arising postbankruptcy from a setoff based on a prebankruptcy discharged claim.

2. The Imaginary Conflict between § 553 and Chapter 11 Plan Confirmation Rules

Survival of preconfirmation rights may depend on these rights having become property of the estate.\textsuperscript{279} Additionally, survival of prebankruptcy

\textsuperscript{276} A number of cases have so held on the basis of state exemption law barring a setoff. \textit{Contra} Daugherty v. Central Trust Co., 504 N.E.2d 1100 (Ohio 1986).

\textsuperscript{277}§ 552(d).

\textsuperscript{278} The interaction of the bankruptcy code and state law on what is exemptible and the effect of exemptions has produced great controversy, including recent Supreme Court misadventures. Farrey v. Sanderfoot, 111 S. Ct. 1825 (1991); Owen v. Owen, 111 S. Ct. 1833 (1991). See generally Kalevitch, \textit{supra} note 40; Morris, \textit{supra} note 40.

\textsuperscript{279} The bankruptcy estate succeeds to all the legal and equitable rights that the prebankruptcy debtor held. In corporate reorganizations, the postbankruptcy debtor takes all the prebankruptcy debtor’s rights because the successorship is simply
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rights may depend on their not having been terminated during the preconfirmation period. For example, the ownership interest of a preconfirmation debtor in an asset of the estate may have been used to provide needed cash to keep the enterprise functioning. A sale or securing of a loan may have terminated the prebankruptcy or preconfirmation rights the debtor had. Third, the plan confirmation may terminate all or some prebankruptcy rights the debtor had. For chapter 11, the rules on plan confirmation and its effect appear to be the most likely code source of law on the general issue.

_derivative with regard to assets. The individual (or oxygen-breather) in bankruptcy presents a more complicated successorship issue due to exemptions or immunities that maybe enjoyed pursuant to bankruptcy or nonbankruptcy law. § 522. Individuals are, of course, eligible to file a case under chapter 11. Tioibb v. Radloff, 111 S. Ct. 2197 (1991). Although exemptions become part of the bankruptcy estate, as may immunities (see Lawrence Kalevitch, Some Thoughts on Entireties in Bankruptcy, 60 AM. BANKR. L.J. 141 (1986)), they are set aside from the rights of the estate by § 522. In chapter 11, an individual debtor retains these exemptions even if a trustee is appointed because the exemption rights do not come under the rights of the trustee. §§ 103(a), 522, 541, 1106. See also In re Fitzsimmons, 725 F.2d 1208 (9th Cir. 1984)(applying the earnings exception of § 541(a)(6) to an individual chapter 11 case).

280 §§ 363, 364.

281 § 1129.

282 Under the code, confirmation of a plan binds the debtor. § 1141(a). Section 1141(a) provides as follows:

Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.


Interestingly, the preconfirmation rights of creditors are addressed in § 1141, but only § 1141(a) could affect a debtor’s preconfirmation rights. The remaining subsections address the survival of debtor’s duties, the issue of debt discharge or the loss of prebankruptcy rights.

If the postconfirmation debtor is a party so bound, (perhaps more precisely, the postconfirmation debtor owes its existence to confirmation of the plan) whether the prebankruptcy or the preconfirmation debtor is also bound to the plan is obscure in the text. The same is true of the prebankruptcy debtor. Assuming that these three labels (prebankruptcy debtor, preconfirmation debtor, and postconfirmation debtor) reflect meaningfully on three different entities, they may affect the question of who owns whatever prebankruptcy rights surviving commencement of the case or confirmation of a plan, as well as dismissal or conversion of a case before or after confirmation. Because this study concerns the debtor’s surviving rights only as an analogy to the primary question of survival of secured or setoff creditor’s rights, this article does not address the above questions. Instead, for the instant purposes, it is important to note how, if at all, debtor’s prebankruptcy rights which do pass to the preconfirmation debtor survive confirmation. For simplification, the text assumes that § 1141(a) speaks to the postconfirmation debtor.
Since no other code text seems to speak to the effect of confirmation on a debtor’s preconfirmation rights, what the code intends to say emerges in § 1141(a). And § 1141(a) merely "binds" the debtor to "the provisions of a confirmed plan". Thus, the confirmed plan determines whether and which preconfirmation rights the debtor retains. A recent recurring issue is whether a rule of law governs survival of preconfirmation debtor rights, as though this were a distinctly rule-governed issue, or, whether this is simply a matter of interpretation of the plan on which a court may exercise its interpretive discretion and any rule is simply an interpretive aid. The decisions reveal differing views but one has very direct implication to the survival of prebankruptcy rights held by a setoff holder.

