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Comment

***In re De Laurentiis Entertainment Group:* Sacrificing Confirmed Chapter 11 Plans to Delinquently Asserted Setoff Rights**

Brett Ludwig

In August 1988, De Laurentiis Entertainment Group (DEG) filed for bankruptcy under Chapter 11 of the Bankruptcy Code.¹ Prior to filing, DEG had purchased \$1.6 million worth of advertising from the National Broadcasting Co. (NBC) through an advertising agency, BBDO Worldwide (BBDO).² In a contemporaneous but separate deal, NBC acquired the right to televise one of DEG's movies for \$1.25 million.³ Following DEG's petition for bankruptcy, NBC asserted a \$1.6 million quantum meruit claim against the bankruptcy estate for the advertising DEG purchased through BBDO.⁴ The bankruptcy court confirmed DEG's reorganization plan in May 1990.⁵ The reorganized debtor, now called Carolco Television (Carolco), subsequently sought the money NBC owed it, and NBC asserted a right to setoff its debt to DEG from the debt DEG owed NBC.⁶ Even though the confirmed plan did not contain

1. Carolco Television v. National Broadcasting Co. (*In re De Laurentiis Entertainment Group*), 963 F.2d 1269, 1271 (9th Cir.), *cert. denied*, 113 S. Ct. 330 (1992).

2. *Id.* BBDO purchased this advertising time from, and signed certain participating sponsorship agreements with, NBC. *Id.* Although DEG approved of the agreements, it was not a direct party to the contract. *Id.* NBC billed BBDO, and BBDO billed DEG on separate invoices. *Id.*

3. *Id.*

4. *Id.* NBC filed a proof of claim against DEG. *Id.* Pursuant to its holding both a debt to the bankruptcy estate and a potential claim against the estate, NBC claimed a \$1.25 million right of setoff against the \$1.6 million it was owed. *Id.* NBC then sought permission from the bankruptcy judge to pursue its claim and setoff rights, and the judge converted NBC's quantum meruit claim into an adversary proceeding before the bankruptcy court. *Id.*

5. Under this plan most of DEG's assets were purchased by Carolco and merged with a Carolco subsidiary, renamed Carolco Television, Inc. *Id.* Under the plan the subsidiary acquired the rights to the \$1.25 million claim against NBC. *Id.*

6. *Id.*

provisions concerning NBC's asserted setoff rights, the bankruptcy court allowed NBC's setoff.⁷ The district court affirmed.⁸ On appeal, the Ninth Circuit held that confirmation of DEG's reorganization plan did not destroy NBC's setoff rights.⁹

In re De Laurentiis Entertainment Group raises the issue of whether a confirmed reorganization plan under Chapter 11 of the Bankruptcy Code precludes the subsequent assertion of setoff rights not included in the plan.¹⁰ The resolution of this issue materially affects the rights and expectations of both debtors and creditors in the reorganization process. By undermining the finality of the plan, the Ninth Circuit's allowance of post-confirmation setoffs also significantly reduces the already slim chances that the debtor will successfully reorganize.¹¹

This Comment examines the effect of a confirmed Chapter 11 reorganization plan on setoff rights asserted after the confirmation. Part I discusses the policies and purposes underlying sections 553, 1141, and 524 of the Bankruptcy Code, the doctrine of *res judicata*, similar provisions in other Bankruptcy Code chapters, and judicial resolutions of the issue. Part II analyzes the Ninth Circuit's holding in *In re De Laurentiis Entertainment Group*. Part III critiques the Ninth Circuit's analysis and argues that upholding the right to setoff following the creditor's failure to object at the confirmation hearing is inconsistent with the text, intent, and general policies of the Bankruptcy Code. This Comment concludes that creditors seeking to exercise setoff rights should be required to assert their rights prior to the plan's final confirmation.

I. BANKRUPTCY: CONFIRMED PLANS AND SETOFFS

In 1978, Congress passed the Bankruptcy Reform Act,¹² re-

7. *Id.* The bankruptcy court granted NBC's motion for summary judgment on its quantum meruit claim. *Id.*

8. *Carolco Television v. National Broadcasting Co. (In re De Laurentiis Entertainment Group)*, Nos. CV 90 6039 JGD, CV 90 6040 JGD, 1991 WL 340567, at *5 (C.D. Cal. March 5, 1991), *aff'd*, 963 F.2d 1269 (9th Cir.), *cert. denied*, 113 S. Ct. 330 (1992).

9. 963 F.2d at 1276, 1278.

10. *Id.* at 1274.

11. The chances of successfully completing reorganization are low. An empirical study found that only 26% of debtors who filed for bankruptcy under Chapter 11 were still operating three years after the study began. Lynn M. LoPucki, *The Debtor in Full Control - Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, 100 (1983). The rest ended up in the liquidation provisions of Chapter 7. *See id.* at 106-08.

12. Pub. L. No. 95-598, 92 Stat. 2549 (1978).

placing the Bankruptcy Act of 1898.¹³ The 1978 Bankruptcy Code (the Code) represents Congress's most recent attempt to deal with the complex problems arising when the liabilities of an individual or business exceed its assets.¹⁴

Bankruptcy law attempts to facilitate a compromise between the interests of all creditors and the well-being of the debtor.¹⁵ The Code provides creditors an orderly system for maximizing collective repayment of all creditors when their total claims exceed the total value of the debtor's property.¹⁶ At

13. Bankruptcy Act, ch. 541, 30 Stat. 544 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, § 401, 92 Stat. 2549, 2682. The Constitution delegates bankruptcy powers to the federal government. U.S. CONST. art. I, § 8, cl. 4. After numerous failed attempts throughout the nineteenth century, Congress finally enacted the first "permanent" act governing bankruptcies in 1898. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 1 (1986); *see also* CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 3-159 (1935) (summarizing the complex history of the attempts to create federal bankruptcy law prior to 1898).

14. *See* ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 187-92 (2d ed. 1991).

