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I. INTRODUCTION

In *Ashland Petroleum Co. v. Appel* (*In re* B&L Oil Co.),[1] the United States Court of Appeals for the Tenth Circuit held that a creditor had properly "recouped" prepetition overpayments made to a debtor by withholding money for purchases made after the debtor filed a petition in bankruptcy.[2] This case is one in a series[3] that has allowed a creditor to improve its status through judicial application of the recoupment doctrine. Recoupment is a very limited exception to the general rule that all unsecured creditors of a bankrupt debtor stand on equal footing for satisfaction.[4]

This Note will examine the court's rationale in *Ashland* and will demonstrate that the court improperly applied the recoupment doctrine. The court's reliance on bankruptcy cases in which recoupment was allowed is too tenuous to grant preferential treatment to an unsecured creditor, and the court's equitable concerns are unfounded.

II. STATEMENT OF THE CASE

B&L Oil Company (B&L) and Ashland Petroleum Company (Ashland) entered into an oil division contract[5] that gave Ashland the right to pur-

1. 782 F.2d 155 (10th Cir. 1986). B&L Oil Co. is the debtor, and Garry Appel is the trustee for the debtor.

2. *Id.* at 156-57.

3. *See, e.g.*, American Central Airlines, Inc., v. Dept. of Transportation (*In re* American Central Airlines, Inc.), 60 B.R. 587 (Bankr. N.D. Iowa 1986); Rakozy v. Reiman Construction (*In re* Clowards, Inc.), 42 B.R. 627 (Bankr. D. Idaho 1984); United States v. Midwest Service and Supply Co., Inc. (*In re* Midwest Service and Supply Co., Inc.), 44 B.R. 262 (Bankr. D.C. Utah 1983); Sapir v. Blue Cross/Blue Shield of Greater New York (*In re* Yonkers Hamilton Sanitarium, Inc.), 34 B.R. 385 (Bankr. S.D. N.Y. 1983); Waldschmidt v. CBS, Inc., 14 B.R. 309 (M.D. Tenn. 1981).

4. *E.g.*, Joint Industry Board of the Electrical Industry v. United States, 391 U.S. 224, 228 (1968); 4 Collier on Bankruptcy, § 547.03 (15th ed. 1986).

5. A division order is a contract of sale to the purchaser of oil or gas. 8 WILLIAMS & MEYERS, OIL AND GAS LAW 233 (1984). The order directs the purchaser to make payment for the value of the products taken in proportions set out in the division order. *Id.*

> Even though the lessee by the terms of the lease has authority to dispose of any products produced, the purchaser usually requests the operator to furnish complete abstracts of title which the purchaser causes to be examined, after which a division order is prepared by the purchaser on the basis of the ownership shown in the title opinion prepared after examination of the abstracts. The purchaser usually requires that the division order be executed by the operator, the royalty owners and other

chase unspecified amounts of crude oil produced by B&L.[6] During August 1982, Ashland overpaid B&L on two occasions.[7] In September 1982, B&L filed a petition under Chapter 11.[8] Ashland then withheld payments for subsequent deliveries in order to recover its overpayments.[9]

Ashland brought an action in the bankruptcy court asking for a declaration both that it had properly "recouped" its overpayment and that it could recoup the remaining balance from future purchases.[10] The bankruptcy court held that recoupment was improper because the debts did not arise from the same transaction,[11] and the United States District Court for the District of Colorado affirmed.[12] The United States Court of Appeals for the Tenth Circuit reversed, holding that the recoupment doctrine applied.[13]

III. BACKGROUND OF THE RECOUPMENT CONCEPT

A. Distinctions Between Setoff and Recoupment

Setoff and recoupment are limited exceptions to the general bankruptcy rule of equal distribution of the debtor's assets among creditors.[14] This section will distinguish these doctrines from one another. Both are often invoked by unsecured creditors for the purpose of receiving preferential treatment[15] over other unsecured creditors in a bankruptcy. If the statutory doctrine of setoff[16] is not applicable,[17] a court may apply the judicially created doctrine of recoupment[18] to reach essentially the same result.[19]

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persons having an interest in the production. When the division order is executed and returned to the purchaser, payment is commenced for the products removed. The division order is typically terminable at the will of either party.

