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Setoff and the Principle of Creditor Equality

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SETOFF AND THE PRINCIPLE OF CREDITOR EQUALITY

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Section 506(a) of the Bankruptcy Code[1] provides that to the extent a creditor's claim is subject to setoff[2] under section 553,[3] the

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1. 11 U.S.C. § 506(a) (1988). Section 506(a) provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. 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.

Id.

2. *See* Robert H. Skelton, *The Secured Party's Rights in a Debtor's Bank Account Under Article 9 of the Uniform Commercial Code*, 1977 SO. ILL. L. REV. 120.

> Setoff is a time honored right of one who is indebted to another to reduce or balance off such indebtedness by charging against the debt sums which his creditor in that transaction may owe him in some other transaction. It may be viewed as a form of self-help, and not merely . . . a defense to be pleaded in case he is sued by his creditors.

Id. at 186.

3. 11 U.S.C. § 553 (1988 & Supp. II 1990). Section 553 provides:

> (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—
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> (1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title;
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> (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

claim is a secured claim. Section 553(a), in turn, provides that, subject to limited exceptions, the Code does not affect a creditor's right to offset a mutual prepetition debt owed to it against its prepetition claim.[4] These provisions raise two distinct issues of bankruptcy policy. The first and more fundamental issue is whether the Bankruptcy Code should recognize a claim subject to setoff as a secured claim.[5] The second issue is whether the exceptions to the recognition of the right to setoff are consistent with the Code's policy against preferential transfers. Although these two issues are related, failure to address them separately muddies the analysis. Therefore, in this Article I will first address the issue of whether a creditor's common-law right to setoff should be a basis for granting the creditor a secured claim.[6] I will then address the issue of whether the limitations that subsections 553(a)(1)-(3) and (b) impose upon the recognition of setoff are consistent with the policy underlying the Code's preference provisions.[7]

I. THE RIGHT OF SETOFF AS THE BASIS FOR A SECURED CLAIM

In his leading article Professor John McCoid addresses the issue of whether the Code should recognize the right of setoff as a basis for a

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such creditor—

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

(B) while the debtor was insolvent; and

(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), 362(b)(14), 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, then 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.

Id. (footnotes omitted).

4. *Id.* § 553(a) (1988).

5. *See* Carmelita J. Hammon, Note, *Setoff in Bankruptcy: Is the Creditor Preferred or Secured?*, 50 COLO. L. REV. 511, 512 (1979).

6. *See infra* text accompanying notes 8-80.

7. *See infra* text accompanying notes 81-128.

secured claim.[8] McCoid asserts that the recognition of setoff "has the same effect as an unrecaptured preference" and hence is inconsistent with the "principle of creditor equality."[9] As a result, McCoid asserts that a persuasive basis must be advanced for preferring a creditor with a right of setoff over other unsecured creditors. McCoid then analyzes the principal arguments that have been advanced to support the right of setoff and concludes that they do not justify deviating from the principle of creditor equality. Specifically, McCoid concludes that "natural justice and equality" do not support the recognition of the right of setoff as a basis for priority in contests between creditors of an insolvent debtor.[10] McCoid further concludes that the right to setoff should not be equated with traditional forms of security recognized in bankruptcy. According to McCoid, setoff can be distinguished from judicial and contractual liens because it arises as a matter of law independent of judicial process or agreement.[11] Moreover, McCoid concludes that setoff is not the equivalent of a relational or statutory lien because setoff is not aimed at establishing priority in a contest between competing creditors.[12]

Although McCoid presents a compelling argument that setoff should not be recognized as a basis for awarding an otherwise unsecured creditor of an insolvent debtor priority over other unsecured creditors, his analysis presents two problems. First, McCoid confuses the issue of whether the right to setoff should be a basis for a secured claim with the issue of whether the creation of a right to setoff should be a preference. As a result of this confusion, McCoid applies the principle of creditor equality in a situation that does not present the normal normative basis for its application.[13] Second, McCoid's analysis

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8. John C. McCoid, II, *Setoff: Why Bankruptcy Priority?*, 75 VA. L. REV. 15 (1989).

9. *Id.* at 18.

10. *Id.* at 19-29.

11. *Id.* at 32-36.

12. *Id.* at 36-39.

13. *See* McCoid, *supra* note 8, at 16-17. In a bankruptcy proceeding the principle of creditor equality applies in two contexts. First, it is the basis for distribution among the unsecured creditors of an insolvent debtor. *See* Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 989 (1992). Second, the principle of creditor equality is the dominant rationale for the avoidance of preferential transfers made by an insolvent debtor on the eve of bankruptcy. Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 748 (1985) (stating that preference law is designed to promote equality only among creditors of the same class and not among all creditors); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 260-61 (1981); Tabb, *supra*, at 994. My principal quarrel with McCoid's analysis is that he uses the principle of creditor equality as a basis for denying a creditor's nonbankruptcy right of setoff, which was created while the debtor was solvent, in bankruptcy.

does not address the issue of whether the Code's recognition of the right to setoff is consistent with the theory of bankruptcy developed by Douglas Baird and Thomas Jackson.[14] As developed below, under the Baird-Jackson theory recognition of the nonbankruptcy right to setoff as a basis for a secured claim is proper.[15] My criticism of McCoid, however, is not that his conclusion is wrong because the Baird-Jackson theory suggests a different result. Rather, my concern is merely that their theory should have been confronted.

In his article McCoid uses an illustration to establish that recognizing a creditor's right of setoff has the same effect on distribution as an unrecaptured preference.[16] In his illustration McCoid compares the position of an unsecured creditor of an insolvent debtor who receives a payment on the eve of bankruptcy with the position of an otherwise unsecured creditor who has a right of setoff that is valid under section 553.[17] McCoid notes that the eve-of-bankruptcy payment is voidable as a preference while the right of setoff is unassailable. McCoid ultimately concludes that, in light of the principles of creditor equality, this disparity is unjustified.

McCoid's illustration is misleading and taints his analysis. By assuming that the right of setoff was valid under section 553, McCoid may imply that the right to setoff was created more than ninety days prior to bankruptcy or when the debtor was solvent. Moreover, his analysis dictates that a right to setoff which arose more than ninety days prior to bankruptcy and while the debtor was solvent should not be a basis for preferring the creditor. If one seeks to compare such a right of setoff with payments to unsecured creditors, however, one should posit a comparable payment—*i.e.*, one that was made more than ninety days prior to bankruptcy and while the debtor was solvent. As demonstrated below, such a comparison establishes a consistency between the preference provision and recognition of setoff as a basis for a secured claim.

Consider the following illustration that presents comparable

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14. *See generally* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY (1992); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986) (stating generally that whenever possible bankruptcy should not interfere with or alter nonbankruptcy entitlements).

15. *See infra* text accompanying notes 34-47.

16. McCoid, *supra* note 8, at 16-18.

17. A right of setoff created within 90 days of bankruptcy and while the debtor was insolvent can be valid under § 553. Section 553(a)(3) empowers the trustee to avoid a right of setoff that results from a creditor incurring a debt to an insolvent debtor during the 90 day period prior to bankruptcy only to the extent the creditor incurred the debt for the purpose of obtaining a right of setoff. *See infra* text accompanying notes 90-91. Whether the Bankruptcy Code should recognize the validity of such a preferential right of setoff, however, is a separate question. *See infra* text accompanying notes 92-110.

transactions:

> *Illustration 1(A)* - On January 10, Bank 1 and Bank 2 each made an unsecured loan to Debtor in the amount of $10,000. On March 1, and while solvent, Debtor opened a deposit account at Bank 1 with a deposit of $5000. Debtor never withdrew or increased the funds in this account. On December 1, Debtor filed for relief under Chapter 7 and listed as its only asset the $5000 balance in this account.

The legal effect of Debtor's opening a deposit account at Bank 1 was to create an indebtedness from Bank 1 to the Debtor.[18] As a result, assuming that the debts are mutual, Bank 1's claim against Debtor is subject to a nonbankruptcy right of setoff. Because Bank 1's debt to Debtor was incurred more than ninety days prior to bankruptcy and while Debtor was solvent, the right is not voidable under section 553(a)(3). Therefore, under section 506(a) Bank 1 has an allowed secured claim of $5000. As a result, Bank 1 will recover $5000 and Bank 2 will recover nothing from Debtor's estate.