DeLaurentiis held that a preconfirmation setoff right offset a confirmation-surviving claim of the postconfirmation debtor against the creditor. The court took the view that the code setoff section conflicted with § 1141. It thought that § 1141 permitted the plan to retain the pre-bankruptcy right of the debtor "free and clear" of any prepetition debt. Further, it thought that the code lacked a priority rule as between the latter and a

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283 The question of what court may interpret the code or plan is itself complicated. Bankruptcy courts may have jurisdiction but this proposition is not clear. State courts frequently determine these issues.


285 Id. at 1274.

286 Id. The court may have misconstrued the legal effect of the most difficult passage in the text of § 1141(c), which is a monument to either meta-precise drafting or obscurity. § 1141(c) provides, in pertinent part:

Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.


The court cited § 1141(c) and it is only that subsection that uses the expression "free and clear." 963 F.2d at 1274. But, what is free and clear is "the property dealt with by the plan..." Id. What is property for this purpose is hopelessly vague as is what is dealt with by the plan. The court reasonably supposed that because the claim against the offset-claiming creditor was included in the plan (the case does not reveal whether the claim was specifically identified or included by boilerplate), it was "property dealt with by the plan." Id. The claim is property in the abstract, as are all rights in this context. But, is the claim property with which the plan dealt deserving of passing free and clear to the postconfirmation debtor simply because it was "dealt with?" Surely, a plan may deal with property by fairly disclosing that confirmation will terminate another’s interests as, for example, where a plan expressly subordinates the interest of another in particular property. But the plan in question seems merely to have granted the debtor the right to continue to prosecute its claim against the creditor claiming offset, litigation which was pending prior to confirmation. Id. As a result, the creditor made no objection to confirmation, arguably under the erroneous view that this plan or any plan could not moot its offset claim. Id. A majority of courts have held that a debtor loses any claim the

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creditor’s setoff right under § 553. Given the conflict it supposed, the court ruled in favor of the setoff section, relying on seemingly persuasive precode reorganization case law favoring holders of setoff rights in conflict with the previous provisions of the Bankruptcy Act concerning confirmation.

The code does not present the conflict the court imagined. The code straightforwardly resolves the issue as one of confirmability of the reorganization plan under § 1129. The court unfortunately created a needless rule of law, that setoff rights under § 553 survive confirmation under the rules of § 1141. Section 1141(c) speaks to whether "property dealt with by the plan" plan does not preserve and a few cases have applied this rule against creditors. Id. at 1276.

The rule is cruel when applied against creditors who are unlikely to know or to find counsel who know how unconscionable this rule would be when applied against creditors. Creditors may not be presumed to enjoy counsel or the opportunity to enjoy counsel who do appreciate these chapter 11 exotica. Attorneys familiar enough with this argument about the effect of confirmation are rare and, if they do represent creditors at all, they are likely to have conflicts barring representation. Indeed, bankruptcy literature lacks discussion of such finery. The reorganization bar propounds the gross view, properly rejected in DeLaurentis, that everything is free and clear from the debtor's viewpoint.

287 Id.


289 The court cited two postcode cases for this precode proposition and one precode decision of the Court of Claims. Record Club of Am. v. United Artists Records, Inc., 80 B.R. 271 (Bankr. S.D.N.Y. 1987); In re Reading Co., 72 B.R. 293 (Bankr. E.D. Pa. 1987); Marley v. United States, 381 F.2d 738 (Ct. Cl. 1967). DeLaurentis acknowledged that a precode Supreme Court decision in a railroad reorganization denied setoff, but dismissed that ruling as limited to extraordinary bankruptcy proceedings. In short, the precode law or practice is, as on all issues, almost certainly as cloudy as the code text. This cloudiness was a reason for the bankruptcy reform which has been notably unsuccessful. Leaving the proper resolution of an obscure text behind the obscure resolution of an even more obscure and repealed text is an interesting heuristic. Hopefully, what courts seek to accomplish by studying history is the same goal sought by historians to understand the present. Why the code should be taken to prefer the postconfirmation claim over another claim requires an understanding of the principles backing each claim. Old law helps understand the strength of the principles as they are, and if they are, absorbed into the present law and procedure.