6. *Ashland*, 782 F.2d at 156. The oil division order gave Ashland the right to buy "all or any part" of the oil produced by B&L until B&L terminated the order by giving thirty days notice. *Id.*

7. *Id.* On August 2, 1982 and August 16, 1982, Ashland overpaid B&L for oil produced and delivered in June of 1982 by $90,721.30. *Id.*

8. *Id.* 11 U.S.C. § 301 (1978).

9. *Ashland*, 782 F.2d at 156. Ashland withheld $81,569.05 from payments owed to B&L.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* at 159.

14. *See supra* note 4.

15. The Bankruptcy Code generally prohibits preferential treatment if it involves a "preference." 11 U.S.C. § 547(b) (1978). A preference is a prepetition transfer that allows a creditor to receive more than he would get in liquidation. *Id.* The elements of a preference as set out in § 547(b) are: 1) a transfer of the debtor's property 2) to a creditor 3) for an antecedent debt 4) made within 90 days of the petition 5) while the debtor is insolvent 6) which depletes the estate. *Id.* The debtor is presumed insolvent on and during the 90 days immediately preceding the date of the filing of the petition. 11 U.S.C. § 547(f) (1978).

16. 11 U.S.C. § 553 (1978).

17. Creditors will first attempt to use setoff because courts are more willing to apply a doctrine when the requirements are set out statutorily. If a creditor cannot meet the requirements of setoff, he will resort to the recoupment doctrine.

18. Waldschmidt v. CBS, Inc., 14 B.R. 309 (Bankr. M.D. Tenn. 1981); *see In re* Monongahela Rye Liquors, Inc., 141 F.2d 864 (3d Cir. 1944).

19. The result is that the creditor will receive a preference. *See supra* note 12.

Each doctrine, however, has specific requirements that must be met before the court will allow their use by a creditor. The doctrine of setoff developed in a nonbankruptcy context as a practical tool to eliminate unnecessary litigation between parties holding mutual debts.[20] In a broad sense, setoff is the discharge or reduction of one demand by an opposite one, or a right one party has to use his claim in full or partial satisfaction of what he owes.[21] Setoff is based on the principle that justice and equity require that the demands of parties mutually indebted be set off against each other, and only the balance recovered.[22] According to the Third Circuit, "[t]he historical antecedents of setoff rights are long and venerable and are based on the common sense notion that 'a man should not be compelled to pay one moment what he will be entitled to recover back the next.' "[23]

Setoff in bankruptcy is rooted in equity.[24] A creditor's right of setoff in bankruptcy is explicitly set forth in Section 553(a) of the Bankruptcy Code.[25] The three elements necessary to establish a creditor's setoff rights are:

1) a debt[26] owing by the creditor to the debtor which arose before commencement of the case;[27]

2) a claim of the creditor against the debtor which also arose before commencement of the case;[28] and

3) the debt and claim must be mutual obligations.[29]

Elements one and two restrict a creditor's right to set off a debt against an amount owed to the debtor, and apply to situations where both the debt and the claim arose prior to the bankruptcy filing.[30] The third element, mutuality of obligation, requires that the creditor is indebted to the debtor

20. Thus, the Supreme Court has stated that 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).

21. 20 AM. JUR. 2D *Counterclaim, Recoupment and Setoff* § 2 (1965).

22. *Id.* at § 7.

23. United States v. Norton, 717 F.2d 767, 773 (3d. Cir. 1983).

24. *In re* Braniff Airways, 42 B.R. 443, 448 (Bankr. N.D. Tex. 1984).

25. 11 U.S.C § 553(a) (1982) provides in pertinent part:

> (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 the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that . . .

26. A "debt" is a liability on a "claim." 11 U.S.C. § 101(11) (1978). "Claim" is very broadly defined in the Bankruptcy Code and means in part, "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . ." *Id.* at § 101(4)(A).

27. The filing of the bankruptcy petition fixes "the line of cleavage with reference to the condition of the bankrupt estate." Only debts or credits existing at the time of filing can be setoff against the other, and transactions occurring later cannot be taken into account. *In re* Howell, 4 B.R. 102, 108 (Bankr. M. D. Tenn. 1980).

28. *Id.* at 108. *See also* Stair v. Hamilton Bank of Morristown (*In re* Morristown Lincoln-Mercury, Inc.), 42 B.R. 413, 417 (Bankr. E.D. Tenn. 1984).

29. *See, e.g.*, Waldschmidt v. Columbia Gulf Transmission Co. (*In re* Fulghum Const. Corp.), 23 B.R. 147, 151 (Bankr. M.D. Tenn. 1982).