Illustration 1(A) demonstrates that the Code prefers creditors whose claims are subject to setoff over claims of other unsecured creditors. The question remains, however, whether this treatment is inconsistent with the preference provision, which evidences the principle of creditor equality. To answer that question one must pose a comparable illustration involving a transfer on account of an antecedent debt. Consider the following:

> *Illustration 1(B)* - On January 10, Bank 1 and Bank 2 each made an unsecured loan to Debtor of $10,000. On March 1, and while solvent, Debtor repaid $5000 to Bank 1. On December 1, Debtor filed for relief under Chapter 7 and the estate had no assets available for distribution on unsecured claims.

Although the payment to Bank 1 in Illustration 1(B) is on account of an antecedent debt, the trustee will not be able to avoid it under section 547(b).[19] Not only was the transfer outside the ninety day preference period, but more importantly the transfer was made while Debtor was solvent. As a result, Bank 1 will be able to retain the $5000 payment while Bank 2 receives no distribution from the estate. Thus, by recognizing the validity of the payment, the Code prefers Bank 1 over other unsecured creditors.

At one level a comparison of Illustrations 1(A) and 1(B) demonstrates that recognition of setoff as a basis for a secured claim is not inconsistent with the provisions of section 547. The purpose of the Illustrations, however, is somewhat more profound. The payment in Il-

18. *See, e.g.*, McManus v. Bank of Greenwood, 171 S.E. 473 (S.C. 1933).
19. 11 U.S.C. § 547(b) (1988).

lustration 1(B) is appropriately protected from avoidance as a preference. As will be developed below, two theories have been advanced to support the preference provision.[20] One theory, advanced by Baird and Jackson, rests upon the necessity of deterring transfers by an insolvent debtor that may injure the creditors as a group.[21] The alternative theory, best articulated by Professor Charles Jordan Tabb,[22] asserts that the principle of creditor equality precludes the validity of transfers made by a debtor while insolvent.[23] These two theories differ dramatically on the significance of creditor culpability.[24] They are consistent, however, on the critical point that only transfers made while a debtor is insolvent can offend the preference policy.

In his article on setoff, McCoid appears to assume that the policy underlying the preference provision is the principle of creditor equality.[25] McCoid then asserts that this principle is equally applicable to the right of setoff. I have no quarrel with his analysis up to this point. In applying the principle of creditor equality to setoff, however, McCoid extends it to situations in which the debtor is not insolvent at the time of the transfer. It is at this point that I find McCoid's analysis troubling. The principle of creditor equality is embodied in the notion that an insolvent debtor holds its assets in trust for its creditors as a group and that the creditors are entitled to share equally in a pro rata distribution of those assets.[26] A transfer by an insolvent debtor to one of its unsecured creditors necessarily injures the other creditors and should be recovered as a preference.[27] In contrast, a transfer to an unsecured creditor that does not render the debtor insolvent does not injure other unsecured creditors. Because transfers from a solvent debtor do not injure other unsecured creditors, such transfers do not offend the principle of creditor equality and are not avoidable under section 547(b).

In summary, because the payment in Illustration 1(B) did not offend the principle of creditor equality, recognition of the right to setoff

20. *See infra* text accompanying notes 83-90, 94-107.

21. *See* BAIRD, *supra* note 14, at 155-61; JACKSON, *supra* note 14, at 123-26.

22. Tabb, *supra* note 13, at 986-95.

23. *See id.* at 991-92; *see also* Countryman, *supra* note 13, at 748.

24. Under the Baird-Jackson theory creditor culpability in the sense of attempting to "opt out" of an impending collective proceeding is an essential element of a voidable preference. *See* BAIRD, *supra* note 14, at 155-56; JACKSON, *supra* note 14, at 125-26.

25. *See* McCoid, *supra* note 8, at 17; *see also* McCoid, *supra* note 13, at 260 ("Equal treatment of creditors is the oldest and most frequently advanced goal of preference law.").

26. *See* Tabb, *supra* note 13, at 991-92 ("A basic notion of equity jurisprudence . . . is that the unencumbered assets of an *insolvent* debtor are held in trust for the benefit of the entire body of unsecured creditors.").

27. *Id.* at 992.

as a basis for a secured claim in Illustration 1(A) does not offend the principle. The critical fact in both Illustrations is that the transfer in issue was made when Debtor was solvent. As discussed below, McCoid's analysis does suggest a basis for refusing to recognize setoff as security in bankruptcy.[28] The theoretical basis for doing so, however, is not the principle of creditor equality that underlies the preference provision.

Even if one does not accept the principle of creditor equality as the standard against which to assess the Code's treatment of setoff, McCoid's article is significant because he advocates a distributional rule in bankruptcy that does not recognize a nonbankruptcy entitlement. In so doing, McCoid sides with the "traditional" bankruptcy scholars[29] in the current spirited debate over the extent to which bankruptcy should recognize the value of creditors' nonbankruptcy entitlements.[30] Elizabeth Warren, a leading "traditional" bankruptcy scholar, maintains that bankruptcy is principally a system for distributing the losses that result from the imminent collapse of an insolvent firm.[31] She maintains that bankruptcy should allocate these losses by providing its own distributional rules that reflect the special circumstances presented when an insolvent firm collapses in the face of multiple creditor demands.[32] Because these circumstances allegedly are different from those contemplated in creating nonbankruptcy entitlements, Warren asserts that nonbankruptcy law should not dictate the distributional rules in bankruptcy.[33]

On the other side of this debate are scholars who subscribe to the theory of bankruptcy developed by Douglas Baird and Thomas Jackson. This theory of bankruptcy is elegant in its simplicity. As applied to the insolvent firm, Baird and Jackson view the sole function of bankruptcy to be the maximization of the benefits to the creditors as a group.[34] They view the mandatory collective proceeding of bankruptcy

28. *See infra* text accompanying notes 78-79.

29. Professor Baird used the term "traditional bankruptcy scholars" to describe those commentators who do not subscribe to the collective value maximization theory of bankruptcy developed by Baird and Jackson. Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 815 (1987).

30. *See, e.g.*, Baird, *supra* note 29; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).

31. *See* Warren, *supra* note 30, at 777, 790.

32. *Id.* at 785-93.

33. *See id.* at 789-90.

34. *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100 (1984) ("[B]ankruptcy law at its core should be designed to keep individual actions against assets, taken to preserve the position of one investor or another, from interfering with the use of those assets

as the solution to the common pool problem that arises when multiple creditors pursue individual remedies.[35] Under nonbankruptcy collection law it is in the interest of an individual creditor to take actions that are adverse to the creditors as a group. Baird and Jackson see the function of bankruptcy as assuring that the actions of individual creditors will not preclude application of the debtor's assets in the manner that will result in the maximum possible recovery to the creditors as a group.

Maximizing the collective benefit to creditors does not depend upon the manner in which that benefit is distributed.[36] As a result, one might assume that the Baird-Jackson theory would not generate distributional rules.[37] Baird, and until recently, Jackson,[38] have asserted, however, that bankruptcy should, as a general rule, adopt the distributional rules of nonbankruptcy law.[39] Under their theory the value of nonbankruptcy entitlements should be recognized in bankruptcy, except to the extent that such recognition would frustrate the goal of maximizing the collective benefit to creditors as a group.[40] Baird and Jackson support this distributional scheme by arguing that imposing a distributional scheme in bankruptcy that varies nonbankruptcy rules would provide perverse incentives to invoke bankruptcy and encourage inefficient forum shopping.[41] At a more fundamental level, they argue that recognition of nonbankruptcy entitlements is mandated by the "creditors bargain" which provides the normative basis of their theory.[42]

Judged under the Baird-Jackson theory, the drafters of the Bankruptcy Code would receive high grades for their treatment of setoff. As

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favored by the investors as a group.").

35. *See* JACKSON, *supra* note 14, at 10-17; Thomas H. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L.J. 287, 288-89 (1987).

36. *See* JACKSON, *supra* note 14, at 57-67; Baird, *supra* note 29, at 819-20; Baird & Jackson, *supra* note 34, at 100-01.

