

I. FACTS

Debtor, CSC Ltd. ("Debtor"), filed for relief under Chapter 11 of Title 11, United States Code, on January 12, 2001 (the "Petition Date"). Debtor's Chapter 11 proceeding was converted to a proceeding under Chapter 7 of Title 11, United States Code, on April 11, 2002. Andrew W. Suhar was appointed the Chapter 7 Trustee on August 6, 2002. Prior to conversion of its Chapter 11 proceeding, on April 13, 2001, Debtor and Wachovia commenced an adversary proceeding by filing a complaint against Defendant under 11 U.S.C. § 542. The Trustee filed an amended complaint on August 15, 2003, which demands that Defendant turn over Nine Hundred Twenty-Four Thousand Four Hundred Three and 26/100 Dollars (\$924,403.26), plus 10% interest, to the estate so that the Trustee may distribute such assets in accordance with the Bankruptcy Code.

Beginning in 1989, Honda of America Manufacturing, Inc. ("HAM") and Debtor entered into an agreement whereby HAM indirectly sold scrap metal to Debtor through a third party scrap dealer, Sims Bros., at a set price per ton. Debtor, in turn, processed the scrap metal into specialty bar quality steel that was suitable for use in HAM's automobile manufacturing and sold it to HAM at a set price per ton. In late 1997, Defendant, a wholly owned subsidiary of HAM, entered into an agreement whereby Defendant became the entity through which all sale of scrap and purchase of speciality

bar quality steel would be directed. Accordingly, the parties cut out Sims Bros.

Under the terms of the new agreement, Debtor purchased scrap metal from Defendant, and Debtor, in turn, sold specialty bar quality steel to Defendant. Under this arrangement, the price of the scrap metal Defendant sold to Debtor was fixed at One Hundred Twenty-Five Dollars (\$125.00) per ton and did not change from 1998 to 2001. Accordingly, the price Debtor charged Defendant for the specialty bar quality steel was fixed annually and fluctuated only marginally because of cost factors other than the price of scrap, which remained constant. Debtor and Defendant maintained separate purchase orders, invoices and payment terms for the sales of scrap from Defendant to Debtor, and for the sales of specialty bar quality steel from Debtor to Defendant.

On December 5, 1997, James R. Duncan, Jr., Debtor's chief financial officer, sent a letter to Defendant (the "Duncan Letter"). Debtor argues that this letter gave Defendant notice that Debtor's accounts receivable were pledged as collateral for indebtedness to Debtor under a secured lending agreement. The Duncan Letter provides, in full:

December 5, 1997

VIA FAX

Mr. Stacey B. Gordon
Honda Trading America Corporation

24500 Honda Parkway
Marysville, Ohio 43040-9140

Dear Stacey:

I am writing in response to your telephone message of December 3, 1997, where you requested that CSC put in writing our concerns regarding any changes to the current scrap arrangements. The proposed scrap arrangements were outlined to CSC on November 7, 1997 by you, Christopher Petersen and Brian Hawkes. Listed below is a brief description of the items that CSC has some concern over.

1. Loan Availability - Our revolver requires that any receivable for a vendor that is used in calculating loan availability be reduced by any payable for the same vendor. Therefore, when the Sims Bros. payable transfers to a Honda payable, CSC will lose borrowing availability. A suggested solution by Honda was to allow extended payment terms, but this would also serve to increase the ineligible amount which offsets the favorable effect of extended payment terms.

2. Netting of Payments - CSC also expressed concern over the proposed netting of payments. Our auditors, Ernst & Young, have highlighted netting arrangements in the past. These types of transactions, although acceptable, often require a great deal of extra work to maintain adequate records. It can cause additional problems main-taining transactions within the stated payment terms.

3. Prompt Scrap Shipments - Another area of concern noted in the meeting was the lack of prompt scrap shipments, especially in periods when the scrap price is high. The obvious question raised in the meeting was what leverage would CSC have over Sims if payment of scrap invoices was controlled by Honda?

4. Recordkeeping Details - CSC did not raise this issue in the meeting, but in hindsight, we do believe that this issue will become more

prevalent for us in light of the course Honda is headed. For example, weekly details of the payable records must be passed to our Lender as backup reducing the loan availability.

