UNPUBLISHED OPINION #324

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In re:	:	
RICHARD MALCOM POWELL and ROSALIE ELLEN POWELL,	:	Bankruptcy Number 90B-01412
	:	[Chapter 13]
Debtors.	:	

MEMORANDUM DECISION and ORDER GRANTING DEBTORS' MOTION FOR SANCTIONS FOR VIOLATION OF THE AUTOMATIC STAY

Grant W.P. Morrison, Esq. of Morrison & Cramer, Salt Lake City, Utah, appeared on behalf of Richard Malcom Powell and Rosalie Ellen Powell, debtors.

Bryce D. Panzer, Esq. of Snow, Christensen & Martineau, Salt Lake City, Utah, appeared on behalf of Unigard Security Insurance Company.

Richard M. Powell and Rosalie E. Powell (Debtors), the Debtors in this chapter 13 case, brought this motion for sanctions against Unigard Security Insurance Company (Unigard) for an alleged violation of the automatic stay provisions of 11 U.S.C. § 362.[1] Unigard defends by asserting the applicability of the doctrine of

[1] Subsequent references are to Title 11 of the United States Code unless noted.

recoupment. The court concludes that recoupment is inapplicable to the facts of this case and grants the Debtors' motion.

FACTS

Richard M. Powell (Powell) was injured on December 22, 1987, while employed at UTACO, Inc. As a consequence of the accident and three resulting surgeries, UTACO's workers compensation insurance carrier, Unigard,[2] paid temporary total disability benefits to Powell from December 25, 1987, through November 27, 1988. After having returned to work in November of 1988, Powell became unable to continue work in January of 1990 because of the injuries suffered in the original accident. Powell contacted Unigard to request a resumption of temporary total disability payments.

As a result of the request, Powell's case was reopened on January 4, 1990, at which time Unigard determined that it had overpaid benefits to Powell in the amount of $3,875.35. Powell continued to receive disability payments but Unigard attempted to retrieve the overpayment by deducting $1,000.00 from the payments made to him from January 3, 1990, through February 13, 1990. Unigard also deducted $50.00 every two weeks thereafter from Powell's continuing disability payments, and intended to do so until the balance of the overpayment was paid. No evidence exists that Powell and Unigard

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[2] Utah Code Ann. § 35-1-46 (1989) provides for the availability of self insurance to employers.

entered into any agreement regarding the repayment of the funds, either oral or written, at any time.

The Debtors filed a petition for relief under chapter 13 of the Bankruptcy Code on March 6, 1990, and included Unigard as a creditor holding an unsecured claim of $2,875.35. Powell contacted Unigard subsequent to the filing of the petition to inform Unigard of the Debtors' bankruptcy filing. Notwithstanding actual notice of the Debtors' bankruptcy petition, Unigard continued to withhold $50.00 every two weeks from Powell's disability payments on the assumption that such action was allowed by the doctrine of recoupment.

Even though the Debtors' confirmed chapter 13 plan proposed 100% distribution to unsecured creditors, Unigard did not file a proof of claim. The parties did not dispute the basic facts at the hearing, and the parties stipulated that $1,300 had been deducted from Powell's payments by Unigard postpetition. The attorney for the Debtors filed an affidavit of attorney's fees and indicating that a total of $1,190.40 in fees and costs had been expended in pursuing this action. Unigard has not objected to the reasonableness of those fees.

ISSUES

The Debtors contend that recoupment is not statutorily excluded from the automatic stay set forth in section 362(a)(3) and (6). Secondly, the Debtors argue that

the doctrine of recoupment is inapplicable because Unigard's claim did not arise out of the same transaction that resulted in the overpayment. Finally, they argue that no contract existed between Powell and Unigard, let alone a contract that allowed for recoupment, and that without such a contract recoupment is unavailable to Unigard.