15. This basic principle is shared by both leading schools of bankruptcy theory: The "traditional" school, represented by Professor Elizabeth Warren of the University of Texas School of Law, and the "collectivist" school, represented by Professors Douglas G. Baird of the University of Chicago and Thomas H. Jackson of the University of Virginia Law School. *See* JACKSON, *supra* note 13, at 4; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 949-60 (1988).

The collectivist school views bankruptcy as existing primarily to further the fair distribution of the bankrupt debtor's estate among its creditors, and as a collective debt collection device. *See* JACKSON, *supra* note 13, at 5-6. As such, Baird and Jackson see limits on the way bankruptcy should disrupt the non-bankruptcy rights and priorities of creditors. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822 (1987).

Warren's traditional school believes in extending the view of bankruptcy beyond the rights and interests of creditors and debtors. She sees creditors' interests in bankruptcy as competing with several other societal interests. Warren, *supra*, at 788.

16. JACKSON, *supra* note 13, at 8-18. The common characterization of the problem a normal individual creditor's remedies scheme creates is that of the "common pool." *Id.* A bankrupt debtor generally owes a group of creditors in a legally created line of priority, yet lacks the funds fully to pay all claims. *Id.* If each creditor acts in her individual self-interest, the tendency of those first in line is to drain the "common pool" of the debtor's assets, leaving subsequent creditors with little or nothing, and ruining any prospect for working out the problem with the debtor. *Id.* Bankruptcy strives for equal treatment of creditors and for maximization of repayment through collective action. *Id.*; *see also* James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law:*

the same time, the Code accords the debtor a fresh start¹⁷ by providing an automatic stay to shield the debtor from actions by its creditors,¹⁸ and by allowing either a reorganization¹⁹ or a discharge of indebtedness,²⁰ or both.

A. CHAPTER 11

Chapter 11 of the Code provides for debt reorganization,²¹ primarily for businesses.²² The 1978 Code instituted major

Bankruptcy Theory and the Elementary Economics of Failure, 88 MICH. L. REV. 2097, 2101 (1990) (explaining the general goal of equality in bankruptcy).

17. Bankruptcy provides the debtor with a "fresh start" by removing the oppressive burden of heavy indebtedness. The Code thus ameliorates the difficulties of saving the troubled business of an honest, but unfortunate, debtor by relieving the debtor of the additional strain of heavy indebtedness caused by past misfortune. See JACKSON, *supra* note 13, at 225-28.

18. Filing a petition for bankruptcy under the Code automatically triggers a stay of all efforts to collect debts from the debtor. 11 U.S.C. § 362 (1988). This "automatic stay" functions much like an injunction preventing any action against the debtor unless the bankruptcy court first grants permission pursuant to § 362. See ROBERT L. JORDAN & WILLIAM D. WARREN, *BANKRUPTCY* 22-23 (1985). The purpose of the automatic stay is to insure the advantages of collective action of bankruptcy by preventing individuals from acting independently to drain the common pool. It thus shuts the door on the debtor's estate, locking the debtor's property in and keeping creditors out. See JACKSON, *supra* note 13, at 151-52.

19. Three chapters of the Code provide for reorganization. Chapter 13 allows individual consumers to reorganize their debts. See 11 U.S.C. §§ 1301-1330 (1988). Chapter 12 provides for family farm reorganizations. See 11 U.S.C. §§ 1201-1231 (1988). Chapter 11 governs reorganization of businesses and individuals with very large debts. See 11 U.S.C. §§ 1101-1174 (1988).

20. Discharge applies to several sections of the bankruptcy code. See 11 U.S.C. §§ 727, 1141, 1228, 1328 (1988). Discharge generally precludes actions to enforce the debt. See 11 U.S.C. § 524 (1988).

21. Reorganization bankruptcy under Chapter 11 thus differs from liquidation bankruptcy under Chapter 7. Under a liquidation bankruptcy, the debtor's property is sold and the proceeds are used to pay groups of creditors. Lucian A. Bebhuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 775 (1988). Chapter 11 allows businesses to avoid liquidation, retain their property, and continue in business in the hope of capturing a greater value than would be received in a liquidation. *Id.* at 776. Debt reorganization usually entails exchanging claims against the old debtor for claims against, or interests in, the newly reorganized entity, enabling the business to continue operations. *Id.* Under Chapter 11, reorganization requires, among other things, that creditors receive at least as much in the reorganization as they would in an immediate Chapter 7 liquidation. See 11 U.S.C. § 1129 (1988).

22. While individuals also can file for reorganization under Chapter 11, Chapter 13 generally provides a more economically rational option for individuals, unless their debt is greater than the maximum prescribed for Chapter 13. Therefore, only in the rare cases where individuals have accumulated huge debts does Chapter 11 apply to non-business entities. WARREN & WESTBROOK, *supra* note 14, at 427; see 11 U.S.C. § 109(e) (1988).

changes in business reorganization under Chapter 11.²³ Chapter 11 provides a struggling business a breathing space through the automatic stay,²⁴ and a chance for reorganization and discharge of indebtedness,²⁵ while providing creditors with the protection and benefit of collective action.²⁶ Repayment occurs as a result of plans that restructure indebtedness within the Code's prescribed limitations.²⁷ The bankruptcy court administers the reorganization process by conducting hearings at which interested parties may object to the proposed plan,²⁸ and by overseeing the implementation of confirmed plans.²⁹

23. WARREN & WESTBROOK, *supra* note 14, at 429. Congress intended to encourage earlier attempts at reorganization under the new Code than had occurred under the old Bankruptcy Act. *Id.* The hope was that if companies restructured earlier more businesses could be saved from eventual failure. *Id.* at 428-29.

24. In Chapter 11, the automatic stay offers the business a respite from hounding creditors while it formulates a reorganization plan. See Robin E. Phelan & Susan L. S. Ernst, *Soloman's Capitulation: The Automatic Stay, Adequate Protection, and Use of Collateral*, in 1 LENDING TRANSACTIONS AND THE BANKRUPTCY ACT 1986, at 191, 199 (PLI Com. Law and Prac. Course Handbook Series No. 374, 1986).