30. *E.g.*, Whitman v. Seedtec International (*In re* Whitman), 38 B.R. 395 (Bankr. N.D. 1984).

who likewise owes a debt to the creditor;[31] the claims must be owing between the same parties, in the same right or capacity, and must be of the same kind or quality.[32]

The requirement of mutuality of parties is of particular significance in the context of bankruptcy.[33] By definition, a "debtor-in-possession" is the debtor when no trustee is serving in the Chapter 11 case.[34] Because the debtor and the debtor-in-possession are separate and distinct entities,[35] the courts have concluded that the requisite element of mutuality of parties is lacking whenever a creditor attempts to offset a prepetition debt against a post-petition claim.[36] A debtor's prepetition claim against a creditor does not involve the same parties as the debtor-in-possession's claim against the same creditor.[37] The automatic stay prevents prepetition obligations from being off-set against post-petition obligations.[38] Setoff effectively elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.[39]

Recoupment, unlike setoff, does not involve the concept of mutuality of obligations.[40] The claim must arise out of the *same* rather than a different transaction.[41] The recoupment doctrine is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation.[42] A recoupment claim may be asserted independently of section 553,[43] and the statutory limitations on setoff in bankruptcy are not applied to recoupment.[44] A recoupment allows the creditor to assert that certain mutual claims extinguish one another in bankruptcy, in spite of the fact that they could not be "setoff" under 11 U.S.C. section 553.[45]

31. *See* Stair v. Hamilton Bank of Morristown (*In re* Morristown Lincoln-Mercury, Inc.), 42 B.R. 413 (Bankr. E.D. Tenn. 1984).

32. *See In re* Braniff Airways, 42 B.R. 443, 449 (Bankr. N.D. Tex. 1984).

33. *See American Central Airlines, Inc.*, 60 B.R. at 590.

34. 11 U.S.C. § 1101(1) (1978). The Code in general is drafted in terms of the powers and duties of the trustee as the representative of the estate. In Chapter 11, a trustee is appointed only when one is needed. *Id.* at § 1104(a). Normally the debtor, now the debtor-in-possession, remains as the estate's representative, in which event the debtor-in-possession has the powers and duties conferred by the various Code provisions on a trustee. *Id.* at § 1107(a).

35. Hill v. Farmers Home Administration (*In re* Hill), 19 B.R. 375, 380 (Bankr. N.D. Tex. 1982).

36. *Id.*

37. *Id.*

38. *In re* Midwest Service and Supply Co., Inc., 44 B.R. 262, 265 (Bankr. D. Utah 1983).

39. 11 U.S.C. § 506(a) (1978). (The claim of a creditor that is subject to setoff under Section 553 is a secured claim to the extent of the amount subject to setoff.) *Id.*

40. *In re* American Central Airlines, Inc., 60 B.R. at 590.

41. Sapir v. Blue Cross/Blue Shield of Greater New York (*In re* Yonkers Hamilton Sanitarium, Inc.), 34 B.R. 385, 386 (Bankr. S.D. N.Y. 1983).

42. *In re* Monongahela Rye Liquors, Inc., 141 F.2d 864, 869 (3d. Cir. 1944).

43. Rakozy v. Reiman Construction (*In re* Clowards, Inc.), 42 B.R. 627 (Bankr. D. Idaho 1984) (citing Quittner v. Los Angeles Steel Casting Co., 202 F.2d 814, 816 n.3 (9th Cir. 1953)).

44. *Accord* Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984).

45. *Id.*

Because the doctrines of setoff and recoupment are exceptions to the rule that bankruptcy operates as a "cleavage" in time,[46] they should be narrowly construed. A creditor's right to setoff is statutorily restricted by the Bankruptcy Code.[47] The recoupment doctrine in contrast is judicially fashioned.[48] While setoff under the Bankruptcy Act is limited to instances involving mutuality of obligations, recoupment is subject to no such limitation.[49] The only real requirement regarding recoupment is that the sum owed can be reduced only by matters or claims arising out of the same transaction as the original sum.[50]

B. Application of the Recoupment Doctrine to Executory Contracts

"Executory contract"[51] is not defined in the Bankruptcy Code, but the legislative history indicates that Congress intended the term be defined as a contract "on which performance remains due to some extent on both sides."[52] Recoupment therefore is applied when a claim and counterclaim arise out of the same contract.[53] When the debtor is party to an executory contract when the bankruptcy petition is filed, a debtor-in-possession may not assume the favorable aspects of a contract (post-petition performance) and reject the unfavorable aspects of the same contract (the obligation to repay prepetition overpayments by means of "recoupment").[54]

46. *Ashland*, 782 F.2d at 159.

