BUSINESS LAW

2nd Circuit Allows N.Y. Utility To Recoup Prepetition Bills

REGULATORY LAW

Reversing Lower Courts, Decision Recognizes Judicial Doctrine

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Special to the Legal

Shakespeare wrote: "Beauty is in the eyes of the beholder." This principle appears to be the crux of the dispute in *In re McMahon*, 1997 U.S. App. LEXIS 30297 (2d Cir., Nov. 4, 1997), in which the 2nd Circuit Court of Appeals has followed the law long established here in the 3rd Circuit in *In re Brooks Shoe Mfg. Co. Inc.*, 39 B.R. 980 (E.D. Pa. 1984), holding that when postpetition (after a customer files for bankruptcy), a utility applies a security deposit, obtained prepetition, to reduce the amount of a customer's unpaid, prepetition utility bills, this constitutes recoupment, not set off.

Thus, the 2nd Circuit reversed the New York District and Bankruptcy Courts, which, having reviewed the same facts and authorities, had concluded that what the utility had done constituted impermissible setoff, which required prior court authorization (not obtained here), and not recoupment.

In so holding, *McMahon* recognized a judicial doctrine, which appears nowhere in the provisions of the U.S. Bankruptcy Code, and ruled that to rely upon recoupment, a utility does not need prior bankruptcy court authorization in the form of a motion for relief from the automatic stay or anything else.

Also, the court reversed the lower courts' award of damages to the debtor under Section 362(h) of the Code for violation of the automatic stay — as the automatic stay is inapplicable when recoupment exists.

What is particularly interesting about *McMahon* is the court's abandonment of the rationale employed by the two lower courts, and, instead, its recognition of the business practicalities involved for a utility like N.Y. State Electric & Gas Corp. (NYSEG), with thousands of customers in the administration of the application of many security deposits against many, unpaid prepetition invoices after the customers file for bankruptcy.

"To the extent such motions are required, a decision forcing utilities to formally request setoffs would seem to impose needless transaction costs upon the utilities, costs borne ultimately by the consumer," the opinion said. *Id.* at 7.

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FACTS

McMahon operated a diner. As a condition of service, NYSEG required the payment of a $6,000 security deposit, which he paid. McMahon became seriously delinquent in the payment of his NYSEG invoices. By the time he filed his petition for relief under Chapter 13 of the Code — an event unknown to NYSEG until afterwards — he had become indebted to NYSEG for over $14,000.

All the while, NYSEG continued to provide utility services to the diner.

After he filed for bankruptcy, NYSEG learned about it, computed the amount of the prepetition debt owed, unilaterally applied the prepetition deposit to reduce same, and then filed a proof of claim with the Bankruptcy Court for the excess balance of about $9,000.

When the Bankruptcy Court learned about the setoff, done without prior court authorization, it permitted the setoff, recognized the claim for the unpaid prepetition balance due, but ruled that NYSEG had violated the automatic stay provisions of Section 362.

Pursuant to Section 362(h) (provides for actual damages, including costs and attorneys' fees, and for punitive damages — upon demonstration of injury for a willful violation of the stay), it imposed actual damages of $550 against NYSEG but no punitive damages. The District Court affirmed.

2ND CIRCUIT'S RATIONALE

Initially, the court analyzed the distinction between setoff and recoupment.

The doctrine of recoupment is deeply established in judicial doctrine, including the U.S. Supreme Court: *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993) (as long as the counterclaim of the creditor arises out of the same transaction as the debtor's claim against the creditor, recoupment may apply); *Id.* at 4, and the 3rd Circuit: *Lee v. Schweiker*, 739 F.2d 870, 875 (3rd Cir. 1984).

While setoff requires prior judicial approval under Section 362 — to escape the otherwise strict automatic stay protection given to debtors' estates — recoupment, if applicable, does not. *Id.* at 4.

● Recoupment: New York Law.

According to the court, the analysis of whether a particular transaction involves setoff or recoupment starts with reviewing what applicable state law provides. According to its review thereof from *Nat'l Cash Register Co. v. Joseph*, 86 N.E. 2nd 561, 552 (N.Y. 1949), and *Constantino v. State*, 415 N.Y.S. 2d 966, 969 (N.Y. Ct. C. 1979), New York law sanctions recoupment.

It is a deduction from a money claim via a process whereby cross demands arising out of the same transaction can compensate each other, and only the balance is recovered.

The court expressly wrote that its decision on this setoff/recoupment distinction was limited to the facts of this case, as applicable to public utilities.

● Recoupment: Bankruptcy Generally.

The next step in its analysis was general bankruptcy law.

Recoupment is permissible "only within a single contract or transaction or a singe set of transactions," the opinion said.