290 Arguably, there is some good sense in the proposition that security interests survive bankruptcy. Thus, it should be noted that this rule would strongly support such a proposition inasmuch as setoffs under the code are treated as secured claims. § 506(a).

But whether security interests or setoffs qua secured claims survive bankruptcy is a deceptive question. The bankruptcy debtor or trustee must often deal with the intra-code conceptualized secured claim. The purpose of § 506(a) is to rule on what the secured claim is, and is merely a definitional rule which is narrower than what may be considered a security interest, a setoff right or any lien outside of bankruptcy. The purpose of § 506(a) valuation is to set a figure for either adequate protection or bankruptcy payment of the secured claim. The secured claim may be protected or paid in bankruptcy in the lesser of the amount of the debt secured and the value of the collateral. E.g., §§ 1129(b)(2)(A)(i)(II), 1225(a)(5)(ii), 1325(a)(5)(ii); Cf. Dewsnup v. Timm,
is affected by preconfirmation claims and interests. That mysterious expression may be inapplicable when the plan provides otherwise. The plan may only give postconfirmation rights to others under the exception to § 1141(c); it may not terminate the rights or interests of others in plan property within the grammar of § 1141(c). The code uses the confirmation standards to resolve

112 S. Ct. 773 (1992) (rejecting cram- or strip-down in chapter 7 because no issues of adequate protection or payment were presented—debtor simply sought to reduce the lien obligation after bankruptcy).

But, from the fact that bankruptcy merely requires such a payment, it need not, and logically does not mean that payment of the bankruptcy figure determined by § 506(a) forever precludes the lien. Perhaps more importantly, the bankruptcy failure to pay that figure raises the question of whether such a default, most clearly seen in a bankruptcy plan default, leaves the prebankruptcy lien rights (including those of a security interest or setoff) unaffected by bankruptcy. The same may be true of chapter 7 unless Dewsnup stems the tide there.

Suppose the trustee determines, and the court permits, a buy-out of the secured creditor's interest in property in which the estate has an interest. Unless agreed upon by the creditor and trustee, the court must value the property under § 506(a) to determine the cash-out figure. Assume a low figure is judicially determined, but fortunately for the secured creditor, the trustee is unable to effect the purchase because of a dry market or, for other reasons, the liquidation case is dismissed. If the secured creditor is granted relief from stay to foreclose, or forecloses upon dismissal, and the foreclosure sale exceeds the bankruptcy valuation, who receives the surplus, assuming that the debt exceeds the proceeds? To say that the debtor or unsecured creditors take the excess rather than the secured creditor is odd, but required, if one believes the intra-bankruptcy determination of the senior creditor's secured claim per § 506(a) is "res judicata" after bankruptcy. See infra text accompanying note 306. Were one to believe otherwise, then one begins to see some wisdom in the idea that liens may survive bankruptcy, just as more clearly "secured claims" only exist in bankruptcy and thus do not survive.

§ 1141(c).

No doubt a plan may terminate some preconfirmation or prebankruptcy rights by application of other provisions of § 1141, but not § 1141(c). The latter takes away the preconfirmation rights in "property dealt with by the plan" from creditors, partners and equity holders. To be an exception to this effect of confirmation, a right in property dealt with by the plan must be acknowledged or created by the plan. Thus, § 1141(c) cannot be read to provide the debtor with any power to terminate a right in property dealt with by the plan. It gives a debtor (or any plan proponent) only the power to continue any preexisting right in property of the debtor.

As the following text explains, the question of the survival of a creditor's setoff right should have been determined in the confirmation process, prior to confirmation. For the question put as a § 1141 issue is pure parody whether setoff claims concededly discharged under § 1141(d)(1) at confirmation, may, nevertheless survive, for the purpose of setoff of a postconfirmation claim of the debtor. No creditor could seriously contest the absoluteness of a discharge of its setoff right if the plan offered it fair treatment; nor would confirmation be barred if the plan provided what, by the confirmation standards (§ 1129), is appropriate for such a creditor. The debtor in DeLaurentiis did neither. Unfortunately, the recent reports are full of debtors so behaving after confirmation.