I believe that each of these issues has merit. I also believe that none of these items creates an insurmountable problem. CSC prides itself in working with our customers to find mutual solutions to obstacles that occur during the course of business. Therefore, CSC and Honda will be able to find mutual resolutions to these issues as well as any others that may be raised in the future. Should you have any additional question on this letter or any other issue, please do not hesitate to contact Fred or myself immediately.

Sincerely,

James R. Duncan, Jr.
Chief Financial Officer
voice 330-841-6676
fax 330-841-6657

JRD/jh
cc: Frederick L. Epp

On January 30, 1998, more than a month and a half after the Duncan Letter was sent to Defendant, Debtor entered into a loan and security agreement with certain lenders ("Lenders") who are parties thereto (the "Security Agreement"). Wachovia is the agent for the Lenders under the Security Agreement.¹ Pursuant to this Security Agreement, the Lenders obtained a first lien on and security interest in all of Debtor's assets, including but not

¹Wachovia is the successor agent to the following entities: (1) First Union National Bank, which it acquired, and (2) Fleet Business Credit Corporation, the original agent for Lenders.

limited to Debtor's accounts receivable.

As of the Petition Date, Defendant owed Debtor Eight Hundred Twenty-Eight Thousand Sixty-Seven and 01/100 Dollars (\$828,067.01) (*i.e.*, Debtor had an account receivable for sales of specialty bar quality steel to Defendant within the 90-day period prior to the Petition Date for this amount). As of the Petition Date, Debtor owed Defendant Nine Hundred Twenty-Four Thousand Four Hundred Three and 26/100 Dollars (\$924,403.26) (*i.e.*, Defendant had an account receivable for sales of scrap steel from Defendant to Debtor in this amount). Debtor and Defendant continued to do business post-petition. Two weeks after the Petition Date, Defendant "set off" or "recouped" Nine Hundred Twenty-Four Thousand Four Hundred Three and 26/100 Dollars (\$924,403.26) against its accounts payable to Debtor, consisting of Eight Hundred Twenty-Eight Thousand Sixty-Seven and 01/100 Dollars (\$828,067.01). Defendant did not obtain relief from stay before doing this.² Debtor and Defendant have each filed motions for summary judgment arguing that there is no material issue of fact and that they are each entitled to judgment as a matter of law.

II. ISSUES

1. Whether Debtor failed to properly notify Defendant of the Lenders' security interest in Debtor's accounts receivable;

²The filing of a petition operates as a stay to "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor[.] 11 U.S.C. § 362(a)(7). However, this Court can retroactively lift the stay so as to permit Defendant's setoff.

thus, entitling Defendant to the right to setoff under Ohio Revised Code § 1309.37, as recognized in bankruptcy by 11 U.S.C. § 553.

2. Whether Defendant's claim against Debtor arose from the same transaction as Debtor's claim against Defendant, thus entitling Defendant to the right of recoupment.

III. STANDARD OF REVIEW

The procedure for granting summary judgment is found in FED. R. CIV. P. 56(c), made applicable to this proceeding through FED. R. BANKR. P. 7056, which provides in part that

[t]he judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Summary judgment is not appropriate if there is a material dispute over the facts, "that is, if the evidence is such that a reasonable jury should return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986).

IV. ANALYSIS

A. Right to Setoff

Section 553(a) preserves certain rights of setoff that exist under applicable nonbankruptcy law. Section 553(a) provides, in rele-vant part:

(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 --

. . . .

11 U.S.C. § 553(a). Accordingly, in applying § 553(a), the Court must first determine whether Defendant has a right to setoff under applicable nonbankruptcy law or Ohio law.

The validity of Defendant's claim against Debtor and Debtor's claim against Defendant for nonpayment are not contested by either party. At issue is the priority of Defendant's setoff claim against the Lenders' security interest in Debtor's accounts receivable. Section 1309.37 of the Ohio Revised Code codifies section 9-318³ of the Uniform Commercial Code and governs rights of account debtors to assert setoff claims against assignees. Section 1309.37 provides, in relevant part:

(A) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in section 1309.17 of the Revised Code, the rights of an assignee are subject to:

(1) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and

(2) any other defense or claim of the account debtor against the assignor which accrues *before* the account debtor receives notification of the assignment.