37. *See* Warren, *supra* note 30, at 799.

38. *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989). Jackson modified his view that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group on the theory that creditors in an ex ante bargain might voluntarily agree to share some losses resulting from the "common disaster" of a debtor's insolvency. *Id.*

39. *See* JACKSON, *supra* note 14, at 22; Baird, *supra* note 29, at 822-24.

40. *See* Baird & Jackson, *supra* note 34, at 100.

41. *See* JACKSON, *supra* note 14, at 26-27; Baird, *supra* note 29, at 824-28.

42. *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982). *But see* Jackson & Scott, *supra* note 38, at 157 (recognizing that nonbankruptcy entitlements are modified under a "common disaster" loss sharing rationale).

a general rule, Baird and Jackson maintain that general creditors should be entitled to reach the same interests in property under bankruptcy law that they could have reached under nonbankruptcy law.[43] This principle dictates the rules for determining whether the value of a creditor's nonbankruptcy entitlement should be recognized in bankruptcy. First, the entitlement must be valid against the debtor.[44] Second, and more significantly, under applicable nonbankruptcy law the holder of the entitlement must be entitled to priority over a judicial lien creditor.[45] If a judicial lien creditor could prime the holder of the entitlement, general creditors outside of bankruptcy could reach the property in issue free of the entitlement. Therefore, in bankruptcy the entitlement should be avoided to render the property available to holders of unsecured claims.[46]

In recognizing a claim subject to setoff as a secured claim under section 506(a), Congress adopted rules consistent with the Baird-Jackson theory. Under nonbankruptcy law a right to setoff within the scope of section 553(a) is enforceable against a debtor. Moreover, an unexercised right to setoff affords a creditor priority over a garnishing creditor.[47] As a result, Baird and Jackson would conclude that the value of the right to setoff should be recognized in bankruptcy. By treating a claim as secured to the extent it is subject to setoff, the Code preserves the value of the nonbankruptcy entitlement.

Although McCoid does not attempt to refute the Baird-Jackson theory, his analysis of the nonbankruptcy right of setoff is consistent with the view of the nonbankruptcy collection system that Elizabeth Warren asserts in her attack on the Baird-Jackson theory.[48] This is significant because the debate over the extent to which bankruptcy should recognize the value of nonbankruptcy entitlements reflects a sharp difference of opinion over the nature of the nonbankruptcy collection system and its relationship to bankruptcy. According to Warren, the nonbankruptcy collection system focuses primarily upon conflicts between the debtor and a single creditor.[49] Warren maintains that rules designed to define the rights of a single creditor are not re-

43. *See* BAIRD, *supra* note 14, at 87-96; JACKSON, *supra* note 14, at 68-79, 89-101; Jackson, *supra* note 35, at 288-94.

44. *See* BAIRD, *supra* note 14, at 87-89.

45. *See* Jackson, *supra* note 35, at 293-94.

46. *See* JACKSON, *supra* note 14, at 70-79; *see also* John C. McCoid, II, *Bankruptcy, the Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L.J. 175 (1985).

47. *See* Schuler v. Israel, 120 U.S. 506 (1887); McCoid, *supra* note 8, at 33 & n.80 (citing authorities).

48. *See* Warren, *supra* note 30.

49. *Id.* at 782.

sponsive to the problems that arise when an insolvent firm collapses in the face of multiple creditor demands.[50] Specifically, she asserts that the rules of nonbankruptcy collection law do not, and need not, contemplate multiple creditor demands upon a debtor's property.[51] Thus, although nonbankruptcy collection law may provide priority rules, those rules are not necessarily well suited to resolve the many priority disputes among multiple creditors of an insolvent debtor.[52] Finally, Warren maintains that nonbankruptcy collection law does not contemplate the discharge of the debtor.[53] Because Warren views nonbankruptcy collection law as not being responsive to the distributional problems presented in the bankruptcy of an insolvent firm, she contends that bankruptcy law need not adopt nonbankruptcy distributional rules and enforce nonbankruptcy entitlements.

In contrast to Warren, Baird and Jackson view bankruptcy as a mere supplement to the nonbankruptcy collection system designed solely to maximize the collective benefit to creditors in the face of the common pool problem that arises when multiple creditors seek to enforce individual remedies.[54] Although they assert that the nature of the distributional rules under nonbankruptcy law is not relevant to their theory,[55] Baird and Jackson maintain that the nonbankruptcy collection system is designed to address the problems of insolvency and priority among conflicting claimants that arise in bankruptcy.[56] If one views Article 9 of the Uniform Commercial Code (UCC)[57] as representative of the nonbankruptcy collection system, Baird and Jackson's characterization of that system is more accurate than Warren's. Certainly, Article 9 envisions a debtor's insolvency because the principal reason for retaining and perfecting a security interest upon a debtor's personal property is to guard against the risk of insolvency.[58] Moreover, Article 9 clearly envisions and resolves, in great detail, potential conflicts among creditors with claims to a debtor's personal property.[59]

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50. *Id.* at 783-85.

51. *Id.* at 782.

52. *Id.* at 783.

53. *Id.* at 784-85.

54. *See* Baird, *supra* note 29, at 822-23, 827-28; Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 729-30 (1984).

55. *See* Baird, *supra* note 29, at 823, 827; Jackson, *supra* note 54, at 731.

56. *See* Baird, *supra* note 29, at 822.

57. U.C.C. §§ 9-101 to -507 (1972).

58. *See* McCoid, *supra* note 8, at 33 ("The primary purpose of consensual liens is to establish the lien creditor's priority, as to the mortgaged property or collateral, over that of unsecured creditors."). *But see* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986) (arguing that the primary purpose of a security interest is to enable a creditor to influence the conduct of a debtor).

59. *See, e.g.*, Philip T. Lacy, *Conflicting Security Interests in Inventory and Pro-*

Warren's characterization, however, appears more accurate when one considers the right of setoff.

In his article McCoid thoughtfully probes the history and function of setoff. He concludes that the historical basis of setoff, promoting "natural justice and equality," justifies the doctrine only when its application is limited to resolving disputes between a single creditor and a solvent debtor.[60] McCoid acknowledges that early legislation and judicial decisions in both England and the United States extended the application of setoff to bankruptcy.[61] Nevertheless, McCoid argues persuasively that in so doing the legislatures and courts failed to perceive the distinction between creditor versus debtor conflicts and the conflicts among creditors of an insolvent debtor.[62] McCoid finds the application of setoff in bankruptcy particularly inappropriate after bankruptcy law had adopted the concept of debtor discharge.[63]

McCoid also analyzes the current justifications for setoff,[64] focusing primarily upon the argument that setoff functions as security.[65] McCoid compares the right of setoff to judicial, contractual, and relational liens.[66] McCoid stresses that these traditional liens share the common purpose of fixing a creditor's relative priority.[67] Because the right of setoff does not depend upon judicial process or consent, he concludes that setoff bears little relation to judicial or contractual liens.[68] McCoid asserts that the form of traditional security which bears the closest resemblance to setoff is the relationship lien.[69] Nevertheless, he concludes that an analogy to relational liens does not support treating setoff as a form of security. McCoid asserts that setoff does not have the essential characteristic of relational liens—a purpose to fix priorities among conflicting claimants.[70] He supports this assertion by demonstrating that an array of conflicting claims can defeat a

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ceeds Under the Revised Article 9 of the Uniform Commercial Code, 41 S.C. L. REV. 247 (1990).

60. McCoid, *supra* note 8, at 21-23.

61. *Id.* at 19-29.

62. *Id.* at 22.

63. *Id.* at 23-24.

64. McCoid noted three contemporary rationales for recognizing the value of a right of setoff in bankruptcy: (1) a creditor with a nonbankruptcy right of setoff should be viewed as a secured creditor, (2) recognition of setoff conforms to business understandings, and (3) preserving setoff encourages banks to carry debtors who are in financial trouble. *Id.* at 29-30.

65. *Id.* at 32-39.

66. *Id.*

67. *Id.*

68. *Id.* at 36.

69. *Id.* at 32, 36.