25. Unlike Chapter 13 reorganizations, the confirmation of a Chapter 11 reorganization plan provides immediate discharge of debts except as provided for in the plan. 11 U.S.C. § 1141 (1988). Under Chapter 13, discharge does not occur until completion of the reorganization plan. 11 U.S.C. § 1328 (1988).

26. Creditors benefit from acting as a group and thus prevent draining of the common pool. See JACKSON, *supra* note 13, at 8-18.

27. Under Chapter 11, a reorganization plan must meet the criteria of § 1129. 11 U.S.C. § 1129 (1988). A creditor is protected if its claim is impaired by the requirements of an acceptable plan. Unless the impaired creditor accepts the plan, the plan must meet both the absolute priority rule and the best interests test. The absolute priority rule requires that for the claims of a class of creditors to be impaired by a reorganization plan, all classes below that class must receive nothing. See 11 U.S.C. § 1129(b)(1)-(2). The best interests test requires that each creditor under the plan receive an amount equal to at least the present value of its claim in an immediate liquidation. See 11 U.S.C. § 1129(a)(7); see also WARREN & WESTBROOK, *supra* note 14, at 427-28 (explaining general restructuring of debts); JACKSON, *supra* note 13, at 68-88 (describing the debtor's powers to affect creditors' claims in bankruptcy).

28. Section 1128 provides that the court shall hold a hearing on the confirmation plan and permits interested parties to object to confirmation. 11 U.S.C. § 1128 (1988). The hearing protects due process rights of creditors who might otherwise be deprived of property rights without notice and an opportunity to respond. One court has held that absent notice and an opportunity to voice objections to the reorganization plan, confirmation violated a creditor's due process rights. *Reliable Elec. Co. v. Olson Constr. Co.*, 726 F.2d 620, 622 (10th Cir. 1984).

29. 11 U.S.C. § 1129 (1988). In order to be confirmed by the bankruptcy court, the bankruptcy judge must find that the plan meets the extensive requirements of § 1129, which insure fair treatment of all classes of creditors and the success of the plan. See *id.*

Chapter 11 has come under increasing fire for its lack of effectiveness.³⁰ The vast majority of businesses filing under Chapter 11 never successfully complete the reorganization process and suffer liquidation.³¹ Critics even suggest abandoning Chapter 11 because the costs of failed attempts to reorganize outweigh any benefits provided.³²

B. CONFIRMATION AND DISCHARGE

Sections 1141 and 524 of the Code provide for the confirmation of a reorganization plan and the discharge of underlying debts under Chapter 11, and serve res judicata policy by binding all parties with a final judgment. Section 1141(a) of the Bankruptcy Code provides that confirmation of a Chapter 11 reorganization plan binds both the debtor and the creditor.³³ Sections 1141(b) and 1141(c) provide that following confirmation, a Chapter 11 plan vests all the property of the bankruptcy estate in the debtor clear of all claims and interests of creditors except as the plan provides.³⁴ Most importantly, confirmation discharges most types of debts.³⁵ Thus the confirmation of a plan solidifies the debtor's and creditors' respective positions,³⁶

30. See Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986); Bebhuk, *supra* note 21, at 779-80; Bowers, *supra* note 16, at 2098.

31. LoPucki, *supra* note 11, at 100.

32. See, e.g., JACKSON, *supra* note 13, at 218-24.

33. Section 1141 provides in part:

(a) Except as provided in subsections (d)(2) and (d)(3) of this section, *the provisions of a confirmed plan bind the debtor . . . and any creditor . . . whether or not the claim or interest of such creditor . . . is impaired under the plan and whether or not such creditor . . . has accepted the plan.*

11 U.S.C. § 1141(a) (1988) (emphasis added).

34. Section 1141 further provides:

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, *after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.*

11 U.S.C. § 1141(b)-(c) (1988) (emphasis added). The legislative history of § 1141 states that the Congress intended to discharge all debts that arose before the date of the order for relief unless the plan or the order confirming the plan specifically provides otherwise. S. REP. NO. 989, 95th Cong., 2d Sess. 129 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5915.

35. 11 U.S.C. § 1141(d)(1) (1988). Section 524 governs discharge under § 1141. 11 U.S.C. § 524(a)(1) (1988).

36. Courts have noted the importance of confirmation as a source of final-

and provides general stability to the reorganization.³⁷ The plan creates a framework on which both the creditors and the debtor in possession, or trustee in bankruptcy, can rely and plan their behavior.³⁸

By discharging the debts of the reorganizing debtor, the confirmation of a Chapter 11 plan prevents further actions by creditors concerning those debts.³⁹ Section 524 of the Code expressly provides that discharge voids any judgment of personal liability of the debtor discharged in bankruptcy and enjoins attempts to offset any such debt.⁴⁰ Significantly, this provision explicitly applies to prevent attempts to "offset," or set off, on the basis of a discharged debt.⁴¹ Thus the combined effect of sections 1141 and 524 is to bind parties with a final judgment, providing a *res judicata* effect to the bankruptcy proceeding.

The doctrine of *res judicata* provides that a final judgment on the merits of an action precludes the parties from relitigating issues that were or could have been raised in that action.⁴²

ity to the bankruptcy proceeding. *See, e.g., In re Blanton Smith Corp.*, 81 B.R. 440, 442 (M.D. Tenn. 1987) (holding that confirmed plans are final judgments binding all parties); *Minstar, Inc. v. Plastech Research (In re Arctic Enters.)*, 68 B.R. 71, 80 (D. Minn. 1986) (noting that debtors and creditors naturally look to the confirmed plan as the final decree determining the rights of all parties involved).

37. *See In re Henderberg*, 108 B.R. 407, 415-16 (Bankr. N.D.N.Y. 1989) (holding that to allow change after confirmation would disrupt the situation and violate basic principles of contract and bankruptcy law which favor "fairness, certainty and finality").