47. 11 U.S.C. § 553 (1978).

48. Lee v. Schweiker, 739 F.2d 870, 875 (3d. Cir. 1984). Social security benefits recipient, who filed a Chapter 13 case, instituted proceeding to recover amounts which the Social Security Administration had withheld from her checks before and after she filed bankruptcy to recover prior overpayments. *Id.* at 872. The Court of Appeals held that the SSA could not recoup overpayments made to a recipient after the recipient had filed a petition in bankruptcy. *Id.* at 876.

49. *See Waldschmidt*, 14 B.R. at 314.

50. *Id.*

51. An executory contract is one that has not as yet been fully completed or performed, in contrast to an executed contract in which everything that was to be done is done. 17 AM. JUR. 2D *Contracts* § 6 (1964). If a transaction is fully executed on both sides, it is not properly described as a contract. WILLISTON, CONTRACTS 3d § 14 (1957). All contracts to a greater or less extent are executory. *Id.*

52. S. REP. NO. 989, 95th Cong., 2d Sess. 58, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5844; H.R. REP. NO. 595, 95th Cong., 2d Sess. 347, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6303.

This definition is similar to the one formulated by Professor Countryman in his seminal article on the topic. Countryman, *Executory Contracts in Bankruptcy; Part I*, 57 MINN. L. REV. 439, 460 (1973). According to Countryman, an executory contract for purposes of the bankruptcy statutes is "a contract under which the obligations of both the bankrupt and the other party are so far unperformed that failure to complete performance would constitute a material breach excusing the performance of the other." *Id.*

53. *See American Central Airlines, Inc.*, 60 B.R. at 590.

54. *See Lee*, 739 F.2d at 876; *In re Yonkers Hamilton Sanitarium, Inc.*, 34 B.R. at 388. For example, in *In re Yonkers Hamilton Sanitarium*, the Sanitarium agreed not to charge Medicare beneficiaries directly but instead to bill the Government to receive payment for services provided. *Id.* The agreement further allowed the Government to reclaim any overpayments to the hospital from current or future payments. After the Sanitarium declared bankruptcy, it continued to receive payments from the Government (post-petition performance) but was also obligated to allow the Government to recoup any prepetition overpayments (prepetition obligation).

IV. DISCUSSION AND ANALYSIS

A. *Discussion of the* Ashland *Court's Rationale*

In the present case, Ashland withheld money owed to B&L for oil deliveries made after B&L had filed a petition in bankruptcy.[55] Ashland apparently recognized that setoff would not be available because its claim was prepetition and its debt was post-petition.[56] Ashland thus claimed that it had "properly" recouped its prepetition overpayment.[57]

One policy of the Bankruptcy Code is that unsecured creditors stand on equal footing.[58] Historically, since the doctrine of recoupment is an exception to the equal treatment policy, courts have allowed recoupment only in very narrow circumstances.[59] Allowing Ashland to recoup its prepetition overpayments directly conflicts with the policies underlying the Bankruptcy Code.

The *Ashland* court admitted that recoupment, like setoff, is an exception to the general rule that unsecured creditors be treated equally.[60] The court also conceded that setoff is allowed only in very narrow circumstances,[61] but refused to limit recoupment in the same way.[62] Instead, the court allowed Ashland to recoup,[63] significantly expanding the doctrine.

As support for its holding, the court looked to "analogous" bankruptcy cases that had allowed recoupment.[64] The court makes no attempt to explain why these cases are analogous to the instant case; it simply briefly

55. *Ashland*, 782 F.2d at 156.

56. Before Ashland could exercise its right to a setoff, it must seek relief from the automatic stay. 11 U.S.C. § 362, 362(a), 553. Had Ashland filed such a claim, the debtor-in-possession could have successfully defeated it because Ashland did not request relief from the automatic stay, nor did it meet the conditions of § 553. *Id.* The mutuality requirement of § 553(a)(3) would not be met because debts and claims must both be prepetition. 11 U.S.C. § 553. Ashland's claim was prepetition, but its debt to B&L was post-petition. *See supra* Section IIIA of text.