70. *Id.* at 37-38.

creditor's right of setoff.[71]

In short, McCoid makes a compelling argument that: (1) setoff is designed to resolve conflicts between a single creditor and the debtor rather than creditor versus creditor conflicts,[72] (2) setoff does not fix priorities among creditors,[73] (3) setoff does not envision the insolvency of the debtor,[74] and (4) setoff does not envision the discharge of the debtor.[75] These are among the characteristics of nonbankruptcy collection law that Warren cites as the justification for separate bankruptcy distributional rules.[76] As a result, under the traditional approach advocated by Warren, the right of setoff is a strong candidate for re-evaluation in light of bankruptcy distributional policy. This task necessarily requires one to articulate a bankruptcy distributional policy. McCoid assumes that the principle of creditor equality in bankruptcy encompasses such a policy. As noted above, however, application of this principle is compelling only if the debtor was insolvent at the time of a transfer.[77] Therefore, it is doubtful that the principle of creditor equality should control the issue of whether a creditor's right of setoff should be recognized as a basis for a secured claim. Nevertheless, McCoid's analysis does provide a solid basis for refusing to recognize the value of a right of setoff in bankruptcy.

Under the traditional approach advocated by Warren, the ultimate purpose of bankruptcy is to determine how to distribute the losses that result from the failure of an insolvent firm.[78] As applied to setoff, this approach poses the question of whether the nonbankruptcy right of setoff should shield creditors from sharing in this distribution.[79] If McCoid is correct in his analysis of the nonbankruptcy right of setoff, a strong argument can be made for requiring those creditors whose claims are subject to setoff to share the losses of an insolvent firm on a pro rata basis with unsecured creditors. Ultimately this argument rests upon the assertion that the right of setoff under nonbankruptcy collection law is not responsive to the special concerns that arise when an insolvent debtor collapses in the face of multiple creditor claims. A nonbankruptcy entitlement that does not contemplate multiple creditor claims, fix priorities, and envision a debtor's insolvency or discharge is a poor basis for a bankruptcy distributional rule. Thus, even

71. *Id.* at 38-39.
72. *Id.* at 38.
73. *Id.* at 37-38.
74. *Id.* at 38.
75. *Id.* at 39.
76. Warren, *supra* note 30, at 781-85.
77. *See supra* text accompanying notes 25-27.
78. *See* Warren, *supra* note 30, at 777.
79. *Id.* at 789-93.

without relying on the principle of creditor equality, McCoid makes a compelling argument that claims subject to setoff should not be recognized as secured claims in bankruptcy.

Before indorsing a bankruptcy distributional rule that would refuse to recognize the value of a nonbankruptcy right of setoff, one must respond to the criticism that such a rule would encourage forum shopping. Under the Baird-Jackson theory a bankruptcy rule that avoids the value of an entitlement which is valid against unsecured creditors under nonbankruptcy law provides a perverse incentive to general creditors and the debtor to file a bankruptcy petition.[80] However, the fact that a bankruptcy rule which avoids the value of a nonbankruptcy entitlement provides an incentive to file bankruptcy does not establish that this incentive is perverse. If the right of setoff should not shield a creditor from bearing a pro rata share of the losses resulting from the collapse of an insolvent firm, a bankruptcy rule avoiding the value of a right of setoff is a proper incentive to place the firm in bankruptcy.

A more significant reason to refrain from adopting a bankruptcy rule that negates a nonbankruptcy entitlement is the impact such a rule would have upon the nonbankruptcy system. Certainly a rule that avoided all Article 9 security interests in bankruptcy would disrupt the nonbankruptcy collection system and preclude the apparent efficiencies of secured credit. This disruption would result because creditors retain and perfect security interests primarily to establish priority and protect against the debtor's insolvency, which frequently results in bankruptcy. If, as McCoid claims, creditors do not rely upon the right of setoff to establish priority and protect against insolvency, a bankruptcy rule negating the value of setoff will not have a substantial adverse impact upon financing patterns established with reference to the nonbankruptcy collection system.

In summary, resolution of the issue of whether the bankruptcy law should recognize the value of a creditor's nonbankruptcy right of setoff ultimately turns upon one's view of the appropriate function of bankruptcy law. If one subscribes to the theory under which the sole function of bankruptcy law is to maximize the collective benefit to creditors as a group, a strong argument can be made in support of treating a claim as secured to the extent that it is subject to setoff. In contrast, if one accepts the view that bankruptcy law should provide distributional rules responsive to the special problems that arise upon the imminent collapse of an insolvent firm, a compelling argument can be made for refusing to recognize the value of the nonbankruptcy right of setoff. The premise for this argument, however, is not the principle of creditor equality which supports the preference provision. Rather, the argu-

80. *See* Jackson, *supra* note 54, at 730.

ment is that security in the form of setoff does not provide an adequate basis for exempting a creditor from sharing in the losses that result from the collapse of an insolvent firm.

II. THE TRUSTEE'S AVOIDING POWERS

This section of the Article addresses the second fundamental issue raised by the Code's treatment of setoff, namely whether the avoiding powers of section 553 are consistent with the policy of avoiding preferential transfers. This issue arises only if the right to setoff is recognized as a basis for a secured claim. If the law reflected the conclusion reached by Professor McCoid—that the right of setoff should not be so recognized—there would be no need to discuss the avoiding powers because the amount subject to setoff already would be part of the bankruptcy estate. I will first consider the trustee's power to avoid the right of setoff under section 553(a). I will then address the sanctions imposed under section 553(b) for the prepetition exercise of a right of setoff.

A. *The Trustee's Power to Avoid the Right of Setoff*

McCoid's assertion that the Code's treatment of setoff is inconsistent with the principles of creditor equality is more compelling if one considers the provisions of section 553(a), which empower the trustee to avoid a right of setoff created while the debtor was insolvent. Subsections 553(a)(2) and (3) provide for the avoidance of a right to setoff created while the debtor was insolvent and within the ninety day period prior to commencement of a bankruptcy case.[81] The later subsection is effectively a preference provision because it addresses the avoidance of a right to setoff that secures an antecedent debt. Under section 553(a)(3) the trustee can avoid a creditor's right of setoff to the extent that the creditor incurred its debt to the debtor within ninety days prior to the commencement of the case, while the debtor was insolvent, and for the purpose of obtaining a right of setoff against the debtor. By conditioning the trustee's power to avoid a preferential setoff upon establishing that the creditor's purpose in incurring the indebtedness to the debtor was to obtain a right of setoff, section 553(a)(3) deviates from the principle of creditor equality.[82]

Historically, the dominant rationale for the avoidance of preferential transfers has been the principle of creditor equality.[83] Under this

81. For the text of § 553, see *supra* note 3.
82. *See infra* text accompanying notes 88-91.
83. *See* McCoid, *supra* note 13, at 260.

principle unsecured creditors of an insolvent debtor should share equally in the estate of an insolvent debtor through a pro rata distribution.[84] This distributional rule rests upon a basic notion of equity jurisprudence under which the assets of an insolvent debtor are held in trust for all unsecured creditors.[85] The event that triggers the application of the pro rata distributional rule is the insolvency of the debtor.[86] Because the insolvency of a debtor typically occurs prior to the commencement of a bankruptcy case, a preference provision is necessary to ensure that prepetition transfers do not distort the equitable distribution of an insolvent debtor's assets.[87]

A preference provision designed to give effect to the principle of creditor equality would not condition avoidance upon a creditor's purpose or state of mind in accepting a preferential transfer.[88] For example, as Professor Tabb establishes, a preference provision designed to implement a policy of creditor equality would not recognize an ordinary course exception to avoidance.[89] Tabb reasons that the evil of a preference is that it distorts the equitable distribution of an insolvent debtor's assets. This distortion occurs whether the creditor sought the transfer because it was aware of the debtor's impaired financial condition or accepted the transfer in the ordinary course.[90]

A simple illustration will demonstrate that section 553(a)(3) is not true to the principle of creditor equality.

> *Illustration 2* - On January 10, Bank made an unsecured loan to Debtor of $10,000. On April 1, and while insolvent, Debtor opened a deposit account at Bank with a deposit of $5000. On April 10, Debtor filed for relief under Chapter 7 listing the $5000 balance in its deposit account as its sole asset.