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the question: When a debtor proposes in its plan to retain the rights against a creditor holding a setoff right, without also retaining the setoff right, does the plan merit confirmation? Asking the question after confirmation creates an issue the confirmation "effect" section ought not answer, as it ought already to have been answered at the confirmation hearing.

Whether a plan proposes to affect a setoff right is the threshold issue. Confirmation of a plan discharges preconfirmation claims of creditors not created or recognized in a plan other than plans of individuals and certain liquidating plans. A plan may lack clarity about whether preconfirmation claims such as setoffs continue. More commonly in light of reported disputes, plans have not clearly provided for the preservation of debtors' preconfirmation claims. The courts have sensibly ruled that after confirmation a debtor has no surviving claim unless their creditors qua debtors should have reasonably known from the disclosure statement, the plan or otherwise that the plan did not resolve both the creditor's and the debtor's claims. The same rationale applies in DeLaurentiis which sketches a perhaps common and mischievous scheme. The debtor was vigorously contesting the prebankruptcy validity of the creditor's claim creating the

293§ 1129. The question would have been whether the plan treated NBC's setoff claim, and if so, whether in terminating that claim, as the debtor later claimed, the creditor had been treated properly under § 1129.

294I mean this in the strongest sense. The code here says "any debt" and relates debt, as other sections do, to claims. §§ 101(5), 101(12), 1141(d)(1)(A)(i)-(iii).

295Under the view that the postconfirmation debtor is a new legal entity, it may be more proper to view all obligations of that entity as created by the plan.

296This is put very technically because the debtor does not have the exclusive right to propose a plan under chapter 11. Any party in interest (§ 1121(c)) may propose a plan (Id.) after the first 120 days (§ 1121(b)), after the order for relief, unless the court increases or reduces the period. § 1121(d). The confirmation of a plan discharges creditors' claims regardless of who proposed the plan (§ 1141(d)), unless the debtor is an individual (§ 1141(d)(2)) or the plan liquidates, inter alia. § 1141(d)(3).

297Exceptions to discharge stated in § 523 survive an individual debtor's (§ 101(43)) confirmation in chapter 11. § 1141(d)(2).

298§ 1141(d)(3).

299§ 1125.

300See infra note 309.

301Supra note 284.

302See infra note 308.

303An adversary proceeding was entertaining the debtor's objection to the creditor's setoff claim at the time of confirmation. DeLaurentiis, 963 F.2d 1269 (9th Cir. 1992).

304The claim asserted by the creditor, NBC, involved a debt owed to NBC for advertising, which had arisen from the debtor's advertising agency's contract with NBC. The debtor preferred NBC's collecting the debt from the agency, which would presumably receive a bankruptcy minibuck distribution on the claim, rather than NBC's
setoff issue. The debtor contemporaneously proposed a plan it evidently supposed would terminate the setoff right.\textsuperscript{305} The creditor, the National Broadcasting Company, perhaps no easy victim, might have sought clarification prior to confirmation about the survival of its setoff rights under the plan. But, it is also the duty to disclose what creditors like NBC need to know to make an informed decision about the plan.\textsuperscript{306} If the plan is ambiguous or vague, and this and many plans may be strategically quiet about what they take away from others, creditors may fail to raise the survival issue. In light of the code's burdening a plan proponent with disclosure, NBC should receive protection from this perhaps duplicitous debtor who engaged in litigating the validity of the creditor's claim while contemporaneously proposing a plan which it construed to terminate the setoff right even if it were valid. Had the plan stated the setoff's termination, the debtor would have properly borne its duty to disclose, and if NBC had not objected to confirmation, then no later misunderstandings would merit respect.