57. *Ashland*, 782 F.2d at 156.

58. *See supra* note 4.

59. California Canners and Growers v. Military Distributors of Virginia, Inc. (*In re* California Canners and Growers), 62 B.R. 18, 19 (9th Cir. BAP 1986).

60. *Ashland*, 782 F.2d at 157.

61. *Id.*

62. *Id.* at 159.

63. *Id.*

64. The cases cited were: Waldschmidt v. CBS, Inc., 14 B.R. 309 (Bankr. M.D. Tenn. 1981) (recording company was allowed to recoup advance royalties paid to a musician, rather than being required to claim as an unsecured creditor for the outstanding overpayment total at the time of the bankruptcy filing); United States v. Midwest Service and Supply Company, Inc. (*In re* Midwest Service and Supply Co., Inc.), 44 B.R. 262 (Bankr. D. Utah 1983) (recoupment allowed when progress payments on repair or construction contracts were made in excess of the value of the work performed before bankruptcy); *Sapir*, 34 B.R. 385 (recoupment doctrine applied to allow the government to recover Medicare overpayments from post-bankruptcy reimbursements to a hospital that continued to operate after filing a Chapter 11 petition); *In re* Clowards, Inc., 42 B.R. 627 (Bankr. D. Idaho 1984) (application of the recoupment doctrine to permit a claim for damages for alleged breach of a construction contract to reduce the balance due under the contract). Each of the above cases involved an executory contract.

describes four cases in which recoupment was allowed.[65] The court then immediately cites two cases[66] in which recoupment was not permitted.[67]

The *Ashland* court focused on the factors the *Lee v. Schweiker* court used to distinguish cases in which recoupment was allowed.[68] According to the *Ashland* court, the *Lee* court asserted that most recoupment cases involved single contracts that provided for advance estimated payments, subject to later corrections.[69] However, the court in *Lee* never used the term "single contract." Evidently, the *Ashland* court was attempting to make a distinction between a "single contract" and a "series of separate contracts."[70] The *Ashland* court concluded that the oil division order was a single contract,[71] basing this conclusion on non-bankruptcy cases in which state courts characterized a division order for oil or gas as one contract between the sellers and the purchasers.[72] According to *Lee*, the analysis of recoupment cases was based on the treatment of executory contracts in bankruptcy;[73] a debtor who assumes the favorable aspects of the contract (post-petition payment) must also take the unfavorable aspects of the same contract (obligation to repay prepetition overpayments).[74] The *Ashland* court applied this reasoning to the oil division order,[75] but never explicitly described the contract between Ashland and B&L as executory.

Finally, the court questioned whether the month-to-month purchases of oil arose out of the same transaction, for purposes of applying the recoupment doctrine,[76] but the court never expressly resolved this issue. Instead, the court conceded that the overpayments and the post-bankruptcy purchases of oil involved were not as closely related as the events in prior cases in which recoupment was allowed.[77] In fact, the court stated "the obligations are easily separable and independently determinable,"[78]

65. *Ashland*, 782 F.2d at 157-58.

66. Lee v. Schweiker, 739 F.2d 870 (3d Cir. 1984); *In re* Hagan, 41 B.R. 122 (Bankr. D. R. I. 1984).

67. *Ashland*, 782 F.2d at 157.

68. *Id.*

69. *Id.*

70. Ashland contended that the district court had erred in finding that a division order constitutes a series of separate contracts. *Id.* at 156.

71. The implication is that if the division order is a single contract as opposed to a series of separate contracts, it is an executory contract. *See supra* note 5.

72. *See* Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326, 1328 (1977), *cert. denied*, 434 U.S. 1065 (1978).

73. *See supra* Section IIIB of text.

74. *Lee*, 739 F.2d at 876.

75. *Ashland*, 782 F.2d at 159.

76. *See Waldschmidt*, 14 B.R. at 314. ("The only real requirement regarding recoupment is that a sum can be reduced only by matters or claims arising out of the same transaction as the original sum.") *Id.*

77. *Ashland*, 782 F.2d at 158.

78. *Id.*

implying that these month-to-month purchases between Ashland and B&L did not involve the same transaction.