In a typical bankruptcy context, where a debtor is overpaid prepetition by the other party to contract, it would be unfair to allow the debtor to make a claim postpetition against that other party without first netting out the prepetition overpayment. On the other hand, as the Code was designed to favor the equal treatment of similar classes of creditors, recoupment should be narrowly construed.

● Prepetition Utility Deposits: Setoff v. Recoupment.

The heart of the court's analysis then followed. It reviewed the existing case law in the limited context of postpetition application by a public utility of a security deposit obtained prepetition from a customer against the customer's unpaid, prepetition invoices.

The majority view sanctions recoupment — without prior bankruptcy court authorization: *Brooks Shoe*, 39 B.R. 980; *In re Norsal Indus. Inc.*, 147 B.R. 85 (Bankr. E.D. N.Y. 1992); *In re Miner Indaus. Inc.*, 119 B.R. 6 (Bankr. D.R.I. 1990); and *In re Pub. Serv. Co. of New Hampshire*, 107 B.R. 441 (Bankr. D.N.H. 1989).

The minority view does not and finds the same set of facts constitutes setoff, which requires prior bankruptcy court authorization under Section 362: *In re Village Craftsman, Inc.*, 160 B.R. 740 (Bankr. D.N.J. 1993); and *In re Cole*, 104 B.R. 736 (Bankr. D.Md. 1989).

Noting that *Norsal*, 147 B.R. 85, the only case decided under New York law, sided with the majority view, the court did also. First, relying upon *Constantino*, (use New York law as the test of whether setoff or recoupment applied), the court defined the ground rules for recoupment to apply.

It said the counterclaim has "to arise out of the same set of transactions as the claim." Clearly, the deposit arose out of a single electric contract between McMahon and NYSEG. All NYSEG was doing was asserting a defense to his claim.

Second, requiring the strict standards of setoff to these facts would have been inequitable to NYSEG, which did not consciously enter the business relationship with McMahon, such as a bank would do when extending a loan to a debtor. NYSEG was required to provide service to him, as part of its duty to serve all customers in its service territory — imposed upon it as a public utility strictly regulated by a state utility commission.

"Like a creditor who mistakenly overpays a debtor ... the utility company that is obligated to offer utility service to a debtor should be able to effect a recoupment when the debtor fails to fulfill its part of the contract," the opinion said.

Third, the court carefully reviewed the New York utility laws; namely, the statutes of the N.Y. Public Service Commission.

Those state laws plainly sanction utilities availing themselves of security deposits as offsets, setoffs and/or credits to reduce outstanding balances on customers' accounts. Thus, but for the bankruptcy, there would have been no question that NYSEG automatically could have set off the $6,000 deposit to reduce the more than $14,000 balance due without judicial or commission intervention.

In fact, New York laws do not create a legal obligation for a utility to return a deposit to the customer — so long as outstanding balances exist.

Fourth, the court adopted the reasoning in *Brooks Shoe*: a utility deposit, in practice, is like an advance payment on an open account. Because McMahon did not fulfill his payment obligations under the contract with NYSEG and New York laws, NYSEG

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was entitled to recoup the "advance payment deposit" which "arose from the same utility contract".

DEBTOR'S ARGUMENTS

The court readily disposed of McMahon's arguments. First, while McMahon interpreted *Constantino* to mean that as NYSEG filed a proof of claim for nearly $9,000 — above and beyond what was his claim for the $6,000 security deposit — this was impermissible, because once a defendant asserts its claim by recoupment, it can have no remaining claim against the plaintiff.

He had support in his argument. That was the conclusion of the Bankruptcy Court in this case, which found this factor to mean setoff existed and not recoupment. The court rejected this saying, *Constantino* "made no suggestion that a party seeking recoupment must drop affirmative claims it possesses beyond recoupment."

Second, McMahon interpreted *Village Craftsman* to mean that a utility deposit is cash collateral under Section 363(a), which a debtor can not use without prior court authorization. The court refused to go in that direction.

Recoupment stacks equity to favor the unsuspecting utility, forced by state regulatory laws to serve all customers, regardless of the ability to pay, which was fortunate enough to have collected the deposit beforehand to protect it against the very misfortune (nonpayment of the utility bills) which occurred. The doctrine of recoupment is an exception under all circumstances to any other apparent requirement under the Code to obtain prior judicial approval.

Third, the court rejected McMahon's argument that a setoff motion was warranted under the circumstances in this Chapter 13. Besides the practicalities involved (attorneys fees and costs to NYSEG to file such motions, expenses which only would be transferred as transaction costs to NYSEG's ratepayers), even McMahon's attorney conceded that upon the filing of a setoff motion, McMahon would have had no defense to the request to approve the setoff.

The court saw no reason to do this. And recoupment was the remedy to sanction NYSEG's actions.

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