3. The Imaginary Need for Res Judicata under the Code Text

Another rationale of the cases uses the principle of res judicata to determine whether a debtor's claim survives confirmation where the claim arose,\textsuperscript{307} if at effectively collecting 100\% on the claim by offsetting the claim against a claim debtor held against NBC. The adversary proceeding arose out of the debtor's objection to NBC's advertising charge on the grounds that the debtor was neither liable for the agency-NBC contract nor, as NBC sensibly claimed, in quantum meruit. The court that ruled that the debtor was liable only in quantum meruit as though the law of principal and agent were inapplicable to the contract issue. That ruling came after confirmation. The sequence of determining confirmation, and then the validity of claims or interests, creates the mistaken idea that § 1141 is controlling. Arguably, § 1141(a) should have a bold exclusion of confirmation effect on all disputed claims or interests on which the court has not yet ruled. But, properly understood, that section already says that, since the plan or the order of confirmation operates to exclude pending disputes.

\textsuperscript{305}§ 1141(d)(1).
\textsuperscript{306}§ 1125(a)-(b).
\textsuperscript{307}Howe v. Vaughan (In re Howe), 913 F.2d 1138 (5th Cir. 1990). These cases do not explore the wonders of the phrase found by Judge Merighe and others on the issue of whether a claim exists under the code even though there is no nonbankruptcy cause of action yet in existence. E.g., Grady v. Robins (In re A.H. Robins Co.), 63 B.R. 986 (E.D. Va. 1986). Although the Supreme Court has ruled that claims under the code have the broadest possible meaning, it is not easy to understand how future claims fit the code definition. Pennsylvania Dep't of Welfare v. Davenport, 495 U.S. 552 (1990). In Robins and other products liability reorganizations, the plans purported to deal with claims of future manifested victims. Whether the rights of these parties have been adjudicated by the confirmation of plans is a separate question from whether in order to make a successful reorganization these anticipated claims may be dealt with. A future claim in a reorganization may be dealt with by providing for a future claim regardless of whether that claim is dischargeable. To suppose that the effect of confirmation on a future claim is discharge follows only from a willful misreading § 1141. Debts and claims only are discharged in § 1141(d)(1). Future victims lack either debts owed by the debtor or claims themselves. That is why the phrase future claim comes so easily. If future claims are
all, prior to bankruptcy. For the most part the cases take the view that, unless carefully retained in the plan, which would provide fair notice as suggested above, the confirmation of the plan terminates the claim. The sensible theory is that these postconfirmation defendants reasonably understood that the confirmation of the plan resolved the parties' prebankruptcy obligations to the debtor. However, the confirmation effect section, § 1141, says drearily little on this subject which may explain why the courts avoid resting the decisions there. What may prove worse, however, would be the courts' deciding that the res judicata principle discharges the debtor's claim upon confirmation, as though the obscurity of § 1141 signals a need for the judge-made principle of res judicata.

Notwithstanding the very difference between the prebankruptcy debtor and the postconfirmation debtor which bankruptcy accomplishes, the courts are saying these are the same parties, same issues etc., and they fall within the res judicata principle. Clearly, reorganization aims to settle the past and go on free from whatever past may be overthrown. So, the res judicata principle may befit these cases about whipsawing debtors who don't disclose an intent to chase a putative prebankruptcy obligor. Surely, res judicata may catch the point of § 1141(a), whatever that is. Yet either res judicata or § 1141(a) may have the unfortunate effect of adjudicating claims of either debtor or creditors to which a plan does not expressly speak. At least, however, § 1141(a) offers the opportunity to ask whether the "provisions" of a chapter 11 plan affect prebankruptcy rights. If either the plan or the confirmation order of the court per se was res judicata of all the parties intersese rights, § 1141(a) may have no reason to address the narrower subject of "provisions of a plan." Nor would it be necessary for a limited settling of past relationships for a plan to list every claim deriving from the preconfirmation setting as to which a plan proposes no change. But that would be necessary under loose versions of res judicata in which judges unfamiliar with bankruptcy might suppose an end to everything outside of a confirmed plan, which no doubt appeals to debtors and creditors satisfied by a plan.

discharged by the cited section, it would follow that any future debt or claim, with any link to preconfirmation behavior of the debtor, would be discharged under (d)(1).

On the other hand, the lack of discharge of such future claims is no more a bar to creating a successful reorganization in chapter 11 than it is outside of bankruptcy. Reserves must somehow be plotted to pay for future claims. As § 1123 illustrates, a chapter 11 plan may contain almost whatever is wanted. The confirmation standards are also not divorced from recognition of future claims. These standards invariably provide tests for whether a class is deemed to accept a plan and for whether impaired but non-accepting classes may involuntarily be bound to the plan. But neither the fair and equitable standard (§ 1129(b)) for cramdown, nor the liquidation value for the best interests standard (§ 1129(a)(7)(ii)), needs to be read as though the value of the enterprise must be determined without regard to future claims.