Nevertheless, the court reasoned that the present situation was sufficiently analogous to other bankruptcy cases in which recoupment was allowed.[79] Although the court stated that any recoupment exception 'perhaps' should be narrowly construed,[80] it applied the doctrine in the instant case.[81]

B. Analysis of the Court's Rationale

The *Ashland* court's analogy to cases where recoupment was permitted is tenuous for several reasons. First, it is debatable whether the contract between Ashland and B&L was an executory contract. The contract bound B&L to permit Ashland to take all or any part of the oil from the lease until B&L terminated the order by giving thirty days written notice.[82] Had B&L terminated the agreement, the amount owed Ashland would have been discharged in the subsequent bankruptcy,[83] because there would have been no further performance necessary. Further, a finding that the transaction between Ashland and B&L was an executory contract does not automatically allow application of the recoupment doctrine.

In a similar case, *California Canners and Growers v. Military Distributors of Virginia, Inc.*,[84] decided after *Ashland,* the United States Bankruptcy Appellate Panel for the Ninth Circuit held that recoupment would not be appropriate where one transaction occurred prepetition and the other post-petition.[85] In the concurring opinion of *California Canners*

79. Specifically, the court cited *In re* Yonkers Hamilton Sanitarium, Inc., 34 B.R. 385, 388 (Bankr. S. D. N. Y. 1983), in which Medicare overpaid a hospital and the court allowed Medicare to "recoup" against payments owed the hospital for patients it treated after filing Chapter 11 bankruptcy proceedings. *Id.*

80. *Ashland,* 782 F.2d at 158.

81. *Id.* at 159.

82. *Id.* at 158.

83. *See* Westinghouse Electric Corp. v. Fidelity and Deposit Co. of Maryland, 63 B.R. 18 (Bankr. E.D. Pa. 1986).

84. *In re* California Canners and Growers, 62 B.R. 18 (9th Cir. BAP 1986). California Canners sold and delivered goods to Military Distributors which subsequently, upon the order of Calif. Canners, shipped goods to various military installations. *Id.* at 19. Military Distributors billed Calif. Canners for the goods it delivered and Calif. Canners in turn billed the government. *Id.* Calif. Canners received payment from the government but did not pay Military Distributors for several orders and shipments before Calif. Canners filed a Chapter 11 petition in bankruptcy. *Id.*

After bankruptcy, Calif. Canners made several shipments in connection with orders placed by Military Distributors. *Id.* Military Distributors admitted that it owed Calif. Canners $86,842.47 for goods delivered to it by Calif. Canners after the Chapter 11 filing. *Id.* Military Distributors contended that it was entitled to a setoff or credit of $68,810.52 for prepetition debts owed to them by Calif. Canners. *Id.*

The Bankruptcy Appellate Panel held that although the claims arose under the same distributors agreement, the recoupment doctrine would not allow the creditor (Military Distributors) to offset its prepetition claim against its post-petition obligation to the debtor (Calif. Canners). *Id.* at 20-21.

85. *Id.* at 21.

and Growers, Bankruptcy Judge Elliot disagreed with the majority's executory contract analogy to the extent that it holds the debtor's continuance of a business relationship with the creditor justifies statutory, contractual, or common law recoupment of prepetition contract claims.[86] The Bankruptcy Code requires full satisfaction of valid prepetition claims for defaults by the debtor when the contract is assumed.[87] Judge Elliot found no congressional authorization for preferential treatment of a contracting party's prepetition claims in absence of court approved assumption of the contract.[88] Another deficiency in the executory contract analogy, according to Judge Elliot, is that recoupment is not limited to contractual transactions, executory or otherwise.[89]

Second, the contract itself did not provide for recoupment. The *Ashland* court recognized that in most of the situations "in which the recoupment doctrine was applied, the contract at issue expressly permitted the withholding of overpayments from future payments."[90] Yet the court still considered the situation in *Ashland* sufficiently analogous to other bankruptcy cases to warrant recoupment.[91] The court stated that the overpayments under the division order were much like advance royalties to a writer or musician.[92] "They are similar to the medicare overpayments to a hospital, which a court allowed to be 'recouped' against payments owed the hospital for patients it treated after filing Chapter 11 bankruptcy proceedings."[93] However, in each of these situations, the contracts expressly provided for repayment of advances or overpayments.[94]

Third, and most questionable, is the *Ashland* court's conclusion that the month-to-month oil purchases arose out of the same transaction.[95] The court admitted that the overpayments and the post-bankruptcy purchases of oil were *not* closely intertwined events.[96] The fact that the same two parties were involved, and that a similar subject matter gave rise to both claims does not mean that the two arose from the "same transaction."[97]