³This section has been renumbered as Ohio Revised Code § 1309.404 (UCC 9-404). Both parties agree, however, that § 1309.37 is applicable in this case because the events giving rise to the dispute occurred before § 1309.404 went into effect.

OHIO REV. CODE ANN. § 1309.37 (Anderson 2000) (repealed 2001)
(emphasis added).

Secured lenders are considered assignees under § 1309.37. *PHD, Inc. v. Coast Bus. Credit*, 147 F. Supp. 2d 809, 816 (N.D. Ohio 2001). Thus, the rights of the Lenders are subject to any defense or claim arising under the terms of the contract, and all defenses, including the right to setoff, that Defendant has against Debtor that accrued *before* Defendant received notification of the Lenders' security interest in Debtor's accounts receivable. See § 1309.37(A)(2). Conversely, the rights of the Lenders are not subject to any defense or claim Defendant has against Debtor that accrued *after* Defendant received notification of the Lenders' security interest in Debtor's accounts receivable. Accordingly, whether Defendant is entitled to setoff against the Lenders depends on whether Defendant received notification of the Lenders' security interest in Debtor's accounts receivable before the mutual indebtedness accrued.

In their motion for summary judgment, Plaintiffs rely on two documents to establish that Defendant had actual notice of the assignment of Debtor's accounts receivable. First, Plaintiffs argue the Duncan Letter provided actual notification of the assignment of Debtor's accounts receivable. Plaintiffs note the first sentence of paragraph two - "Loan Availability" - states:

"Our [Debtor's] revolver requires that any receivable for a vendor that is used in calculating loan availability be reduced by any payable for the same vendor." Plaintiffs also note the last sentence of paragraph 5 - "Recordkeeping Details" - states: "For example, weekly details of the payable records must be passed to our Lender as backup reducing the loan availability." Plaintiffs thus argue Defendant received notification of the Lenders' security interest on December 5, 1997, well before the mutual indebtedness accrued.

Second, Plaintiffs rely upon the deposition of Christopher C. Petersen, the manager of Defendant's raw materials group. The transcript of Mr. Petersen's deposition provides, in relevant part:

MR. CHERNEY [Lenders' Counsel]: Let me show you [Mr. Petersen] a document I've marked Exhibit 4, which is Bates numbered D001-000191 through 92. It's a December 5, 1997 letter from James Duncan to Stacey Gordon. Would you take a minute and look at that, Mr. Petersen.

(Pause).

MR. CHERNEY: Have you seen this letter before?

MR. PETERSEN: Yes, I have.

MR. CHERNEY: Does this refresh your recollection about whether you had any knowledge of a lending relationship that CSC had with secured lenders in late 1997 or early 1998?

MR. PETERSEN: Lending relationship, I was never in a position to have access to the details of any lending relationship.

MR. CHERNEY: Let me clarify the question then. Did you know that CSC, that the CSC account receivable were pledged to lenders in connection with some lending relationship?

MR. READ [Defendant's Counsel]: At the time?

MR. CHERNEY: Yes.

MR. PETERSEN: At the time of receiving this letter?

MR. CHERNEY: Yes. At that time or sometime shortly thereafter.

MR. PETERSEN: Yes.

MR. CHERNEY: Okay. Did you see a copy of this letter on or about the date it was sent?

MR. PETERSEN: Yes, I did.

(Petersen Dep., 50:4-51:8) Plaintiffs argue Mr. Petersen admitted that he was aware of the Lenders' security interest, and that since Mr. Petersen is one of Defendant's agents, his testimony constitutes testimony of Defendant itself.