38. *See Astroglass Boat Co. v. Eldridge (In re Astroglass Boat Co.)*, 32 B.R. 538, 543 (Bankr. M.D. Tenn. 1983). The court emphasized the importance of the finality of the confirmation order in allowing the infusion of new capital which is vital to the very success of any reorganization under Chapter 11. *Id.*

39. 11 U.S.C. § 524 (1988).

40. Section 524 provides in part:

(a) A discharge in a case under this title—

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived.

11 U.S.C. § 524(a)(1) (1988).

41. Section 524 further provides that a discharge "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived." *Id.* § 524(a)(2) (1988) (emphasis added). The legislative history behind § 524 reveals that Congress intended to "eliminate any doubt concerning the effect of the discharge as a total prohibition on debt collection efforts." S. REP. NO. 989, *supra* note 34, at 80, reprinted in 1978 U.S.C.C.A.N. at 5866.

42. *Federated Dep't Stores v. Moitie*, 452 U.S. 394, 398 (1981).

The doctrine avoids relitigation of issues, insures the finality of judicial decisions, and, most importantly, requires interested parties to assert related claims in that same action.⁴³

The policies of certainty and reliance underlying *res judicata* are particularly important in the Chapter 11 context. The infusion of additional capital, vital to most reorganization attempts, is jeopardized if lenders cannot be sure of the finality of the debtor's situation following confirmation.⁴⁴ Thus courts have held that confirmation of a plan and discharge of indebtedness without contest and appeal result in a *res judicata* effect.⁴⁵ Also, courts have held that creditors who had notice of a confirmation hearing but who failed to object to the reorganization plan at the hearing are subsequently bound by the plan,⁴⁶ even if the bankruptcy court discharged debts that should not have been discharged under the Code.⁴⁷

C. SETOFF

In bankruptcy, setoff permits a creditor to subtract, or "set off," a debt that it owes the bankrupt debtor from the debt that

43. *Reed v. Allen*, 286 U.S. 191, 201 (1932). Judgments that are not directly appealed are deemed conclusively decided. *Id.* This is true even if the judgment was based on an erroneous view of law, in order to provide certainty and to create a conclusive character in judgments. *Id.* By precluding relitigation of claims that could have been asserted, *res judicata* also requires interested parties to raise those claims in the initial proceeding. *Moitie*, 452 U.S. at 398.

44. *See Astroglass Boat Co. v. Eldridge (In re Astroglass Boat Co.)*, 32 B.R. 538, 543 (Bankr. M.D. Tenn. 1983). The success of a struggling business's reorganization requires the execution of new contracts and loan agreements to infuse the new capital required by the reorganizing business. *Id.* at 543-44. If the order of confirmation is not given the full effect of a final judgment as to the reorganized debtor, the infusion of capital is jeopardized. *Id.* at 544. Without this capital, the chance of a successful reorganization, which is the primary goal of Chapter 11, is greatly diminished. *Id.* at 543.

45. *See In re Henderberg*, 108 B.R. 407, 411-14 (Bankr. N.D.N.Y. 1989) (plan confirmed under § 1141 precluded later contesting of priority of claims paid in plan); *In re Blanton Smith Corp.*, 81 B.R. 440, 443 (M.D. Tenn. 1987) (Chapter 11 plan confirmed pursuant to § 1141 was given *res judicata* effect even if based on an erroneous interpretation of law); *Minstar, Inc. v. Plastech Research (In re Arctic Enters.)*, 68 B.R. 71, 79-80 (D. Minn. 1986) (confirmed Chapter 11 plan precluded lien which was not included in the plan).

46. By failing to object at the hearing, creditors waive their right to object to the reorganization plan. *See Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1049-50 (5th Cir. 1987); *Lawrence Tractor Co. v. Gregory (In re Gregory)*, 705 F.2d 1118, 1123 (9th Cir. 1983); *Henderberg*, 108 B.R. at 415; *Blanton Smith*, 81 B.R. at 442; *Minstar*, 68 B.R. at 80.

47. *See Republic Supply Co.*, 815 F.2d at 1049-50 (explaining the result of failing to appeal a confirmation order).

the debtor owes the creditor.⁴⁸ Thus setoff benefits the creditor by allowing it to apply to its own claim the funds that it owes the bankrupt, which would otherwise go to the bankruptcy estate for division among all creditors. Consequently, the creditor is able to increase its priority of repayment in relation to other creditors.⁴⁹ The policy behind setoff is one of equity and fairness, and setoff historically has been viewed as permissive and within the equitable judgment of the court.⁵⁰

The current Bankruptcy Code recognizes the doctrine of setoff in section 553.⁵¹ Section 553 states that the Code generally does not affect any right of setoff.⁵² While the Code provides rules for when to apply setoff, it does not define "setoff."⁵³ Courts, therefore, have looked to general historical

48. 4 COLLIER ON BANKRUPTCY ¶ 553.02 (Lawrence P. King ed., 15th ed. 1992).

49. *Id.* This is an exception to the general rule in bankruptcy which proscribes equality of treatment for creditors in the same class. See Robert L. Ordin, *Setoffs Under the Bankruptcy Code*, in 1 LENDING TRANSACTIONS AND BANKRUPTCY ACT 1986, *supra* note 24, at 519, 564.

50. See Ordin, *supra* note 49, at 564.

51. 11 U.S.C. § 553 (1988 & Supp. III 1991). The Code basically re-enacted previous rules concerning setoffs found under the old bankruptcy act of 1898 with only minor changes. 4 COLLIER ON BANKRUPTCY, *supra* note 48, ¶ 553.01.

52. Section 553(a) provides in pertinent 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.

11 U.S.C. § 553(a) (1988 & Supp. III 1991).

53. See 11 U.S.C. § 553 (1988 & Supp. III 1991). The legislative history behind § 553 states that Congress intended to preserve the right of setoff as it existed under § 68 of the Bankruptcy Act of 1898. S. REP. NO. 989, *supra* note 34, at 91, *reprinted in* 1978 U.S.C.A.N. at 5877-78. Section 68 of the Bankruptcy Act of 1898 provided:

Set-Offs and Counterclaims.