The effect of the April 1 deposit was to grant Bank a right of setoff which if recognized in bankruptcy will prefer Bank over the other unsecured creditors of Debtor. Moreover, recognizing this right of setoff will offend the principle of creditor equality because the right was

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84. *See* Tabb, *supra* note 13, at 987 & n.20.

85. *See id.* at 991-92.

86. *Id.* at 993.

87. *See* McCoid, *supra* note 13, at 260-61; Tabb, *supra* note 13, at 989.

88. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 178 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139 ("[A] creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution . . . ."); *see also* Countryman, *supra* note 13, at 748 ("The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution [which preserves equality within classes of creditors]. Transfers that do distort this policy do so without regard to the state of mind of either the debtor or the preferred creditor.").

89. Tabb, *supra* note 13, at 994.

90. *Id.* at 992.

created while Debtor was insolvent. As a result, under the principle of creditor equality the right of setoff should be avoidable. Under section 553(a)(3), however, the trustee can avoid Bank's right of setoff only if the trustee can prove that Bank accepted the April 1 deposit for the purpose of obtaining a right of setoff. If Bank accepted the deposit in the ordinary course, the preferential right of setoff is not avoidable. Bank, however, is effectively preferred in Illustration 2 whether it accepted the deposit for the purpose of obtaining a right of setoff or in the ordinary course. As discussed below, by conditioning avoidance upon establishing that Bank obtained the deposit for the purpose of obtaining security through a right of setoff, section 553(a)(3) appears to implement a deterrence theory of preference avoidance.[91]

To assert that section 553(a)(3) is inconsistent with the principle of creditor equality—the dominant rationale for the preference provision—does not establish that the provision is inconsistent with section 547 as currently enacted. For example, in Illustration 2, if Debtor had paid Bank $5000 on April 1 rather than opening a deposit account, the avoidability of the payment as a preference would turn on Bank's state of mind. The payment would clearly be a preference under section 547(b); however, Bank would have a potential defense under section 547(c)(2).[92] If Bank could establish that the payment was made and accepted in the ordinary course, Bank would be entitled to retain the benefit of the preferential payment. Thus, it appears that the policy underlying section 553(a)(3) may be the same as the policy underlying section 547.[93] That both section 553(a)(3) and section 547(c)(2) recognize an ordinary course exception to the avoidance of preferences does not establish that, as a normative matter, the exceptions are proper.

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91. *See infra* text accompanying notes 94-98, 100-07.

92. 11 U.S.C. § 547(c)(2) (1988). Section 547(c)(2) provides:

> (c) The trustee may not avoid under this section a transfer—
>
> . . .
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

Id.

93. One could challenge this conclusion by varying the illustration to assume that the preferential transfer consisted of granting a perfected security upon Debtor's equipment. This transfer would be a preference under § 547(b) and not subject to the ordinary course exception of § 547(c)(2). This variation suggests that the policy underlying § 547(b) may be equality. In response, however, one can assert that the purpose of taking a lien to secure an antecedent debt is always to obtain security. Thus, § 547(b) in the variation is consistent with § 553(a)(3). Both provisions effectively condition avoidance upon the creditor's purpose or state of mind.

Rather, if, as Professor Tabb has persuasively argued, the ordinary course exception of section 547(c)(2) is improper because it offends the principle of equality, the purpose limitation of section 553(a)(3) also appears improper.

By conditioning the avoidance of a right to setoff upon the creditor's purpose in incurring a debt to the debtor, section 553(a)(3) sanctions only those creditors who intentionally sought to obtain security during the prebankruptcy period of insolvency. Therefore, as suggested above, section 553(a)(3) appears to implement a policy of deterring creditors from knowingly extracting preferences from a financially impaired debtor. Deterrence is frequently advanced as an alternative rationale for the avoidance of preferences.[94] As traditionally asserted, however, the deterrence analysis rests upon the foundation of the principle of creditor equality.[95] The deterrence analysis is based upon the premise that preferences are objectionable because they distort the equitable distribution among the creditors of an insolvent debtor. Because preferences are objectionable, they should be deterred. The analysis then posits that a bankruptcy rule which requires creditors to disgorge any benefit received in a preferential transfer tends to deter creditors from extracting transfers from a financially distressed debtor.[96] The preference rule can be effective to deter prebankruptcy collection actions only if it is used against creditors who are aware of the debtor's financial condition.[97] To this point the deterrence analysis is unobjectionable because it merely describes the limited deterrent effects of a preference rule. It certainly does not provide an independent rationale for avoiding preferences.

The traditional deterrence analysis falters at its next step. Because only creditors with knowledge of the debtor's insolvency can be deterred from extracting preferences, the theory posits that preferences should be recoverable only from those creditors who were aware of the debtor's financial condition at the time of the transfer. This deduction is totally unfounded. If a preference is bad because it distorts the equal distribution of an insolvent debtor's estate, it is bad whether or not the preferred creditor knew the debtor was insolvent.[98] By elevating a collateral consequence of the preference rule to an independent rationale, the traditional deterrence analysis undercuts its own foundation.

If one accepts the principle of creditor equality as the foundation

94. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 177 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138.

95. *See* McCoid, *supra* note 13, at 263.

96. *Id.*

97. *Id.*

98. *See* Countryman, *supra* note 13, at 748; Tabb, *supra* note 13, at 992.

of preference policy, some justification other than deterrence must explain the protection afforded innocent creditors. For example, perhaps there is a value realized in excepting ordinary course payments from avoidance that outweighs the impairment to the principle of creditor equality.[99] The conclusion that protecting innocent creditors impairs the principle of equality, however, appears inescapable. In contrast, if preference theory rests on a foundation other than equality, then deterrence may be a viable rationale for avoiding only those preferences that result from unusual collection actions by knowledgeable creditors.

Baird and Jackson's theory of bankruptcy rejects the principle of creditor equality as a justification for the avoidance of preferences.[100] Rather, they view the sole function of the preference provision as deterring prepetition collection actions that impair the goal of maximizing the collective benefit to creditors.[101] Baird and Jackson posit that insolvency typically precedes bankruptcy and that creditors of a debtor will become aware of the insolvency at differing times. In the absence of a preference rule, it would be in the individual interest of each creditor to press for immediate payment upon learning of the debtor's insolvency.[102] Baird and Jackson, however, perceive a problem with unrestrained creditor actions against an insolvent debtor. The problem is not that diligent or otherwise knowledgeable creditors will be paid to the exclusion of other creditors, for Baird and Jackson are largely unconcerned with the rules of distribution.[103] Rather, the problem from Baird and Jackson's perspective is that the diligent creditors will remove crucial assets from the common pool of debtor assets and destroy the remaining value of the firm.[104] In so doing, the diligent creditors will benefit, but the creditors as a group will suffer. Baird and Jackson view preference law as a solution to the prepetition common pool problem.[105] By providing a rule that requires creditors to disgorge preferences, bankruptcy law deters creditor actions that impair the collective value of the estate.[106]

Unlike the traditional analysis, under which deterrence is merely a

99. *See* Tabb, *supra* note 13, at 1021-26 (considering and rejecting the argument that the ordinary course exception is justified because it provides an incentive to creditors to extend credit to financially distressed debtors).

100. *See* JACKSON, *supra* note 14, at 125-26; *see also* BAIRD, *supra* note 14, at 156 (asserting that the policy behind the preference provision is to deter last minute grabs by creditors that interfere with the norms of a collective proceeding).

101. *See* JACKSON, *supra* note 14, at 125-26, 128.

102. *See id.* at 125.

103. *See* Baird, *supra* note 29, at 819-20.

104. *See* JACKSON, *supra* note 14, at 124-25, 128.

105. *Id.* at 125.

106. *See id.* at 138.

consequence of a preference rule designed to effectuate creditor equality, deterrence is the sole function of a preference rule under Baird and Jackson's theory. As a result, it is logical that preferences should be recoverable only from those creditors whose actions a preference rule could deter.[107] In other words, only those creditors who were aware of the debtor's impaired financial condition and nevertheless resorted to individual collection remedies should be required to disgorge the benefit of a preferential transfer.