308 Compare In re Jartran, 886 F.2d 859 (7th Cir. 1989); In re Benjamin Coal Co., 978 F.2d 823 (3d Cir. 1992)(denying administrative priority status in converted chapter 7 case to former chapter 11 administrative claim where postconfirmation conversion under § 1141(d)(1)) with In re White Farm Equip. Co., 943 F.2d 752 (7th Cir. 1991), cert. denied,
The correct analysis of whether a debtor’s claim from the prebankruptcy past survives confirmation comes from the more limited source of the bankruptcy text in § 1141(a) under which the obscurity of both "provisions" and "binds" must be faced. Yet the emergent res judicata analysis might affect a claim of setoff like that in DeLaurentiis. In the leading case, Judge Kaufman correctly denied the confirmed debtor the opportunity to pursue a lending liability claim resting wholly on prebankruptcy facts. As the judge pointed out, "the timely bringing of such a claim may have affected the parameters of a bankruptcy repayment schedule." That this reasoning supports the suggested debtor’s burden of going forward on such matters prior to confirmation, however, results in suggesting, again on res judicata principles, that creditors with interests in property of the debtor might also qua claimant have to go forward. In the latter view, the setoff holder may not safely ride outside the reorganization proceeding.

Nevertheless, the core of good sense in the proposition that liens survive bankruptcy should apply as well to the setoff right. At least the lien or setoff right should survive a bankruptcy in a manner narrower than the possible res judicata constructions. Where a setoff right is not addressed or addressed impermissibly, no debtor should have any greater claim against a setoff claimant.

112 S. Ct. 1292 (1992)(IRS priority trust fund tax claim in second chapter 11); compare Bank of Louisiana v. Pavlovich (In re Pavlovich), 952 F.2d 114 (5th Cir. 1992)(concluding that preconfirmation grounds for debt nondischargeability are discharged by chapter 11 confirmation and inapplicable in converted chapter 7) with Spring Valley Farms, Inc. v. Crow (In re Spring Valley Farms, Inc.), 863 F.2d 832 (11th Cir. 1989)(standing for the proposition that § 1141 does not discharge a claim of creditor lacking knowledge of claim's bar date, although creditor had general knowledge of bankruptcy proceedings).

Cf. § 348(d).

309Sure-Snap Corp. v. State Street Bank & Trust Co. (In re Sure-Snap Corp.), 948 F.2d 869 (2d Cir. 1991). See also Bank of Lafayette v. Baudoin (In re Baudoin), 1993 WL 1871 (5th Cir. 1993); Eubanks v. FDIC, 970 F.2d 1389 (5th Cir. 1992); In re Brady Municipal Gas Corp., 936 F.2d 212 (5th Cir.), cert. denied, 112 S. Ct. 657 (1991); In re Howe, 913 F.2d 1138 (5th Cir. 1990); Hendrick v. Avent, 891 F.2d 583 (5th Cir.), cert. denied, 111 S. Ct. 64 (1990); Southmark Properties v. Charles House Corp., 742 F.2d 862 (5th Cir. 1984); Cf. Latham v. Wells Fargo Bank, N.A., 896 F.2d 979 (5th Cir. 1990); In re Colley, 814 F.2d 1008, 1009 (5th Cir.), cert. denied, 484 U.S. 898 (1987)(stating that "[o]ld bankruptcy cases, like old soldiers, never die").

310Sure-Snap Corp., 948 F.2d at 870.

311A plan or an order confirming a plan might provide general language terminating all interests in property of the estate not provided for in the plan. Such language cannot affect parties beyond the limits of due process or bankruptcy procedure. Bankruptcy court jurisdiction permits the bankruptcy court to disallow claims or invalidate liens. 28 U.S.C. § 157(b)(2)(B) (K). However, if terminative language in a plan or order has the effect of terminating setoff or lien rights, then the established procedures providing normal litigational notice and an opportunity to be heard under the Bankruptcy Rules (e.g., 7001) will not have been provided such parties.