In the instant case, Ashland mistakenly overpaid B&L for oil produced

86. *Id.* at 24 (Elliot, J., concurring).
87. *Id.*
88. *Id.*
89. *Id.*
90. *Ashland*, 782 F.2d at 157.
91. *Id.* at 159.
92. *See* Waldschmidt v. CBS, Inc., 14 B.R. 309, 314 (Bankr. M.D. Tenn. 1981).
93. *Ashland*, 782 F.2d at 159. *See In re* Yonkers Hamilton Sanitarium, Inc., 34 B.R. 385, 386 (Bankr. S.D. N.Y. 1982).
94. *Lee*, 739 F.2d at 875.
95. *Ashland*, 782 F.2d at 158.
96. *Id.*
97. *Lee*, 739 F.2d at 875. For example, two parties could enter into a contract involving certain goods. At a later point in time, the same two parties could enter into another contract involving the same goods, but it would not be considered the *same* transaction.

and delivered prior to B&L's bankruptcy petition.[98] After B&L's petition, Ashland received subsequent oil deliveries for which it owed payments to B&L.[99] As the *Ashland* court observed, "the obligations are easily separable and independently determinable."[100] It is illogical to conclude that these purchases arose out of the same transaction.[101] In like manner, transactions between Ashland and B&L should be considered separate. The withholding of payments due to B&L from Ashland does not meet the requirements of a proper recoupment because the transactions are different.[102]

C. Discussion and Analysis of the Court's Equitable Consideration

The *Ashland* court reiterates the justification espoused in *Lee v. Schweiker* for invoking the recoupment doctrine:[103] "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."[104] This justification, however, is unpersuasive in the *Ashland* case. The *Ashland* court found that "Ashland's overpayment is not 'essentially a defense' to B&L's current claims for payment on post-bankruptcy deliveries."[105] Furthermore, to support this justification, the *Lee* court cited *In re Monongahela Rye Liquors*,[106] which noted that the right to recoupment did not arise from the setoff provisions of former Section 68.[107] However, in *Monongahela Rye Liquors* the bankruptcy trustee attempted to recoup against the claim of the Commonwealth of Pennsylvania in order to avoid the bar of sovereign immunity.[108] There

98. *Ashland*, 782 F.2d at 156.

99. *Id.*

100. *Id.* at 158.

101. In another bankruptcy case, Westinghouse Electric Corporation v. Fidelity and Deposit Co. of Maryland, 63 B.R. 18 (Bankr. E. D. Pa. 1986), decided after *Ashland*, but involving a similar issue, the court stated that ". . . it does not necessarily follow that every contract contemplates only one series of transactions." *Id.* at 22. In *Westinghouse*, pursuant to a previous contract, the Westinghouse Corp. withheld commissions due the Enviro-Scope Corp. subsequent to Enviro-Scope's initiation of Chapter 11 proceedings. *Id.* at 19. The commissions were withheld in payment for goods purchased from Westinghouse by Enviro-Scope. *Id.* at 20. The court held that the creditor's (Westinghouse) obligation to pay the commission arose from a different transaction than did the debtor's (Enviro-Scope) obligation to pay for goods purchased directly from the creditors. *Id.* at 22. The creditor's retention of commissions owed to the debtor was held to be an improper setoff, rather than a recoupment. *Id.*

102. Instead, Ashland's actions constitute an improper setoff in violation of the automatic stay because the condition of mutuality of parties cannot be satisfied.

103. *Ashland*, 782 F.2d at 157.

104. *Lee*, 739 F.2d at 875.

105. *Ashland*, 782 F.2d at 158.

106. *In re* Monongahela Rye Liquors, 141 F.2d 864, 869 (3d Cir. 1944).

107. 11 U.S.C. § 68 (1978).