Unigard argues that debts owed from one party to another relating to a single transaction may be offset one against the other. Even though section 362(a) enjoins a creditor from setting off a debt postpetition, this case involves recoupment instead of setoff, according to Unigard. Thus, continues Unigard's argument, recoupment is applicable in this case because recovery of the overpayments is simply an adjustment of the parties' rights under a single contract, all arising out of the same occurrence.

LEGAL ANALYSIS

Section 362(a)(7) prohibits setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor. The automatic stay, however, does not enjoin recoupment where the creditor's claim arose out of the same transaction as the debtor's claim. *Davidovich v. Welton (In re Davidovich)*, 901 F.2d 1533, 1537 (10th Cir. 1990) (held recoupment inapplicable); *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155, 157 (10th Cir. 1986) (allowed recoupment); *United States v. Midwest Serv. & Supply Co., Inc., (In re Midwest Serv. & Supply Co., Inc.)*

44 B.R. 262, 266 (D. Utah 1983) (allowed recoupment). Recoupment[3] "allows the creditor to assert that certain mutual claims extinguish one another," and as a result, the funds retained by the creditor are not property of the estate and not subject to the automatic stay. *Lee v. Schweiker,* 739 F.2d 870, 874-75 (3d Cir. 1984).

For recoupment to be applicable, three elements must be fulfilled: 1) the competing claims must arise out the same transaction, 2) there must be a contract involved that either provides for recoupment or calls for advance payments and subsequent adjustments, and, 3) the debtor must assume or perform on the contract postpetition. *Midwest*, 44 B.R. at 265-66.

There are two theories used by the courts to support the use of recoupment in bankruptcy:

> the first of these is an application of the concept of executory contracts in bankruptcy to determine that a debtor cannot accept the benefits of a contract without also accepting the intrinsic burdens. Under the second theory, courts have found that the interest of a creditor asserting a valid right of recoupment is not property of the debtor's estate.

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[3] Recoupment was first established as an equitable rule of joinder. The doctrine allowed in one suit the adjudication of two competing claims arising out of the same transaction that under common law forms of action had to be brought separately. *Davidovich*, 901 F.2d at 1537. The justification for recoupment is that where the creditor's claim arises from the same transaction as the debtor's claim, it is "essentially a defense to the debtor's claim against the creditor rather than a mutual obligation." *Davidovich*, 901 F.2d at 1537, *citing Lee v. Schweiker*, 739 F.2d 870, 875 (3d Cir. 1984).

The function of recoupment is to reduce the amount of the plaintiff's claim by the amount of the defendant's competing claim. The reduction can only be to the extent of the plaintiff's claim, thus no judgment may be had for any excess over the claim of plaintiff. *Long Term Disability Plan of Hoffman-LaRoche, Inc. v. Hiler (In re Hiler)*, 99 B.R. 238, 243 (Bankr. D.N.J. 1989). The doctrine of recoupment in bankruptcy "derives from the rule that the trustee takes the bankrupt's property subject to the equities therein." *In re Monongahela Rye Liquors*, 141 F.2d 864, 869 (3d Cir. 1944).

Long Term Disability Plan of Hoffman-La Roche, Inc. v. Hiler (In re Hiler), 99 B.R. 238, 243 (Bankr. D.N.J. 1989) (allowed recoupment). The most common application of the recoupment doctrine is in the instance of governmental overpayment made pursuant to a contract providing for advance payments and subsequent adjustments after the debtor's performance.

In bankruptcy, the recoupment doctrine has been applied primarily where both claims arise out of a "single, integrated contract or similar transaction," rather than out of different transactions. *Davidovich*, 901 F.2d at 1538 (the two claims were not part of the same transaction). *Accord B & L Oil*, 782 F.2d at 157; *Midwest*, 44 B.R. at 266; *Lee*, 739 F.2d at 875. *Midwest* stated that the "only real requirement regarding recoupment is that a sum can be reduced only by matters or claims arising out of the same transaction as the original sum." 44 B.R. at 266. *Midwest* required the existence of a contract and the postpetition assumption or performance on the contract by the debtor in order for recoupment to be applicable. Some cases recognize that "most recoupment cases involved single contracts that provided for advance payments based on estimates of what ultimately would be owed, subject to later correction, and that the analysis in those cases was based on the treatment of the executory contracts in bankruptcy." *B & L Oil*, 782 F.2d at 157 *citing Lee*, 739 F.2d at 876.