Baird and Jackson's analysis appears reasonable if one assumes that an unsecured creditor physically levies upon an essential piece of equipment of an insolvent debtor engaged in manufacturing. The levy deprives the debtor of use and possession of the equipment and may cripple the firm. Under these facts the benefit to the levying creditor may well be outweighed by the loss to creditors as a group. A preference rule that deterred the levy would therefore advance the goal of maximizing the collective value of the debtor's property for the benefit of all creditors.

The analysis is less persuasive if an unsecured creditor obtains and perfects a nonpossessory security interest upon the essential piece of equipment. Although the action allows the creditor to obtain a preference over other creditors, it does not withdraw the equipment from the pool of assets that the debtor can use in its business. Therefore, the retention of the security interest does not impair in a meaningful manner the value maximization goal.[108]

A further flaw in the Baird-Jackson deterrence analysis is that a

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107. *See id.* at 130.

> In principle, a bankruptcy statute's section on voidable preferences should basically read as follows: "If a creditor tries to change his position after the extension of credit in order to improve his lot in an anticipated bankruptcy (or other collective) proceeding, or if the debtor at the behest of such creditor so tries to change the position for such creditor in order to improve such creditor's lot in an anticipated bankruptcy (or other collective) proceeding, the creditor must return any advantage so obtained." Such wording would most accurately reflect the policies that shape a preference section.

Id.

108. Baird admitted this inconsistency in his analysis of preference policy.

> [O]ne can argue that taking a security interest should not be treated the same way as a naked seizure of assets because taking a security interest only affects how the pie is divided among creditors. It does not actually destroy value in the same way that seizure of assets does.

BAIRD, *supra* note 14, at 164 n.183.

Jackson argued that the taking of a perfected security interest on the eve of bankruptcy to secure an insolvent debtor's antecedent debt does impair the goal of collective value maximization because the "additional costs to the creditors both, in the race itself and in the dispersion of outcomes, . . . reduce the *net* collective value of the pool of assets." JACKSON, *supra* note 14, at 128.

typical preference provision does not sanction many forms of creditor conduct that effectively remove assets from the pool of debtor property available to an insolvent debtor and its unsecured creditors. For example, the enforcement of a perfected and nonpreferential security interest is not a preference even though the secured party repossesses the collateral and deprives the debtor of use and possession. One can argue, however, that subjecting repossessions to the preference rule is not necessary to preserve the value of the collateral for the collective benefit of the creditors. If the collateral is repossessed, the debtor or the unsecured creditors could commence a Chapter 11 case and obtain a turnover of the collateral to the debtor upon providing adequate protection to the secured party.[109] However, if enforcement of the security interest had progressed beyond repossession of the collateral to its sale prior to bankruptcy, the turnover provision would not be available to the debtor and its unsecured creditors. The only method to recover the benefit of the collateral for the unsecured creditors would be to prevail in a highly controversial *Durrett* fraudulent conveyance action.[110] Absent a valid fraudulent conveyance action, the collateral would be beyond the reach of unsecured creditors even though the enforcement of the security interest injured the creditors as a group.

Thus, the Baird-Jackson deterrence rationale for the avoidance of preferences is not persuasive. Their rationale fails to explain why certain preferential transfers, such as the retention of a perfected nonpossessory security interest to secure an antecedent debt, are avoidable. Moreover, under their rationale certain transactions that are not preferences, such as the enforcement of a security interest, should be avoidable. If a preference statute were to give effect to the Baird-Jackson theory, it would bear little resemblance to the current statute.

In summary, since neither the traditional nor the Baird-Jackson deterrence analysis supports a deviation of the principle of creditor equality, it appears that the ordinary course exception of section 553(a)(3) is unjustified. As a result, the "purpose of obtaining a right to setoff" condition upon avoidance of preferential setoffs should be repealed.

Repealing the "for the purpose of obtaining a right of setoff" condition upon the trustee's section 553(a)(3) avoiding power draws another aspect of the provision into focus. Section 553(a)(3), unlike section 553(b), makes no allowance for fluctuations in the amounts of the mutual debts between the debtor and creditor during the ninety day period prior to bankruptcy. A creditor deprived of its ordinary course exception to avoidance under section 553(a)(3) may view this omission

109. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198 (1983).
110. *See* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

with understandable alarm. To illustrate this problem, consider the following:

> *Illustration 3* - On January 10, Debtor was indebted to Bank in the amount of $10,000 evidenced by an unsecured note. Debtor maintained a checking account at Bank, and on January 10, the balance in this account was $8000. The balance in the account remained constant until March 31 when Debtor withdrew $5000. On April 5, and while insolvent, Debtor deposited $2000 into the account which Bank accepted in the ordinary course of business. On April 10, Debtor filed under Chapter 7 owing Bank $10,000 and with a balance in its checking account of $5000.

As currently enacted the Code would recognize Bank's right of setoff by affording Bank a secured claim of $5000. The trustee would be precluded from avoiding the right of setoff to the extent of $2000 because Bank did not accept the April 5 deposit for the purpose of obtaining a right of setoff. Under the proposed amendment deleting section 553(a)(3)(C), however, the trustee could avoid the right of setoff to the extent of $2000. The wisdom of such a result appears at least debatable because Bank did not improve its position during the preference period. On January 10, Bank had a secured claim of $8000, and on April 10, its secured claim could not exceed $5000.

If the amounts of the mutual debts between a debtor and a creditor are subject to fluctuation, as appears likely in the case of a customer and a creditor bank, an argument can be made that section 553(a)(3) should be further amended to include a two point in time test comparable to that provided under sections 553(b) and 547(c)(5).[111] Under such a rule the right to setoff would be avoidable only to the extent of an improvement in the creditor's position as measured by the two points in time. If the provision specified the date of filing and the date ninety days prior to filing as the two points in time, Bank's right of setoff in Illustration 3 would be unavoidable.

Interestingly, H.R. 8200, the House version of the Bankruptcy Reform Act of 1978, included an improvement in position test similar to that proposed herein.[112] Under section 553(a)(4), as proposed in H.R.

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111. 11 U.S.C. §§ 553(b), 547(c)(5) (1988).

112. Section 553(a)(4) of H.R. 8200, which was reported on September 8, 1977, provided that a right of setoff was unaffected except to the extent that,

> (4) the amount that may be offset under this section on the date of the filing of the petition exceeds the amount that may have been offset if the case had been commenced on the later of—
>
> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date on which both such debt and such claim were owing.

H.R. 8200, 95th Cong., 1st Sess. § 553(a)(4) (1977), *reprinted in* 12 BANKRUPTCY REFORM

8200, a trustee could avoid a right of setoff to the extent that the amount that could be offset, *i.e.*, the debt owed to the debtor, on the date of filing exceeded the amount that could have been offset ninety days prior to the filing. There are problems with the technical application of this provision because it does not take into account variations in the amount owed to the creditor. Nevertheless, it provided for the avoidance of an increase in the value of a right of setoff during the period immediately prior to bankruptcy without reference to the purpose or state of mind of the creditor.

If we return to Illustration 3, section 553(a)(4), as set forth in H.R. 8200, would effectuate the result herein advocated. Even though an ordinary course exception does not protect Bank's right of setoff the improvement in position provision would. On the ninetieth day prior to bankruptcy the insufficiency of $2000 was less than the $5000 insufficiency on April 10. Therefore, under section 553(a)(4) the right of setoff would not be voidable.

In H.R. 8200 the improvement in position provision of section 553(a)(4) stood alongside section 553(a)(3) in its current form. Under H.R. 8200, however, the role of section 553(a)(3) was limited. It would have applied only in cases in which there was no improvement in position under the two points in time test under subsection (a)(4) and in which the indebtedness to the debtor was incurred within the ninety day period prior to filing, while the debtor was insolvent, and for the purpose of obtaining a right of setoff. Returning once again to Illustration 3, assume that the balance in Debtor's account was $8000 on January 10, but had been reduced to $3000 by March 31. Assume further that on April 5, and while Debtor was insolvent, Bank elicited a $2000 deposit from Debtor for the purpose of obtaining a right of setoff. Finally, assume that this deposit increased the balance in the account to $5000 and that there was no further activity in the account prior to the April 10 bankruptcy filing.