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy.

Bankruptcy Act, ch. 541, § 68, 30 Stat. 544, 565 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, § 401, 92 Stat. 2549, 2682.

Congress adopted § 553 to establish a two-prong test of when setoff was applicable and to continue preventing the acquisition of claims by creditors for

principles of legal and equitable setoff in defining the doctrine.⁵⁴ A significant attribute of the Code's treatment of setoff is the discretion granted judges to weigh the equities before granting setoff in individual cases.⁵⁵

D. CONFLICTS BETWEEN SETOFF AND CONFIRMATION

Both section 553's right to setoff and section 1141's finality of confirmation are written in absolute terms.⁵⁶ While section 553 states that the right to a setoff is never destroyed in bankruptcy except in certain enumerated circumstances,⁵⁷ section 1141 states that when a plan is confirmed, all property of the estate is transferred to the debtor in possession or trustee in bankruptcy free from any obligations or liens.⁵⁸ The two provisions therefore conflict when both sections operate in a single case.⁵⁹

the purpose of conducting setoff. S. REP. NO. 989, *supra* note 34, at 91, *reprinted in* 1978 U.S.C.C.A.N. at 5877-78. Creditors often seek setoff "preferences," the acquisition of setoff rights, to increase their standing in relation to other creditors also waiting in line before the common pool.

54. 4 COLLIER ON BANKRUPTCY, *supra* note 48, ¶ 553.02; *see* United States *ex rel.* IRS v. Norton, 717 F.2d 767, 772 (3d Cir. 1983) (noting the necessity of looking to common law and equitable principles when dealing with setoff); Kaiser Steel Corp. v. Frates (*In re* Kaiser Steel Corp.), 110 B.R. 20, 25-26 (D. Colo. 1986) (same); Lessig Constr. v. Schnabel Assoc. (*In re* Lessig Constr.), 67 B.R. 436, 441 (Bankr. E.D. Pa. 1986) (same).

55. 4 COLLIER ON BANKRUPTCY, *supra* note 48, ¶ 553.02.

56. Section 553 states in pertinent part that "this title does not affect *any* right of a creditor to offset a mutual debt." 11 U.S.C. § 553(a) (1988 & Supp. III 1991) (emphasis added). Section 1141's absolute language provides that "after confirmation of a plan, the property dealt with by the plan is free and clear of *all* claims and interests of creditors, equity security holders, and of general partners in the debtor." 11 U.S.C. § 1141(c) (1988) (emphasis added).

57. Section 553 provides for two enumerated exceptions to the right to setoff. First, setoffs are not granted where the creditor's claim is not allowed in bankruptcy. 11 U.S.C. § 553(a)(1) (1988 & Supp. III 1991). Second, setoffs are not granted where the creditor acquires a debt owed to the debtor immediately prior to the bankruptcy or for the specific purpose of achieving setoff. 11 U.S.C. § 553(a)(2) (1988 & Supp. III 1991). This is called a "setoff preference," because the creditor has tried to receive preferential treatment over other creditors in anticipation of bankruptcy. *See* WARREN & WESTBROOK, *supra* note 14, at 537-38. Also, any increase in preexisting setoff rights during the 90 days preceding bankruptcy may be voided by the debtor in possession. 11 U.S.C. § 553(b) (1988 & Supp. III 1991).

58. 11 U.S.C. § 1141(b)-(c) (1988).

59. The legislative history does not indicate that the drafters recognized the conflict. *See* S. REP. NO. 989, *supra* note 34, at 91, *reprinted in* 1978 U.S.C.C.A.N. at 5877-78. This lack of legislative history addressing the sharp textual conflict suggests that Congress did not foresee situations in which § 553 and § 1141 would conflict.

Courts have yet to decide conclusively which provision controls in cases where both sections are operative. In *In re Newport Offshore*, the bankruptcy court found that sections 1141 and 524 controlled.⁶⁰ It held that confirmation of the reorganization plan had a res judicata effect with respect to the creditor's setoff, in part because the creditor failed to assert its setoff rights in a timely fashion at the confirmation hearing.⁶¹ Other courts have also disallowed setoff if the creditor failed to assert its rights at the confirmation hearing.⁶²

At least one court has taken a contrary position regarding the effect of confirmation upon section 553 setoff rights. The *In re Slaw* court held that section 553 prevailed despite confirmation because of the setoff provision's absolute language and its limited enumerated exceptions.⁶³ The court also perceived potential equitable problems if it allowed debtors to evade setoff by seeking repayment from creditors post-confirmation.⁶⁴

E. CONFLICTS BETWEEN SETOFF AND DISCHARGE

Conflicts between the right to setoff under section 553 and the confirmation of a debtor's plan also occur in Bankruptcy Code Chapters 13, 12, and 7. In individual consumer reorganization situations under Chapter 13, plans are confirmed pursuant to section 1325.⁶⁵ Once the plans are completed the

60. 86 B.R. 325, 326 (Bankr. D.R.I. 1988). The Army sought to set off funds owed by the debtor to the Navy against its debt to the debtor. *Id.* The court ruled that the Army had ample opportunity to object to the reorganization plan, and that by remaining idle it had forfeited its right to setoff. *Id.*

61. *Id.*

62. See, e.g., *In re Charter Co.*, 103 B.R. 302, 305 (M.D. Fla. 1989) (holding that because the creditor did not seek bankruptcy court approval for its setoff prior to confirmation, it waived any setoff rights), *rev'd on other grounds*, 913 F.2d 1575 (11th Cir. 1990); *In re Crabtree*, 76 B.R. 208, 210 (Bankr. M.D. Fla. 1987) ("It cannot be gainsaid that a creditor whose prepetition claim is allowed and was not dealt with by the confirmed Plan of Reorganization should not have a right to a setoff.").

63. *Slaw Constr. Corp. v. Hughes Foulkrod Constr. Co. (In re Slaw Constr. Corp.)*, 17 B.R. 744, 748 (Bankr. E.D. Pa. 1982) (§ 553 setoff rights could not be extinguished even by confirmation).

