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Introduction

Setoff is the principle of allowing a party to reduce the debt it owes to an entity by applying a credit for any claim it has against the same entity.¹ The purpose of setoff rights is rooted in “avoiding the absurdity of making A pay B when B owes A.”² It is meant to be used by debtors as affirmative defenses or counterclaims.³ Section 553 of title 11 of the United States Code (the “Bankruptcy Code”) generally preserves the right of setoff in bankruptcy cases.⁴

This memorandum explores how and when foreign debtors and representatives may exercise setoff rights in cases recognized under Chapter 15 of the Bankruptcy Code. Part I outlines the recognition process in the U.S. under Chapter 15, and how setoff is asserted. Part II highlights considerations courts have given foreign representatives in allowing or denying an assertion of setoff. Part III explores an exception to disallowing foreign representatives to assert

¹ *In re Delta Air Lines*, 359 B.R. 454, 465 (Bankr. S.D.N.Y. 2006) (“[T]he right of setoff refers to a situation where two parties have mutual claims against and debts owing to each other.”).

² *Pereira v. United Jersey Bank, N.A.*, 201 B.R. 644 (S.D.N.Y. 1996).

³ See *In re Rancher's Legacy Meat Co.*, 630 B.R. 308 (Bankr. D. Minn. 2021).

⁴ 11 U.S.C. § 553 (2018).

setoff rights that derive from debts incurred specifically for the purpose of asserting setoff rights in future proceedings.

Discussion

I. Process of Foreign Representatives Asserting Setoff Rights

Chapter 15 is the United States' adoption of the Model Law on Cross-Border Insolvency, aimed to "[represent] a culmination of a long-standing effort by the United States and other countries to develop a uniform system."⁵ A "foreign representative" is defined under Chapter 15 as a "person or body . . . authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets . . . or to act as a representative of such foreign proceeding."⁶ A foreign representative files a petition for recognition with the U.S. court to have their foreign proceeding officially recognized.⁷ The court then conducts a three-prong analysis to determine if recognition is warranted.⁸ The burden is on the foreign representative to prove the foreign proceeding exists.⁹ Upon recognition of a foreign proceeding under Chapter 15, the foreign representative may appear in any court in the United States and may utilize common, state, or federal laws to, among other things, assert their setoff rights.¹⁰

The Bankruptcy Code covers setoffs in section 553, specifying the "right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of

⁵ *In re Condor Ins. Ltd.*, 601 F.3d 319, 322 (5th Cir. 2010).

⁶ 11 U.S.C. § 101(24).

⁷ *See id.* § 1515.

⁸ *See id.* § 1517. The requirements under section 1517 for a foreign proceeding to be recognized are:

- (1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;
- (2) the foreign representative applying for recognition is a person or body; and
- (3) the petition meets the requirements of section 1515.

⁹ *See In re Ashapura Minechem Ltd.*, 480 B.R. 129, 136 (S.D.N.Y. 2012).

¹⁰ *See* 11 U.S.C. § 1502(7); *see also In re Vitro S.A.B. de CV*, 701 F.3d 1031 (5th Cir. 2012) (describing recognition as a federal court's "acknowledgment of the validity of the foreign proceeding").

the case . . . against a claim of such creditor against the debtor.”¹¹ Section 103 of the Bankruptcy Code provides which sections of the Bankruptcy Code are made applicable to its chapters.¹² It does not make section 553 applicable to Chapter 15 cases.¹³ However, because section 553 is not explicitly excluded from Chapter 15 under section 1521(a)(7), courts have held the section applicable to Chapter 15 cases.¹⁴

The Bankruptcy Code does not create a right of setoff.¹⁵ Section 553 preserves setoff rights, as well as other setoff rights that are available by law.¹⁶ Accordingly, rights of setoff that exist elsewhere in both foreign and domestic law are preserved and applied when pertinent.¹⁷ A debtor asserts their equitable right to setoff for mutually offsetting debts under section 553.¹⁸