Under H.R. 8200 the trustee could not recover under section 553(a)(4) because there was no improvement in position under the two points in time test. Nevertheless, because Bank incurred the April 5 indebtedness to Debtor for the purpose of obtaining a right of setoff, the trustee could avoid Bank's right under section 553(a)(3) to the extent of $2000. This result raises two issues. First, should individual deposits during the ninety day period prior to bankruptcy be avoidable when there is no net improvement in position during that period? Second, assuming that individual deposits are avoidable, should their avoidability depend upon Bank's purpose in accepting the deposit?

ACT OF 1978: A LEGISLATIVE HISTORY 432 (Alan N. Resnick & Eugene M. Wypyski eds., 1979).

I would dispose of the problem by concluding that the individual deposits should not be voidable. In part, this position rests upon the assumption that the right of setoff is recognized as a secured claim in bankruptcy because the right bears some relation to security. As discussed above, this assumption is, at best, debatable.[113] Nevertheless, if the right of setoff is security, it appears comparable to inventory and accounts in that there is likely to be a constant flow of deposits and withdrawals. If the right of setoff is comparable to such collateral, then the extent of setoff avoidance also should be comparable. Under section 547(c)(5) fluctuations during the preference period are ignored for administrative purposes.[114] If the rough justice of section 547(c)(5) is acceptable with respect to transfers of security interests in inventory and accounts, then such a provision should be acceptable if applied to setoff. Moreover, if a two point in time test did not preempt the avoidance of setoff, it would appear that a provision comparable to the new value exception in section 547(c)(4)[115] would have to be adopted to address a bank's extension of new value after receiving a deposit that triggers avoidance under 553(a)(3). Because new value in this context would presumably include allowing the debtor to withdraw deposited funds,[116] the end result might well be the equivalent of a two points in time test and certainly would be cumbersome.

Thus, section 553(a)(3) should be further amended to limit the trustee's power to avoid a right of setoff to the extent debts incurred by the creditor during the preference period improved the creditor's position as measured by a two points in time test similar to that of sections 547(c)(5) and 553(b). Under this proposal the amount by which a creditor's claim exceeded the debt it owed to the debtor would be determined on the date of bankruptcy and the later of ninety days prior to the bankruptcy filing or the first date on which the mutual debts were owing. To the extent that the debts incurred by the creditor to the debtor reduced the amount by which the creditor's claim exceeded the mutual debt to the debtor, the right of setoff would be avoidable.

In summary, section 553(a)(3) should be amended to delete the "for the purpose of obtaining a right of setoff" condition upon avoidance and to limit the trustee's recovery to the net amount by which debts incurred by the creditor during the preference period increased

113. *See supra* text accompanying notes 60-77.

114. *See* 11 U.S.C. § 547(c)(5) (1988); *cf.* Countryman, *supra* note 13, at 824.

115. 11 U.S.C. § 547(c)(4) (1988). *See generally* Countryman, *supra* note 13, at 781-90.

116. *See* 11 U.S.C. § 547(a)(2) (1988) (stating that new value includes a release of collateral).

the creditor's right of setoff. If these proposals are adopted, section 553(a)(3) would give effect to the principle of creditor equality.

B. *The Trustee's Power to Avoid the Exercise of a Right of Setoff*

Perhaps the most controversial provision in section 553 is the avoiding power in subsection (b).[117] Section 553(b) empowers the trustee to avoid a creditor's prepetition exercise of an otherwise unavoidable right of setoff to the extent that the difference between the amount of the creditor's claim and the debt owed to the debtor was reduced under a two points in time test. An array of technical criticisms can be levelled at section 553(b).[118] For example, its application to nonbank creditors is problematic,[119] its two point in time test is arbitrary,[120] and it fails to address adequately the situation in which the reduction in the insufficiency between the amount of the creditor's claim and the debt to the debtor resulted from preferential payments.[121] I am not, however, concerned with these mechanical problems. Rather, my concern is with the basic purpose of the provision, which is to deter creditor banks from exercising an otherwise unavoidable right of setoff against the deposit account of a financially distressed debtor.[122]

To assist in the analysis of section 553(b) consider the following relatively noncontroversial illustration of its application:

> *Illustration 4* - On January 10, Debtor was indebted to Bank in the amount of $10,000 on an unsecured note payable on March 31. Debtor maintained its general checking account at Bank, and on January 10, the balance in the account was $5000. As a result of deposits made while Debtor was insolvent and accepted by Bank in the ordinary course and not for the purpose of obtaining a right of setoff, the balance in Debtor's checking account on April 1 was $8000. Debtor failed to pay the note when due, and on April 1, Bank exercised its right of setoff, applying the $8000 balance in the checking account towards satisfaction of the $10,000 note. On April 10, Debtor filed for relief under Chapter 7.

Under the facts of Illustration 4, the trustee cannot attack Bank's

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117. For the text of § 553(b), see *supra* note 3.

118. *See* Morris G. Shanker, *The Unsettled Setoff Right in Bankruptcy: A Critique of Statutory Lotteries in and the Braniff-Exxon Dogfight Over § 553*, 1988 ANN. SURV. BANKR. L. 103.

119. *Id.* at 112-15.

120. *Id.* at 108-10.

121. *See* Braniff Airways, Inc. v. Exxon Co., U.S.A., 814 F.2d 1030 (5th Cir. 1987); Shanker, *supra* note 118, at 117-20.

122. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 186 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6146.

right of setoff under section 553(a)(3) because it is stipulated that Bank did not accept the deposits and incur its debt to Debtor for the purpose of obtaining a right of setoff. As a result, if Bank had refrained from exercising its right of setoff and Debtor had filed under Chapter 7 on April 10 without withdrawing its funds from the checking account, Bank would have had an allowed secured claim of $8000.[123] Bank's decision to exercise its right of setoff, however, triggered section 553(b). Because the insufficiency between Bank's claim and its indebtedness was $5000 ninety days prior to the bankruptcy filing and $2000 on the date of setoff, the trustee is entitled to recover $3000 from Bank under section 553(b).

The most controversial aspect of section 553(b) is that the enforcement of an otherwise unavoidable right triggers a recovery for the trustee.[124] The provision is clearly at odds with the notion that the enforcement of a nonpreferential security interest does not constitute a preference. The purpose behind section 553(b), however, is clear. Congress believed that a bank's exercise of its right of setoff against a debtor's general deposit account frequently triggers a bankruptcy proceeding that injures both the debtor and its unsecured creditors.[125] Congress therefore enacted section 553(b) to deter banks from exercising their right of setoff against the deposit accounts of financially distressed debtors. Moreover, in contrast to section 547, the sanction imposed by section 553(b) is substantial. 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.[126] In contrast, under section 553(b) a creditor who exercises a right of setoff, such as Bank in Illustration 4, may well be in worse shape than if it had refrained from exercising its right.

Section 553(b) is striking in that it conforms to the deterrence theory advanced by Baird and Jackson as the foundation for preference policy. Congress enacted the setoff avoidance provision to deter actions by individual creditors that injure creditors as a group by withdrawing an essential asset from the debtor's pool of assets. An issue presented, however, is whether there are less draconian means available to achieve the laudable goal posited by the Baird-Jackson theory. A partial answer is that if section 553(a)(3) were amended so as to delete the "purpose of obtaining a right of setoff" condition and to include the two

123. *See* 11 U.S.C. § 506(a) (1988).

124. *See* Shanker, *supra* note 118, at 107-10.

125. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 186 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6146.

126. *See* McCoid, *supra* note 13, at 264.

points in time test proposed above, section 553(b) would not be necessary to avoid an improvement in position resulting from debts incurred by the creditor during the ninety day preference period and while the debtor was insolvent. Such an amendment, however, would avoid the improvement in position to further the principle of creditor equality and only indirectly deter creditor conduct. Moreover, the creditor conduct deterred would be the obtaining rather than the exercising of a right of setoff. More significantly, the proposed amendments to section 553(a)(3) would not ensure that the purpose of section 553(b) would be realized. For example, if the deposits in Illustration 4 were made while Debtor was solvent, the improvement in position would not be avoidable under the proposed modification of section 553(a)(3). Nevertheless, Bank's exercise of its right of setoff would deprive Debtor of an essential asset, thereby frustrating the purpose of section 553(b).