64. *Id.* The judge feared that debtors would use confirmation and discharge to cheat creditors out of setoff rights by not pursuing their claims against the creditor until after confirmation. *Id.* A cautious creditor could prevent this danger by objecting to the confirmation of any plan which did not provide for the contingent claim.

65. 11 U.S.C. § 1325 (1988). Section 1327 provides:

(a) The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by

underlying debts are discharged under section 1328.⁶⁶ Section 524 governs the effect of discharge under section 1328 as well as that under Chapter 11.⁶⁷ Chapter 13, therefore, is similar in structure to Chapter 11 and provides for similar results upon confirmation.

In the Chapter 13 arena, courts have split on the issue of whether confirmation takes precedence over setoff rights. Several courts have held that confirmation prevails over subsequently asserted setoff rights.⁶⁸ The general approach, as in the Chapter 11 context, looks to the equities of the situation and bars the creditor from asserting post-confirmation setoffs where the creditor failed either to assert its rights prior to confirmation⁶⁹ or to object to the plan at the confirmation hearing.⁷⁰

the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all property of the estate in the debtor.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

11 U.S.C. § 1327 (1988).

Thus the language of § 1327 closely parallels that of § 1141. Both contain the same three sections performing essentially identical functions. See 11 U.S.C. §§ 1141, 1327 (1988). The effect of confirmation under Chapter 13 is therefore analogous with that under Chapter 11. The main difference is that Chapter 13 does not discharge debts until the plan is completed, see 11 U.S.C. § 1328 (1988), whereas discharge occurs immediately after confirmation under Chapter 11, see 11 U.S.C. § 1141.

66. 11 U.S.C. § 1328(a) (1988).

67. 11 U.S.C. § 524 (1988).

68. See, e.g., *United States ex rel. IRS v. Norton*, 717 F.2d 767, 774 (3d Cir. 1983) (finding that the IRS's delinquency in not objecting to plan at confirmation barred it from asserting setoff); *Edelsberg v. Thompson McKinnen Sec. (In re Edelsberg)*, 101 B.R. 386, 390 (Bankr. S.D. Fla. 1989) (holding that the confirmed plan is res judicata and subject to attack only in limited ways); *In re Warden* 36 B.R. 968, 972 (Bankr. D. Utah 1984) (holding that un-asserted setoff rights were lost on confirmation); *In re Alexander*, 31 B.R. 389, 391 (Bankr. S.D. Ohio 1983) (finding that confirmation of Chapter 13 plan barred § 533 setoff rights); *In re Hackney*, 20 B.R. 158, 159 (Bankr. D. Idaho 1982) (finding that creditor was bound to the payment provided for in the plan and could not assert setoff not provided for in the plan); *In re Holcomb*, 18 B.R. 839, 841 (Bankr. S.D. Ohio 1982) (holding that the failure to exercise setoff prior to confirmation barred post-confirmation setoff).

69. See *Norton*, 717 F.2d at 774; *Edelsberg*, 101 B.R. at 390; *Warden*, 36 B.R. at 972; *Alexander*, 31 B.R. at 391.

70. See *Lawrence Tractor Co. v. Gregory (In re Gregory)*, 705 F.2d 1118, 1123 (9th Cir. 1983); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1049-50 (5th Cir. 1977); *In re Henderberg*, 108 B.R. 407, 415 (Bankr. N.D.N.Y. 1989); *In re*

Other courts deciding Chapter 13 cases reached the opposite conclusion. One court largely followed the absolute terms of section 553's language in granting setoff.⁷¹ It concluded setoff must prevail because confirmation is not one of the enumerated exceptions to the right of setoff.⁷² Courts holding setoff superior to confirmation in the Chapter 13 setting also looked to equitable principles in each case that warranted finding creditors' setoff rights superior to the finality of confirmation.⁷³

Chapter 12 of the Code, governing farm reorganizations, also contains confirmation provisions that have led to conflicts over post-petition setoff rights.⁷⁴ Under Chapter 12, plans for the reorganization of family farms are confirmed and thereafter bind the parties.⁷⁵ Following confirmation the debts are discharged.⁷⁶ Two cases under Chapter 12 have dealt with this scenario, finding that confirmation overrode any attempt at a

Blanton Smith Corp., 81 B.R. 440, 442 (M.D. Tenn. 1987); *Minstar, Inc. v. Plastech Research (In re Arctic Enters.)*, 68 B.R. 71, 80 (D. Minn. 1986).

71. See *United States ex rel. IRS v. Orlinski (In re Orlinski)*, 140 B.R. 600, 603 (Bankr. S.D. Ga. 1991).

72. *Id.* at 603-04.

73. See, e.g., *id.* at 604 (holding that allowing setoff would not prejudice other creditors and would not impede debtor's reorganization); *United States ex rel. IRS v. Johnson (In re Johnson)*, 136 B.R. 306, 307-09 (Bankr. M.D. Ga. 1991) (holding that tax code provisions concerning setoff tipped balance in favor of allowing setoff).

74. See, e.g., *In re Butz*, 104 B.R. 128, 131-32 (Bankr. S.D. Iowa 1989) (disallowing setoff rights asserted after confirmation); *In re Stephenson*, 84 B.R. 74, 77-79 (Bankr. N.D. Tex. 1988) (holding confirmation trumped the late assertion of setoff).

75. 11 U.S.C. § 1227 (1988). Section 1227 provides:

(a) Except as provided in section 1288(a) of this title, the provisions of a confirmed plan bind the debtor, each creditor, each equity security holder, and each general partner in the debtor, whether or not the claim of such creditor, such equity security holder, or such general partner in the debtor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as provided in section 1228(a) of this title and except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

Id. These provisions also closely parallel the language of § 1141, containing the same three subdivisions with virtually identical language. See 11 U.S.C. § 1141 (1988).