When there are conflicting laws between the jurisdictions involved, a court will conduct a choice of law analysis.¹⁹ A conflict exists when the applicable laws provide “different substantive rules in each jurisdiction that are ‘relevant’ to the issue at hand’ and have a ‘significant possible effect on the outcome of the trial.’”²⁰ In *Tongyang, Inc. v. Tong Yang Am., Inc.*, when faced with a conflict between New York and South Korean law regarding setoffs, the New York State Supreme Court analyzed “which State [had] ‘the most significant relationship to the transaction and the parties,’ [as well as] the location of the subject matter and the domicile or

¹¹ 11 U.S.C. § 553

¹² See 11 U.S.C. § 103.

¹³ *Id.*

¹⁴ See *In re Awal Bank, BSC*, 455 B.R. 73, 87 (Bankr. S.D.N.Y. 2011).

¹⁵ *In re Corporate Res. Servs., Inc.*, 564 B.R. 196, 202 (Bankr. S.D. N.Y. 2017); see also 11 U.S.C.A. § 1523.

¹⁶ *In re LTC Holdings, Inc.*, 597 B.R. 565, 572. (Bankr. D. Del. 2019).

¹⁷ See *id.*

¹⁸ See *id.*

¹⁹ See *Tanges v Heidelberg N. Am.*, 93 N.Y.2d. 48 (1999).

²⁰ *Fin. One Pub. Co. Ltd. v Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 331 (2d Cir. 2005).

place of business of the contracting parties.”²¹ The Court held that New York law should apply, allowing the debtor to assert setoffs.²²

II. U.S. Courts Have Generally Allowed Foreign Defendants to Assert Setoff Rights Under U.S. or Foreign Law

Courts consider foreign setoff doctrines when rejecting or accepting foreign representatives’ claims for setoff.²³ In *In re Energy Coal*, the debtor asserted setoff rights.²⁴ The U.S. bankruptcy court was careful to point out that the party opposing setoff “[had] not asserted in this Court that setoff . . . is barred under Italian law.”²⁵ Because the bankruptcy court found no evidence that the setoff was barred under Italian law, they allowed the foreign debtor to assert it.²⁶ Similar to *In re Energy Coal*, courts consider foreign setoff doctrines to “facilitate the distribution of the debtor’s assets in an equitable, orderly [] manner.”²⁷ The *In re Energy Coal* Court also considered the provisions of a Homologation Order, which is an approval of a restructuring plan by a foreign tribunal (in this case, the Genova Bankruptcy Court).²⁸ The Homologation Order entered by the Italian court did not preclude setoff rights.²⁹ In accordance with the Italian Court’s approval of the Homologation Order, the court preserved the debtor’s setoff rights.³⁰

When prepetition claims are valued and reduced to judgment, U.S. courts typically allow the party with the greater judgment to assert setoff to avoid “circuitry of action and injustice.”³¹

²¹ 2018 N.Y. Misc. LEXIS 5551, *29 (2018).

²² *Id.*

²³ *In re Energy Coal S.P.A.*, 582 B.R. 619, 632 (Bankr. D. Del. 2018).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *In re Artimm, S r.l.*, 335 B.R. 149, 161 (Bankr. C.D. Cal. 2005).

²⁸ *In re Energy Coal S.P.A.*, 582 B.R. at 632.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Clarke v. Hot Springs Elec. Light & Power Co.*, 76 F.2d 918 (10th Cir. 1935).