Because the injury to a debtor and its unsecured creditors that results from a creditor's exercise of its right of setoff does not depend upon whether that right is avoidable, expanding the avoidability of the right of setoff cannot prevent the injury. Section 553(b) seeks to avoid the injury resulting from the exercise of a right of setoff by imposing a sanction against the creditor in a subsequent bankruptcy. If the threat of section 553(b)'s sanction does deter the creditor from setting off, the purpose of the provision is realized. In many cases, however, section 553(b) will not deter a setoff because during the descent into bankruptcy, the balance in the debtor's account typically declines, thereby precluding an improvement in position. Moreover, if the creditor sets off despite the threat of the sanction, the potential section 553(b) recovery does little to cure the injury caused by the creditor's conduct. In realistic terms what the debtor and the unsecured creditors need is prompt access to the entire deposit account against which a creditor bank has exercised its right of setoff, not the possibility of ultimately recovering a judgment under section 553(b) for the amount by which the bank has improved its position.

A potentially more efficient means to realize the purpose of section 553(b) would be to entitle the trustee or debtor in possession to obtain a turnover of the bank account that is subject to prepetition setoff, upon granting the creditor bank adequate protection. In essence, the bank account subjected to a prepetition setoff would be treated as cash collateral. 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. Therefore, an avoiding power is necessary. If the Code provided that a prepetition setoff could be reversed, with the effect that the creditor retained a secured claim upon the indebtedness, the avoiding power of section 553(b) would be unnecessary. For example, assume that the deposit of $3000 in Illustration 4, which increased the balance in the checking

account to $8000, was made while the debtor was solvent. Even under the proposed amendment to section 553(a), this improvement in position would not be avoidable. However, Bank's decision to setoff on April 1 would still have a pronounced effect upon Debtor and it's unsecured creditors. The solution of section 553(b) is to seek to deter such conduct by sanctioning Bank to the extent of the reduction in the insufficiency. The solution proposed herein is to reverse the setoff and treat the $8000 balance in the deposit account as cash collateral which Debtor can use upon providing adequate protection. The proposed solution would provide Debtor and its unsecured creditors meaningful protection against the consequences of Bank's decision to exercise its right of setoff, without depriving Bank of the value of its nonpreferential right. Again, the solution advanced herein is not novel. H.R. 8200 also addressed the problem of the exercise of a right of setoff against a financially distressed debtor in a manner similar to that advocated herein. The relevant provision was section 547(c)(6),[127] which excepted from avoidance as a preference the exercise of an otherwise unavoidable right of setoff if the setoff was made more than five days prior to bankruptcy or the trustee could not use the property recovered under section 363. This provision would have enabled the trustee to avoid the exercise of a nonpreferential right of setoff if the right was exercised within five days prior to bankruptcy and the trustee provided adequate protection for using the recovered cash collateral.[128]

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127. H.R. 8200, § 547(c)(6), exempted from avoidance the prepetition exercise of a right to setoff,

> (6) to the extent that—
>
> (A) such transfer was a setoff of a debt owing to the debtor against a claim against the debtor;
>
> (B) any right to offset such debt against such claim would not have been affected by section 553 of this title if such setoff occurred after the commencement of the case; and
>
> (C)(i) such transfer was made before five days before the date of the filing of the petition; or
>
> (ii) the trustee may not use, sell or lease, under section 363 of this title, any property recovered as a result of the avoidance of such transfer.

H.R. 8200, 95th Cong., 1st Sess. § 547(c)(6) (1977), *reprinted in* 12 BANKRUPTCY REFORM ACT, *supra* note 112, at 423.

128. The House Report describes the operation of § 547(c)(6) as follows:

> Different treatment of setoff that occurs prepetition and post-petition may generate problems for insolvent debtor [sic]. If the restrictions placed on postpetition setoff are greater than those placed on prepetition setoff, there is an incentive for creditors with a right of setoff, especially banks, to offset during a period of financial difficulty of the debtor, rather than continuing to carry the debtor in hopes that matters will improve. Thus, whatever limitations are adopted for postpetition setoff, it is important to apply them to prepetition setoff as well. If they are not applied equally, a creditor may attempt to avoid

There were problems with section 547(c)(6) as set forth in H.R. 8200, not the least of which was why the exercise of an unavoidable right to setoff was a preference under section 547(b). Moreover, by conditioning the exception to avoidance upon bankruptcy being filed within five days after the setoff, the provision virtually assured that all bank setoffs would trigger bankruptcies. Despite these defects, the provision reflected the meritorious policy decision that a debtor should be able to use funds subjected to a prepetition exercise of a right of setoff upon providing the creditor adequate protection. If a comparable provision were now codified in section 363, the need for section 553(b) would be eliminated. Moreover, such a provision would respond to the injury actually caused by the exercise of a bank's right of setoff, which is the loss of use of the entire deposit account. Such a provision would also treat the bank fairly by recognizing the value of its right of setoff through adequate protection, rather than imposing the unpredictable sanction of section 553(b). Finally, such a provision might deter the exercise of setoff rights, and hence a resulting bankruptcy, more effectively than section 553(b) because it provides a predictable framework upon which to structure a workout.

III. CONCLUSION

In this Article I have attempted to analyze the provisions of the Bankruptcy Code that govern the recognition of a creditor's nonbankruptcy right of setoff in light of some of the leading contemporary theories of bankruptcy policy. Initially, I argued that the principle of creditor equality ought not determine whether the right of setoff should be recognized as a basis for a secured claim. Although the principle of creditor equality governs the distribution of an insolvent debtor's assets in a collective proceeding and provides the dominant basis for recovering preferential transfers made by an insolvent debtor, it does not provide valid grounds for avoiding a right of setoff that

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> the postpetition limitations by offsetting prepetition, perhaps precipitating the bankruptcy of the debtor.
>
> The bill accomplishes this result by permitting the trustee to avoid any setoff that occurs less than five days before bankruptcy. However, the avoiding power is limited by the same adequate protection standard as governed postpetition setoffs. That is, the trustee may not recover unless he provided adequate protection to the person asserting the right of setoff. The result is to encourage business workouts, by discouraging precipitous action. If a bank offsets, it will force the bank's debtor into bankruptcy, to everyone's disadvantage, so that the debtor will be able to avail himself of the avoiding power to recover the setoff.

H.R. REP. No. 595, 95th Cong., 1st Sess. 186 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6146-47.

arises when a debtor is solvent. As a result, I argued that creditor equality does not provide a compelling basis for a rule that would preclude recognition of a prepetition right of setoff.

I then argued that whether the Code should recognize the right of setoff as a basis for a secured claim depends upon whether one views bankruptcy as serving the sole function of maximizing the collective benefit to creditors as opposed to serving the primary function of distributing losses upon the collapse of an insolvent firm. If one adopts the former view, the Code's recognition of the value of setoff is defensible. In contrast, if one adopts the more traditional latter view, the Code's treatment of setoff as security is at least debatable.

I then analyzed the provisions governing the trustee's power to avoid the prepetition creation and exercise of a nonbankruptcy right of setoff in light of the debate over the policies that should underlie the avoidance of preferential transfers. This debate pits the principle of creditor equality against the policy of deterrence. I noted that section 553(a)(3) effectively embraces the deterrence theory by conditioning the trustee's power to avoid a right of setoff upon establishing that the creditor incurred a debt to the debtor for the purpose of obtaining a right of setoff. Finding the principle of creditor equality a more compelling basis for the preference policy, I concluded that the creditor's state of mind condition imposed under section 553(a)(3)(C) should be repealed.

Finally, I considered the trustee's power to avoid a prepetition exercise of an otherwise unavoidable right of setoff. Although this provision appears to conform to the deterrence theory for avoiding preferences, on closer examination I concluded that the deterrence theory does not provide an adequate justification for the provision. Moreover, I concluded that the goal of section 553(b) could be more effectively realized by affording the debtor the right to use a bank account, or other indebtedness, against which a creditor had exercised an unavoidable right of setoff, if the debtor provides adequate protection to the creditor. As a result, I advocated the repeal of section 553(b) and the adoption of a provision that would treat an indebtedness subjected to a prepetition exercise of a right of setoff as cash collateral.