



## ENERGY CLIENT ALERT

### “Netting” JIBs Against Working Interest Revenue Payments in Bankruptcy

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In the energy industry, it’s common for oil and gas well operators to “net” unpaid joint interest billings (JIBs) against working interest revenue payments in the ordinary course of business. However, the moment a petition is filed by a debtor under any chapter of the United States Bankruptcy Code, the automatic stay goes into effect which affects the right to “net,” depending upon whether the netting constitutes a *setoff* or *recoupment*.

Here are the general rules in the Fifth and Tenth Circuits, which include Texas and Oklahoma: where payables and receivables arise from the same contract or transaction, the practice of netting is called “recoupment,” which may continue without obtaining relief from the automatic stay from the bankruptcy court,<sup>1</sup> and may be used to “net” a pre-bankruptcy debt owed by the debtor against a pre- or post-bankruptcy debt owed to the debtor. When the mutual obligations don’t arise out of the same contract or transaction, the practice of netting is called “setoff,” which is subject to the automatic stay and requires prior bankruptcy court approval. *Setoff* will only be permitted if authorized by the contract or applicable non-bankruptcy (state) law, and even then, only to “net” pre-bankruptcy receivables against pre-bankruptcy payables.<sup>2</sup>

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<sup>1</sup> “The weight of authority holds that recoupment does not violate the automatic stay.” *In re Chapman*, 265 B.R. 796, 807 (Bankr. N.D. Ill. 2001) (citing numerous cases); *see also* *Beaumont v. Dep’t of Veteran Affairs (In re Beaumont)*, 586 F.3d 776, 781 (10th Cir. 2009) (*citing Aetna U.S. Healthcare, Inc. v. Madigan (In re Madigan)*, 270 B.R. 749, 754 (9th Cir. BAP 2001) (“Since recoupment is neither a claim nor a debt, it is unaffected by either the automatic stay or the debtor’s discharge.”); *Matter of Holford*, 896 F.2d 176, 179 (5th Cir. 1990).

<sup>2</sup> Unlike recoupment, setoff is addressed by statute. 11 U.S.C. § 553; *see also* *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 19 (1995) (*Strumpf* holds that where stay relief is required, an administrative “freeze” may be placed on the account pending a motion to lift the automatic stay); *In re Commc’n Dynamics, Inc.*, 382 B.R. 219, 236 (Bankr. D. Del. 2008). Regarding setoff, *see In re Sivec SRL*, 476 B.R. 310, 327 (Bankr. E.D. Okla. 2012):

The U.S. Bankruptcy Code recognizes and preserves any right to setoff that may exist under applicable non-bankruptcy law in § 553. “The right of setoff ... allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding ‘the absurdity of making A pay B when B owes A.’” [Citations omitted.] The requirements for setoff under § 553 include the following: (1) the amount owed by the debtor must be a prepetition debt; (2) the debtor’s claim against the creditor must also be prepetition; and (3) the debtor’s claim against the creditor and the debt owed the creditor must be mutual. [Citation omitted.] Pursuant to § 101(5), a claim is any right to payment or remedy for breach of performance, regardless of whether it has been reduced to judgment, or is liquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured. A debt or claim arises prepetition when “all transactions necessary for liability have occurred, regardless of whether the claim was contingent when the petition was filed.” [Citations omitted.] Postpetition litigation to determine the amounts of the claims will not bar setoff. [Citation omitted.] The requirement of mutuality mandates that the claims involved be between the same parties standing in the same capacity. [Citation omitted.]

Recoupment reduces a debt. It's not a claim in bankruptcy, nor is it subject to the automatic stay or the discharge injunction. *Supra*, fn. 1; see also *Matter of Gaither*, 200 B.R. 847, 850 (Bankr. S.D. Ohio 1996). "In recoupment, the elements of the debt may arise either before or after the commencement of the case." *Gaither*, 200 B.R. at 850 (internal citation omitted.) "The only real requirement regarding recoupment is that the sum can be reduced only by matters arising out of the same transaction as the original sum." *Id.* (internal citation omitted).

"For the purposes of recoupment, a mere logical relationship is not enough: the 'fact that the same two parties are involved, and that a similar subject matter gave rise to both claims, ... does not mean that the two arose from the 'same transaction.' Rather, both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *Comm'n Dynamics*, 382 B.R. at 236 (quoting *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1081 (3d Cir. 1992) (additional citations omitted)). "Use of this stricter standard for delineating the bounds of a transaction in the context of recoupment is in accord with the principle that this doctrine, as a non-statutory, equitable exception to the automatic stay, should be narrowly construed." *In re Peterson Distrib., Inc.*, 82 F.3d 956, 960-61 (10th Cir. 1996) (quoting *Univ. Med. Ctr.*, *supra*).

In short, distinguishing recoupment rights from setoff rights means identifying rights to payment and obligations that arise from the same contract or transaction. Doing so isn't always easy. Note, too, that a single contract is not *necessarily* required for recoupment to apply. While recoupment is "narrowly construed," it's possible for more than one contract to be part of a "single integrated transaction" to which recoupment will apply.

Finally, also note that the distinction between recoupment and setoff is only relevant to the extent you are owed a *pre-bankruptcy* debt by the debtor. Assuming the debtor's bankruptcy is filed under chapter 11, the debtor is required to continue paying its debts *incurred after the bankruptcy filing date* as they come due. The debtor's failure to do so is grounds for dismissal of the case or conversion to chapter 7.

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