While setoff requires all the relevant transactions to occur prepetition, courts have held in Chapter 15 cases that “postpetition litigation to determine the amounts of the claims will not bar setoff.”³² In *In re Sivec*, a domestic creditor asserted setoff on district court judgments that awarded them \$1,744,043 on a breach of contract claim, while awarding the foreign debtor \$952,840 on a warranty retainage claim.³³ The Bankruptcy Court allowed the creditor to offset the judgments because the claims arose prepetition “between the same parties standing in the same capacity.”³⁴ While this case involves a U.S. creditor asserting setoff against a foreign debtor, the Court held that judgments may be offset in Chapter 15 cases by either party and also held that U.S. courts should “balance the relief sought by the foreign representative against the interests of those affected by the relief.”³⁵

III. Foreign Representatives Have Been Disallowed to Apply Setoff Rights if the Debt was Incurred for the Purpose of Obtaining Setoff Rights

The Bankruptcy Code prevents creditors from applying rights of setoff under any law when they incur a debt “for the purpose of obtaining a right of setoff against the debtor.”³⁶ This prevents the rewarding of creditors “who persuade a debtor to engage in conduct which has the effect of impermissibly improving the creditor’s position among other creditors.”³⁷ Courts retain the power held before the enactment of Chapter 15 to “invoke equity to bend the rules, if required, to avert injustice,” particularly when dealing with foreign representatives.³⁸

³² *In re Sivec* SRL, 476 B.R. 310, 327 (Bankr. E.D. Okla. 2012).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 323.

³⁶ 11 U.S.C. § 553(a)(3)(C).

³⁷ *Woodrum v. Ford Motor Credit Co. (In re Dillard Ford, Inc.)*, 940 F.2d 1507, 1513 (11th Cir. 1991).

³⁸ *In re Bennett Funding Grp., Inc.*, 212 B.R. 206, 212 (B.A.P. 2d Cir. 1997).

The debtor bears the burden of proving that the debt in question was incurred for the purpose of later obtaining setoff rights.³⁹ In *In re Arcapita*, the bankruptcy court for the Southern District of New York struck down two Bahraini creditors' claims of safe harbor protections and assertion of setoffs.⁴⁰ The court held that foreign creditors could not utilize Bahraini setoff rights because the debts they were purportedly owed by the foreign debtor were purposefully incurred with the objective to later assert setoff as an affirmative defense.⁴¹ The court first addressed that the debts incurred were "outside of the regular course of business for the parties."⁴² Through detailed evidence of the parties' thinking in their communications, the court found the undisputed facts to demonstrate that the debts were incurred solely for obtaining a right of setoff against the debtor, and these facts showed clear "intent to manipulate the balance."⁴³ The court also held the setoffs were invalid under Bahraini law.⁴⁴ Because the Central Bank of Bahrain ordered both creditors to comply with requests to return the funds to the debtor, the court held that the foreign representatives improperly attempted to utilize Bahraini Civil Code to validate their setoff rights.⁴⁵

Conclusion

In U.S. courts, foreign representatives and debtors generally maintain their ability to apply setoff rights, using both Bankruptcy Code provisions and laws from their home countries. Chapter 15 aims to provide fair and efficient administration of cross-border insolvencies that protects the interests of all interested entities.⁴⁶ In general, setoff rights are available to foreign

³⁹ See *In re Arcapita Bank B.S.C.*, 628 B.R. 414, 446 (Bankr. S.D.N.Y. 2021); see also *In re Clean Burn Fuels, LLC*, 492 B.R. 445, 466 (Bankr. M.D.N.C. 2013).

⁴⁰ See 628 B.R. 414.

⁴¹ See *In re Arcapita B.S.C.*, 628 B.R. at 423.

⁴² *Id.* at 447.

⁴³ *Id.* at 446; see also *In re Clean Burn Fuels, LLC*, 492 B.R. at 467.

⁴⁴ See *In re Arcapita B.S.C.*, 628 B.R. at 438.

⁴⁵ See *id.* at 423.

⁴⁶ 11 U.S.C. § 1501.

representatives who bring forward the affirmative defense under valid U.S. or foreign law, and who avoid incurring certain debts in a way that “manipulates” the equity of the proceeding.⁴⁷

⁴⁷ See *In re Arcapita B.S.C.*, 628 B.R. at 467.