The fifth circuit recently purported to untangle its own conflicting res judicata analyses of postconfirmation issues by rejecting res judicata when chapter 13 debtors did not object to a secured claim. Sun Finance Co. v. Howard (In re Howard), 972 F.2d 639 (5th Cir. 1992). The debtors listed the secured claim as disputed because they claimed

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holder than it had prior to confirmation. In such a case no provision of a plan should bind a setoff holder to a legal relation different than had previously existed. \textsuperscript{312} Nor should such a plan have "dealt with property" subject to a setoff right or lien such that it might be "free and clear" of preconfirmation claims. \textsuperscript{313}

Surely much remains to be discovered about the effects of confirmation of chapter 11 and the analogous stages of other bankruptcy proceedings. The remarkable tale of lien survival after bankruptcy lacks a conclusion. We are also ignorant of whether or how setoffs will fare in this or their own tale. Nevertheless, setoff holders must defend their rights and beware chapter 11 plans which ignore setoffs. Courts should not follow the imaginary conflict \textit{DeLaurentiis} supposed in order to protect setoff claims. Nor should courts indulge creditors with setoff claims who reasonably should have known a chapter 11 plan proposed to cancel such claims. Nevertheless, debtors should not expect more from what their plans propose than what they say. The provisions of a chapter 11 plan bind debtor and creditors and not any silence which might stir frivolous pleas of res judicata.

\textbf{VII. CONCLUSION}

The right question about setoff under the code is what priority and not why priority for the setoff. Setoffs are eligible for priority so long as the setoff right has a value greater than zero. When a debtor is insolvent the value of a setoff right may be closer to zero than the face amount. Courts do not merely have the discretion to value the setoff. The code mandates valuation of the setoff in bankruptcy. Though here as elsewhere valuation is difficult and problematical, that is required. Though here the effect of that valuation is difficult and problematical, such questions bear on the setoff in bankruptcy.

\begin{footnotesize}
\begin{itemize}
\item an action against secured claimant for unfair and deceptive trade practices as an asset. Their plan provided for compromise of the parties' mutual claims by payment on the secured claim of less than 10\%. The court granted that § 1327(a) "[g]ives a Chapter 13 reorganization plan sweeping binding effect on all creditors . . . whether or not the claim [sic] of such creditor has objected to, has accepted, or has rejected the plan." 972 F.2d at 640. Yet that section of the code "[c]annot be read in isolation." \textit{Id.} Because the debtors had never objected to the proof of claim the secured claimant had filed, the plan could not reduce the claim. So the \textit{Howard} court interpreted \textit{In re Simmons}, 765 F.2d 547 (5th Cir. 1985).

The circuit had also decided that although the bankruptcy court lacked the authority to release a guaranty of a third party to creditors, confirmation of a chapter 13 plan so providing was res judicata. Republic Supply Co. v. Shof, 815 F.2d 1046 (5th Cir. 1987). Squaring \textit{Simmons} and \textit{Shof}, the \textit{Howard} panel held that "[S]hoaf stands for the proposition that a confirmed chapter 13 plan is res judicata as to all parties who participate in the confirmation process." 972 F.2d at 641. \textit{Cf. In re Szostek}, 886 F.2d 1405 (3d Cir. 1989). Parties who receive no objection to their claim, nor participate in the confirmation process, fall outside the res judicata effect of confirmation under \textit{Simmons}.

312\$ 1141(a).

313\$ 1141(c).
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Valuing setoffs in bankruptcy fits the general treatment of liens in bankruptcy as well as other well-positioned prebankruptcy creditors. As well, valuing setoffs in bankruptcy leaves the setoffs proscribed completely by § 553(a) and (b) intact. Valuing setoffs in bankruptcy corrects the conventional perpetuation of face valuation of setoff as a policy in favor of reorganization which is sufficiently accomplished by present bankruptcy law.

Finally, the treatment of setoff in and after bankruptcy has created controversy including imaginary rules precluding debtors in bankruptcy from asserting setoff; conflicts between the setoff provision and the plan confirmation or the confirmation effect provisions; and conflict between the latter and the rule of res judicata. To these controversies, and others, a better theory of setoff in bankruptcy based on valuation of setoffs may bring needed relief.