In order to have the right of recoupment, there must exist a contract authorizing recoupment, or the contract must be of such a nature that recoupment is

permissible, i.e., the contract must be an executory contract. *B & L Oil*, 782 F.2d at 158-59; *Hiler*, 99 B.R. at 244.[4] Several courts have based their analysis on the treatment of executory contracts:

> In a number of cases involving the bankruptcy of health-care providers, the courts have allowed insurers to "recoup" overpayments from amounts owed to the debtor post-petition, *under a contract providing for such recoupment.* These contracts provided for advance payment to providers based on estimates of the amount which would ultimately be owed, subject to later correction.

Lee, 739 F.2d at 875-76 (emphasis added, citations omitted). The debtor must also perform on the contract postpetition in order to activate the recoupment right. The court in *Midwest* referenced the debtor's decision to continue performance under several of the contracts postpetition "with full knowledge of the terms of the contracts and the existing

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[4] In *Hiler*, recoupment was allowed pursuant to a reimbursement agreement between the parties. The Long Term Disability Plan of Hoffman-La Roche (Plan) itself was not solely responsible to pay the gross disability income, but was designed to be reduced by the sum of the other benefits received to arrive at the "net benefits" payable.

The Plan granted Hiler's request that the Plan cease deducting the amount of the estimated Social Security disability benefits from his gross disability income before having received a final determination from Social Security, and the parties stipulated that any benefits received in the future from Social Security would be deducted from his gross disability income. Hiler agreed in writing to repay the Plan any benefits that he would receive from Social Security, and agreed to notify the Plan of any subsequent determinations made Social Security. Subsequently, Hiler received a favorable decision from Social Security, but failed to notify the Plan as previously agreed. Upon learning of the favorable decision, the Plan commenced recouping the overpayments from Hiler.

Hiler then filed a voluntary chapter 7 petition. The Plan continued to recoup the overpayments, but asked the court for declaratory relief affirming the validity of its express right of recoupment under the Plan. The court stated that "the [Plan's] claim for reimbursement for overpayment stems from the same contract under which [Hiler] asserts a claim." *Id.* at 242. The court concluded that

> in the case where overpayments are made under a *contract which provides for recoupment* prior to the filing of a bankruptcy petition, the debtor should not be allowed to avoid the burdens of reimbursement of such sums by having them discharged in bankruptcy while he continues to receive the benefits under the same contract.

Hiler, 99 B.R. at 244 (emphasis added, citations omitted).

unliquidated progress payments, including overpayments." *Midwest* 44 B.R. at 266; *In re Yonkers Hamilton Sanitarium Inc.*, 22 B.R. 427 (Bankr. S.D.N.Y. 1982), *aff'd*, 34 B.R. 385 (S.D.N.Y. 1983) (allowed recoupment under contractually imposed right).[5]

Unigard relied on *Midwest* wherein the debtor, Midwest, had entered into a time and materials agreement with the government. Though Unigard disputed that *Midwest* requires a written contract, the twenty executory contracts in existence at the time of Midwest's bankruptcy filing were what allowed Midwest to bill the government as work progressed and to receive progress payments under a specific progress payments clause.

After Midwest filed a chapter 11 petition, the government discovered that it had made overpayments on the progress payment amounts. Midwest continued performing under the contracts postpetition, and the government recouped the overpayment of progress payments from revenue generated from postpetition contracts performed by Midwest. Consequently, Midwest filed a motion to hold the government in contempt for violation of the automatic stay. The district court stated that the progress payment clause of the contracts authorized the reduction of payments for current or future

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[5] In *Yonkers*, the debtor was a provider of medical services under the Medicare program. The program allowed for partial interim payments that were an approximation of the debtor's costs and expenses under the Medicare program, subject to adjustment after an audit at the close of each fiscal year. An audit showed that the debtor had been overpaid, so the parties entered an agreement in which the government would withhold a certain amount from the partial interim payments until the excess payments were repaid.