76. Under Chapter 12, as in Chapter 11, debts are discharged immediately after confirmation rather than after completion of the plan as in Chapter 13. See 11 U.S.C. § 1228(a) (1988).

post-confirmation setoff.⁷⁷ The courts' rationale rested largely on the equities of effectuating the purposes of farm reorganization and the creditor's failure to assert timely its setoff rights.⁷⁸

A final analogous situation involving conflicts between setoff and discharge concerns liquidation bankruptcies under Chapter 7.⁷⁹ Under Chapter 7 the debtor's property is liquidated, creditors are paid from the proceeds, and the debtor receives a discharge from all debts.⁸⁰ Although no plan is confirmed,⁸¹ discharge under Chapter 7 is governed by section 524, the same section that delineates the effect of discharge under 1141, 1228, and 1328.⁸²

The courts also disagree on the effect of discharge on prepetition setoff rights in Chapter 7 cases.⁸³ Several courts favored setoff, because of the danger of denying due process to creditors who may lose their claims without notice.⁸⁴ Other courts, however, held discharge superior to setoff rights by twisting the language to avoid conflict,⁸⁵ or by considering the equities of the individual cases and the nature of setoff doctrine.⁸⁶

Bankruptcy Code Chapters 13, 12, and 7 contain conflicting language regarding confirmation and discharge and their effects on unasserted setoff rights. Most courts favor confirmation and discharge over creditors' attempts to assert setoffs late in the process. Especially where the Code requires reorganization plans and confirmation hearings, the majority of courts do not allow creditors who failed to object to the plan during the hear-

77. See *Butz*, 104 B.R. at 131-32; *Stephenson*, 84 B.R. at 77-79.

78. See, e.g., *Stephenson*, 84 B.R. at 79.

79. 11 U.S.C. §§ 701-766 (1988).

80. 11 U.S.C. § 727 (1988).

81. Unlike Chapters 11, 12, and 13, Chapter 7 does not involve a reorganization; consequently there is no reorganization plan.

82. 11 U.S.C. § 524 (1988).

83. See, e.g., *Camelback Hosp. v. Buckenmaier* (*In re Buckenmaier*), 127 B.R. 233, 237 (Bankr. 9th Cir. 1991) (holding that valid setoff cannot be defeated by discharge); *Davidovich v. Welton* (*In re Davidovich*), 901 F.2d 1533, 1539 (10th Cir. 1990) (allowing setoff); *Dezarn v. First Farmers Bank* (*In re Dezarn*), 96 B.R. 93, 95 (Bankr. E.D. Ky. 1988) (holding discharge trumps setoff); *Johnson v. Rutherford Hosp.* (*In re Johnson*), 13 B.R. 185, 189 (Bankr. M.D. Tenn. 1985) (finding discharge defeated setoff attempt); *Krajci v. Mount Vernon Consumer Discount Co.*, 16 B.R. 464, 466-67 (E.D. Pa. 1981) (upholding setoff rights even after discharge).

84. See, e.g., *Buckenmaier*, 127 B.R. at 237; *Davidovich*, 901 F.2d at 1539; *Krajci*, 16 B.R. at 466-67.

85. See *Johnson*, 13 B.R. at 189.

86. *Dezarn*, 96 B.R. at 95 (holding discharge trumps setoff); *Johnson*, 13 B.R. at 189 (finding discharge defeated setoff attempt).

ing subsequently to assert setoff rights not accounted for in the plan.

II. *IN RE DE LAURENTIIS ENTERTAINMENT GROUP*: ALLOWING SETOFF DESPITE CONFIRMATION

In *In re De Laurentiis Entertainment Group*, DEG sought reorganization under the provisions of Chapter 11.⁸⁷ In accordance with the Bankruptcy Code, DEG developed a reorganization plan⁸⁸ that the bankruptcy court confirmed pursuant to section 1141,⁸⁹ and its debts accordingly were discharged.⁹⁰ NBC, after failing to object to the reorganization plan at the confirmation hearing,⁹¹ subsequently sought to assert its right to setoff under section 553 as a defense to the payment of a debt claimed against it by the newly reorganized debtor, Carolco.⁹² The result was a conflict between the setoff provision of section 553 and the confirmation and discharge provisions of sections 1141 and 524.⁹³

The district court ruled in favor of NBC.⁹⁴ On appeal, the Ninth Circuit confronted the issue of whether section 553 rights to setoff trumped sections 524 and 1141.⁹⁵ It affirmed the judgment of the district court and held that NBC's setoff rights could not be extinguished, even by confirmation of the reorganization plan.⁹⁶

87. 963 F.2d 1269, 1271 (9th Cir. 1992).

88. *Id.* Reorganization plans are governed by § 1129. 11 U.S.C. § 1129 (1988).

89. 963 F.2d at 1271.

90. *Id.* The effects of discharge are delineated in § 524. 11 U.S.C. § 524 (1988).

91. *See* 11 U.S.C. § 1128 (1988).

92. 963 F.2d at 1271. It is unclear why NBC asserted a claim against the bankruptcy estate at all. NBC possessed a valid contractual claim against the advertising agency BBDO. *See supra* note 2 and accompanying text. Ordinarily one would expect NBC to assert its claim against BBDO and allow BBDO to worry about its claim against DEG. One probable explanation is that NBC tried to insure the payment of at least most of the debt at stake. Even with a reorganization, the debt is at risk of never being paid off in full. As the possessor of DEG's claim for \$1.25 million purchase, NBC could insure repayment of most of the advertising debt through the mechanism of setoff. Perhaps BBDO was in danger of bankruptcy if DEG did not pay its debt in full. In that event, NBC may have hoped to maximize its chances for repayment by using the mechanism of setoff and preventing DEG's bankruptcy from causing the nonpayment and bankruptcy of BBDO and subsequent nonpayment of NBC.

93. 963 F.2d at 1274.

94. *Id.* at 1271.

95. *Id.* at 1278.

96. *Id.* at 1276-77.