In its motion for summary judgment, Defendant argues that it had no notice of the Lenders' security interest prior to January 12, 2001, *i.e.* the Petition Date. First, Defendant notes that it had no contract with the Lenders and thus did not receive notice from any bank regarding Debtor's receivables from Defendant. Second, Defendant argues that the Duncan Letter is too vague to have placed it on notice of the Lenders' security interest. Third, Defendant argues that the letter, even if it was sufficiently definite to have placed Defendant on notice, fails because the

Lenders' security interest was created nearly two months after the letter was received. Thus, Defendant asserts that it did not know on December 5, 1997 that an assignment had actually been made because no assignment had, in fact, been made at that point in time. Finally, Defendant notes the letter fails to specifically state that Defendant's receivables had been assigned, and there is no identification of the assignee.

Regarding Mr. Petersen's testimony, Defendant notes that Mr. Petersen's only source of knowledge regarding any security interest in Debtor's receivables is the Duncan Letter. Since the letter references a nonexistent security interest, it could not have provided actual notice of the Lenders' security interest in Debtor's receivables. Moreover, Mr. Petersen stated that he "was never in a position to have access to the details of any lending relationship." Accordingly, Defendant argues that it did not have notice of the Lenders' security interest and, thus, its right to setoff is not subject to such interest under Ohio law.

The Duncan Letter is sufficiently vague that it did not provide Defendant with actual notice of the assignment of Debtor's accounts receivable. The Duncan Letter does not specifically state that Debtor's accounts receivable have been assigned. Furthermore, as Defendant points out, the plain language of § 1309.37(A)(2) refers to a "notification of the assignment." (emphasis added). "The" is a definite article "used as a function word to indicate

that a following noun or noun equivalent is definite" or "is a unique or a particular member of its class." WEBSTER'S COLLEGIATE DICTIONARY (10th ed. 1993). The use of the word "the" particularizes the "assignment" to the "assignee" referred to in paragraph (A).

The Lenders did not have a security interest in Debtor's accounts receivable when the Duncan Letter was sent, and the Lenders are not the assignees of a security interest that was in existence when the Duncan Letter was sent. Defendant was put on notice that Debtor had a relationship with an unknown lender that had an interest in some or all of Debtor's accounts receivable. The Duncan Letter could have not put Defendant on notice of the Lenders' security interest because it did not come into existence until January 30, 1998. Since Mr. Petersen's only source of knowledge regarding any security interest in Debtor's receivables is the Duncan Letter, Mr. Petersen's admission cannot be construed as an acknowledgment that Defendant had notice of the Lenders' security interest. Debtor failed to properly notify Defendant of the Lenders' security interest in Debtor's accounts receivable. Thus, Defendant has a valid right to setoff under Ohio Revised Code § 1309.37, as recognized in bankruptcy by 11 U.S.C. § 553.

B. Doctrine of Recoupment

The recoupment doctrine is applicable in bankruptcy. *Sheehan v. Wiener (In re Wiener)*, 228 B.R. 647, 650 (Bankr. N.D. Ohio 1998) (citing *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993)).

Since recoupment is based on claims arising from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim in that it denies the alleged indebtedness. *Steinberg v. Ill. Dep't of Mental Health & Developmental Disabilities (In re Klingberg Schools)*, 68 B.R. 173, 178 (N.D. Ill. 1986). Recoupment does not involve mutual debts and, thus, is not subject to the automatic stay. *Wiener*, 228 B.R. at 650. "For recoupment to apply, however, the creditor must have a claim against the debtor that arises from the *same transaction* as the debtor's claim against the creditor." *Bird v. Carl's Grocery Co. (In re NWFEX, Inc.)*, 864 F.2d 593, 597 (8th Cir. 1989) (citing *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155, 157 (10th Cir. 1986) (emphasis added)). This is the main distinction between the doctrine of recoupment and setoff: Setoff is a form of cross action that depends on the existence of two separate, mutual obligations; whereas, recoupment is like a compulsory counterclaim in that the obligations must arise out of the same transaction. See 5 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 553.10 (15th ed. 2003).