108. *In re Monongahela Rye Liquors*, 141 F.2d at 869.

was no problem of preferential distribution to a creditor. To say that it would be inequitable to apply 11 U.S.C. § 553's limitations on setoff to recoupment is to fail to understand that Congress has carved out a limited exception to the rule of equal distribution by allowing setoff in the first place.[109]

Two of the primary goals of the bankruptcy laws are: 1) to permit the debtor the broadest possible relief in the bankruptcy court,[110] and 2) to distribute any assets of the debtor equally among the creditors.[111] To insure that these policies are met, the bankruptcy laws established the rule that an unsecured creditor's claim which arises prior to the debtor's bankruptcy petition cannot be used to recoup a claim of the assignee, receiver, or bankruptcy trustee brought against the unsecured creditor.[112] Since a debtor-in-possession essentially performs the same role as a trustee,[113] the rule also applies to creditors' claims arising before the debtor-in-possession was created by the debtor filing for bankruptcy.[114] Ashland's claims for overpayment arose before B&L filed for bankruptcy and became a debtor-in-possession.[115] Thus, in the instant case, the rule applies to B&L Oil Co.

To allow Ashland to recoup its prepetition overpayment against the post-bankruptcy claim of the debtor-in-possession (B&L), may enable Ashland to receive full payment of its claim.[116] Payment of all or part of Ashland's claim would be a preference[117] over other unsecured creditors who, unless given special treatment under the Bankruptcy Code, would typically be paid less than 100% on their claim. The goal of equal distribution among general creditors is thereby thwarted as is the policy of allowing the debtor, B&L, the broadest possible relief.

Finally, the *Ashland* court is concerned that if Ashland is unable to recoup the overpayments made to B&L, B&L's other creditors would receive a windfall.[118] According to the court, this is a classic case of

109. *California Canners and Growers*, 62 B.R. at 23. *See* 4 COLLIER ON BANKRUPTCY 91 § 553.02 (15th ed. 1985).

110. *See* United States v. Wall (*In re* Wall), 60 B.R. 512, 514 (Bankr. W.D. Ky. 1986); *see also*, H.R. No. 595, 95th Cong., 1st Sess. 309 (1977); S.R. No. 989, 95th Cong., 2nd Sess. 21 *reprinted in* 1978, U.S. CODE CONG. & AD. NEWS 5787, 5807, 6266.

The basic relief of bankruptcy is what is known as a "fresh start"—the ability of the debtor to start over. This "fresh start" allows the debtor to "discharge" his debts and to be free from the obligations they impose. 11 U.S.C. § 727 (1978).

111. 4 COLLIER ON BANKR. § 547.03 (15th ed. 1985).

112. Quittner v. Los Angeles Steel Casting Co., 202 F.2d 814 (9th Cir. 1953).

113. *See* 11 U.S.C. § 1107(a) (1978).

114. *See* 11 U.S.C. §§ 101(12), 1101(1) (1978).

115. *Ashland*, 782 F.2d at 156.

116. Recoupment, however, does not allow affirmative assertion of the recouping party's claim above the amount of the opposing party's claim. Frederick v. United States, 386 F.2d 481, 487 (5th Cir. 1967).

117. Payment by B&L of any of Ashland's claim would be a preference because it meets the conditions set forth in § 547(b) of the Bankruptcy Code. *See supra* note 15.

118. *Ashland*, 782 F.2d at 159.

unjust enrichment.[119] In continuing its contract with Ashland, B&L, as the debtor-in-possession, was acting on behalf of all B&L's creditors. By granting Ashland's claim, the court interfered with the ratable distribution of assets among the other unsecured creditors.[120] It seems clearly unfair to B&L's other creditors to allow recoupment in this situation solely because of the fortuitous and debatable circumstances that Ashland's claim arose from the "same transaction" rather than separate transactions. Thus, the court's decision cannot be maintained on equitable grounds.

V. CONCLUSION

Setoff and recoupment are exceptions to the basic rule in bankruptcy that the debtor's estate is distributed equally among unsecured creditors. While Congress restricted the use of setoff statutorily in the Bankruptcy Code, the courts imposed limitations on the recoupment doctrine. The Court of Appeals for the Tenth Circuit expanded the doctrine of recoupment in *Ashland* by allowing a creditor to recoup overpayments that did not arise out of the same transaction, and were not essentially a defense to the debtor's claim. This decision failed to uphold one of the primary goals of the bankruptcy laws—ratable distribution of the debtor's estate among all unsecured creditors.

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119. *Id.* (Although this argument is appealing, it is unclear how this situation differs from many of the typical situations presented in bankruptcy where a debtor has received the benefit of a contract or a loan but is discharged from his obligations thereunder.) *See, e.g., Westinghouse Elec. Corp.*, 63 B.R. at 21.

120. *See* Republic Supply Co. v. Richfield Oil Co., 59 F.2d 35, 37 (9th Cir. 1931).