The debtor then filed a Chapter 11 petition and the government continued withholding part of the partial interim payments. The trustee sought to recover the monies withheld postpetition claiming a violation of the automatic stay. The court held that as long as "the debtor continues to receive benefits under such contract it must also bear the burdens or obligations imposed under the contract." *Yonkers*, 22 B.R. at 435.

deliveries to recover prior overpayments. *Midwest*, 44 B.R. at 265. The court allowed recoupment and held that

> having sought the benefit of post-petition performance under the contracts, the debtor must also accept the burden of the liquidation portion of the progress payment contract clause. As long as the debtor continues to receive the benefits under a contract it must also bear the burdens of obligations imposed under the contract.

Midwest, 44 B.R. at 265.

Contrary facts produce different results. The court in *Lee v. Schweiker*, 739 F.2d 870 (3d Cir. 1984) disallowed the Social Security Administration (SSA) from recouping prepetition overpayments. Lee, the debtor, was the recipient of old age benefits under the Social Security Act and received overpayment of benefits as a result of failing to report earned income. The SSA made arrangements with Lee to withhold part of her monthly benefits until the overpayments were recovered, though the nature of the arrangement is not reported. *Lee*, 739 F.2d at 872. Lee had requested the SSA to recover the overpayment by means of installment benefit reductions. Subsequent to the agreement, Lee filed a petition for relief under chapter 13, and the SSA continued withholding part of the monthly benefits until it had recovered the entire overpayment. Lee brought suit to recover the amount of the overpayments, claiming a violation of the automatic stay. The court held that the "welfare payments such as Social Security, are statutory 'entitlements' rather than contractual rights," but more importantly the court stated the following with regard to government benefits such as social security: "a social-

welfare statute entitling an individual to benefits is not a contract, and . . . the obligation to repay a previous overpayment is a separate debt subject to the ordinary rules of bankruptcy." *Lee*, 739 F.2d at 876. *Lee* held that the SSA was not entitled to recoup prepetition overpayments from benefits owed the social security recipient postpetition.

In the present case, the Debtors allege that recoupment is violative of the automatic stay. In this jurisdiction, recoupment is not prohibited by the automatic stay. *Midwest*, 44 B.R. at 266.

The Debtors' second argument is that the competing claims do not arise out of the same transaction. The Debtors rely on *Hagan v. Heckler (In re Hagan)*, 41 B.R. 122, 126 (Bankr. D.R.I. 1984) for the proposition that "each payment (past or future) should be viewed as a separate transaction, since eligibility for benefits is independently made each month, without regard to the amount of previous disbursements." The Debtors argue that this is similar in many respects to what occurs between an insured and a "permanently" disabled employee when he is reevaluated periodically to determine if he is still permanently disabled, such as occurred in this case. Powell was injured on December 22, 1987, returned to work in 1989 but, because he was unable to continue working, had his case reopened on January 4, 1990. A subsequent reevaluation was made that he was indeed disabled. The Tenth Circuit Court of Appeals has stated generally that a bankruptcy petition operates as a "cleavage" in time. *B & L Oil*, 782 F.2d at 158. The period of employment in 1989, in conformity with the Debtors' argument, would act

as a cleavage in the single transaction continuum. If Powell would have been determined to be no longer disabled in 1990, no further disability payments would have been required; therefore, the Debtors postulate, each reevaluation acts as a "separate transaction." *See Hagan*, 41 B.R. at 126. However, in the case *sub judice*, Powell's eligibility did not necessitate reevaluation for each successive biweekly $50.00 deduction.