Courts apply various tests to determine whether claims arise from the same transaction. See *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392 (9th Cir. 1996) (applying logical relationship test); *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065 (3rd Cir. 1992) (applying integrated

transaction test). The best such test, according to Colliers, is the logical relationship test because the integrated transaction test is arguably inconsistent with Supreme Court precedent. See 5 COLLIER ON BANKRUPTCY at ¶ 553.10[3] (citing *Reiter*, 507 U.S. at 263-65). Under the logical relationship test, the concept of a "'[t]ransaction' is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." *Newbery Corp.*, 95 F.3d at 1402 (quoting *Moore v. N.Y. Cotton Exch.*, 270 U.S. 593 (1926)). "[C]ourts have permitted a variety of obligations to be recouped against each other, requiring only that the obligations be sufficiently interconnected so that it would be unjust to insist that one party fulfill its obligation without requiring the same of the other party." *Aetna U.S. Healthcare, Inc. v. Madigan (In re Madigan)*, 270 B.R. 749, 755 (B.A.P. 9th Cir. 2001) (quoting 5 COLLIER ON BANKRUPTCY at ¶ 553.10[1]).

In its response to Defendant's motion for partial summary judgment, Plaintiffs argue that the parties' respective obligations under the agreement do not arise out of the same transaction or occurrence because the obligations in question did not arise from one contract. First, Plaintiffs note the contract itself explicitly provides that "[e]ach Order accepted [under the agreement] will be a separate and individual contract[.]" Second,

Plaintiffs note the parties maintained separate purchase orders, invoices and payments. Third, Plaintiffs note the scrap sold by Defendant to Debtor was not segregated or dedicated solely to processing special bar quality steel for Defendant, and Defendant's scrap was not in batches dedicated exclusively to Defendant.⁴ Finally, Plaintiffs note the parties never explicitly agreed that their agreement would constitute a single transaction.

The arguments put forth by Plaintiffs are unpersuasive for the reasons set forth by Defendant. It is obvious that Defendant's sale of scrap metal to Debtor and Debtor's sale of special bar quality steel to Defendant are logically related. The main purpose of the parties' agreement was to establish a stable supply of special bar quality steel at a stable price for Defendant by establishing a stable supply of scrap at a fixed price to Debtor. The fact that the parties maintained separate purchase orders, invoices and payments is clearly related to accounting formalities and does not address the substance of the transaction. The fact that Defendant's scrap was not earmarked for the production of

⁴The Declaration of Joseph A. Rooney provides, in relevant part:

5. CSC's steel processing was done in manufacturing units known as "heats." A heat is a processing cycle represented by charging an electric furnace with scrap.

. . .

6. The CSC invoices to HTA [Defendant] which I reviewed covered six heats and, based upon the use of CSC's 85-ton furnace, the output sold to HTA covered as little as 5% and as much as 60% of any given heat. Thus, from the documents made available to me, there were no heats exclusively dedicated to Honda, and any scrap used in those heats generated product for Honda as well as other customers of CSC.

special bar quality steel sold to Defendant does not negate the fact that scrap metal like that supplied by Defendant was essential to the production of special bar quality steel. Defendant sold scrap metal to Debtor because Debtor processed scrap metal and sold special bar quality steel to Defendant. It would be inequitable to force Defendant to pay for the specialty bar quality steel when Debtor failed to pay for scrap metal that was provided to Debtor because Debtor agreed to supply the specialty bar quality steel.

Defendant's claims against Debtor and Debtor's claims against Defendant are logically related and thus arise out of the same transaction or occurrence.

Defendant had the right to recoup Nine Hundred Twenty-Four Thousand Four Hundred Three and 26/100 Dollars (\$924,403.26) against its accounts payable to Debtor, consisting of Eight Hundred Twenty-Eight Thousand Sixty-Seven and 01/100 Dollars (\$828,067.01). Since recoupment does not involve mutual debts and is thus not subject to the automatic stay, Defendant did not violate the automatic stay. Alternatively, Defendant had the right to setoff such amount, which this Court will recognize *nunc pro tunc* as of the date such setoff was taken.

V. CONCLUSION

Accordingly, Defendant's motion for partial summary judgment is hereby granted and Plaintiffs' motion for summary judgment is hereby denied.

An appropriate order shall enter.

HONORABLE KAY WOODS
UNITED STATES BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Memorandum Opinion and Order were placed in the United States Mail this _____ day of January, 2005, addressed to:

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