Unigard responds that Utah law permits overpayments on workers compensation benefits to be recouped from payments later becoming due. Unigard's reliance on *Hudson v. Kaiser Steel Corp.*, 662 P.2d 29 (Utah 1983), however, is misplaced. The issue in *Hudson* related to setoff and not recoupment and involved whether amounts due an employee for permanent partial disability could be offset against previous overpayment for temporary total disability pertaining to the same injury. The *Hudson* court seemed to view the injury, and not the distinction between permanent partial disability versus temporary total disability, as the focal point. Though the facts of *Hudson*[6] are dissimilar to those in this case, this court follows the *Hudson* view that the source of the injury is the controlling factor in determining whether the claims arose out of a similar transaction. Therefore, Unigard has proven the first prong of the recoupment test, that the events arose out of the same transaction.

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[6] *Hudson* was a nonbankruptcy case in which the Industrial Commission had ordered that since the recipient's employer had already paid the temporary total disability, the employer could offset the overpayment against the permanent partial disability award.

Unigard has, however, failed to prove that a contract existed between the parties and that the contract itself or subsequent agreement allowed for recoupment. As has been stated above, a contract must be in existence, and specifically one that would give rise to the right of recoupment. There is no evidence that Unigard and Powell at any time entered into a contract allowing for recoupment.[7] Oral agreements that the recovery of overpayments be taken out from the recipient's regular benefits, somewhat similar to the arrangement in *Lee*, are not sufficient to meet the contract requirement. To be consistent with case law, contracts providing for recoupment should be entered into initially, and not after the beneficiary files a bankruptcy petition or after the overpayments are discovered. Furthermore, there is lack of privity between Unigard and Powell because Unigard has failed to show the existence of any contract between it and Powell that would give it the right to recoupment. If there were any contract at all, it would have been between Unigard and UTACO, Powell's employer at the time of his injury.

Unigard has also failed to show the existence of an executory contract that Powell has assumed or performed postpetition. This case is more easily likened to the *Lee* case in which government benefits were treated as statutory entitlements "rather than treated as part of a 'contract' between the government and the debtor." *Lee*, 739 F.2d at 876. Finally, Unigard has not demonstrated why it, as an unsecured creditor, should be

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[7] Powell's affidavit has attached to it as exhibit A, a document signed by Sharon Thompson, an adjustor, indicating the amount of overpayment. The insurance carrier statement is a unilateral declaration and does not constitute a written contract providing for recoupment.

paid ahead of other unsecured creditors in contravention of the equitable doctrine that unsecured creditors stand on equal footing.[8]

The doctrine of setoff is inapplicable because Unigard seeks to offset a prepetition claim against payments arising postpetition. Further, for the court to consider setoff, a motion to lift the automatic stay must be filed, an event that has not yet occurred.

In their motion, the Debtors requested sanctions including "attorney fees, contempt, disgorging of funds, and so forth." Under section 362(h), this court shall award actual damages including reasonable attorney's fees and costs expended by the Debtors in bringing this action if Unigard's action was willful. Arguably, Unigard's action in effectuating the deductions were supportable by some colorable legal basis. Although Unigard did not file a proof of claim and continued to violate the stay after actual notice of the bankruptcy, the court will not find that the actions warrant punitive damages. Unigard's actions were, however, willful and subject the creditor to actual damages.

ORDER

Based on the foregoing analysis, the court orders Unigard to pay the Debtors actual damages of one thousand one hundred ninety dollars and forty cents ($1,190.40) in

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[8] In bankruptcy, recoupment is occasionally used "as an exception to the rule that all unsecured creditors of a bankrupt stand on equal footing for satisfaction. Recoupment . . . sometimes allows particular preference over others." *B & L Oil*, 782 F.2d at 157.

attorney's fees and costs, and to repay all funds improperly deducted from Powell's payments postpetition in repayment of the prepetition claim, plus interest on the amounts deducted at the federal judgment rate.

DATED this 9th day of April, 1991.

JUDITH A. BOULDEN
United States Bankruptcy Judge

THIS ORDER WAS SIGNED AND
ENTERED

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