The Ninth Circuit began its analysis of this issue⁹⁷ by admitting the harsh textual conflict and impossibility of finding superiority simply by looking to the Code's language.⁹⁸ The court noted, however, that the list of exceptions to setoff rights enumerated in section 553 did not contain an exception for confirmation.⁹⁹ The court reasoned that because discharge was not a specified exception in the Code,¹⁰⁰ and because the wording of section 553 was absolute,¹⁰¹ setoff must trump confirmation and discharge.¹⁰²

The court also noted precedents dealing with the conflict between the two sections. Citing two Chapter 11 cases¹⁰³ that resolved the conflict in favor of confirmation,¹⁰⁴ the court disagreed with their brief reasoning.¹⁰⁵ The court also noted potential equitable characteristics distinguishing the precedents.¹⁰⁶

The Ninth Circuit then turned to three lines of analogous cases.¹⁰⁷ The court noted that several cases under the provisions of Chapter 13, which also involved confirmation of a reorganization plan, did not allow late assertion of setoff rights.¹⁰⁸

97. The court first considered a separate issue concerning the validity of NBC's quantum meruit claim against DEG. *Id.* at 1272-74. NBC successfully contended that California law did not require DEG to have an expectation of repayment by NBC in order to establish a valid quantum meruit claim. *Id.* at 1273.

98. *Id.* at 1274.

99. *Id.* at 1276-77; see 11 U.S.C. § 1141(b)-(c) (1988).

100. 963 F.2d at 1274; see 11 U.S.C. § 553 (1988 & Supp. III 1991).

101. 963 F.2d at 1276.

102. *Id.* at 1276-77.

103. The Ninth Circuit also cited another Chapter 11 case, *Slaw Constr. Corp. v. Hughes Foulkrod Constr. Co.* (*In re Slaw Constr. Corp.*), 17 B.R. 744 (Bankr. E.D. Pa. 1982), but incorrectly classified it as a Chapter 7 case. See 963 F.2d at 1276. The misclassification stems from the court's misconception that § 524 only applies to Chapter 7 cases. *Id.* The court recounted the provisions of § 524(a)(2), noting that the textual conflict between § 524 and § 553 is even greater than the conflict that it faced. *Id.* at 1276 n.14. The court did not realize that § 524 was applicable in the DEG Chapter 11 case.

104. *Service Decorating Co. v. Travelers Ins. Co.* (*In re Service Decorating Co.*), 105 B.R. 859, 862 (N.D. Ill. 1989); *In re Newport Offshore*, 86 B.R. 325, 326 (Bankr. D.R.I. 1988).

105. 963 F.2d at 1275.

106. *Id.*

107. The court stated that it is used four lines of analogous cases, but subsequently only provided analogies with Chapter 7, Chapter 11, and cases under the old Bankruptcy Act of 1898. See *id.* at 1275-76.

108. *Id.* at 1275 (citing *United States ex rel. IRS v. Norton* (*In re Norton*), 717 F.2d 767 (3d Cir. 1983); *In re Hackney*, 20 B.R. 158 (Bankr. D. Idaho 1982); *In re Holcomb*, 18 B.R. 839 (Bankr. S.D. Ohio 1982)).

The court also examined Chapter 7 cases involving the conflict between setoff rights and discharge under section 524 and found that a majority of these cases subordinated discharge to setoff rights.¹⁰⁹ Finally, the court considered provisions under the old Bankruptcy Act involving a similar problem.¹¹⁰ Noting the close tracking of the provisions, the court stated that decisions under the Bankruptcy Act suggested that section 553 set-off rights should predominate over confirmation and discharge.¹¹¹

The Ninth Circuit also considered policy arguments in support of its conclusion to allow NBC's setoff rights. The court first noted that disallowing setoff rights in this case would emasculate the language of section 553, making it superfluous.¹¹² The court determined that, historically, judicial interpretation of the Code favored setoff rights and granted them liberally.¹¹³ Denying setoff rights to NBC would be contrary to the history of setoffs in bankruptcy law.¹¹⁴

The court further reasoned that denying setoff rights following confirmation would be inequitable to creditors who would have to pay their obligation to the debtor in full, while facing the possibility of only partial repayment of their debts from the debtor.¹¹⁵ The court concluded that nullification of NBC's setoff rights would be unfair because NBC diligently pursued its case before the bankruptcy court.¹¹⁶

III. WHY SETOFF SHOULD NOT BE ALLOWED AFTER CONFIRMATION IN CHAPTER 11

A. TEXTUAL INTERPRETATION

The court's textual analysis holding section 553 setoff rights superior to section 1141 rested on an incorrect reading of

109. *Id.* at 1275-76 (citing *Camelback Hosp. v. Buckenmaier* (*In re Buckenmaier*), 127 B.R. 233 (Bankr. 9th Cir. 1991); *Davidovich v. Welton* (*In re Davidovich*), 901 F.2d 1533 (10th Cir. 1990); *Krajci v. Mount Vernon Consumer Discount Co.*, 16 B.R. 464 (E.D. Pa. 1981)).

110. *Id.* at 1276 (citing *Record Club of Am. v. United Artists Records*, 80 B.R. 271 (S.D.N.Y. 1987) (allowing setoff in § 68 reorganization); *In re Reading Co.*, 72 B.R. 293 (E.D. Pa. 1987) (allowing setoff in § 77 railroad reorganization)).

111. *Id.*

112. *Id.* at 1277.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 1277-78.

the Bankruptcy Code. The court first identified the conflicting absolute wording contained in sections 1141 and 553.¹¹⁷ The court, however, then reached the faulty conclusion that Congress's failure to place confirmation in section 553's enumerated exceptions to setoff¹¹⁸ illustrated that Congress intended to grant setoffs superiority over confirmation and discharge.¹¹⁹

The Ninth Circuit's textual analysis improperly stretches the meaning of the Code. Section 1141 and section 524 also have enumerated exceptions to confirmation and discharge.¹²⁰ Section 1141 does not include setoffs as an exception to the effects of confirmation.¹²¹ Nor is setoff one of the specified exceptions to discharge.¹²² Consequently, the same reasoning concerning enumerated exceptions the court used to find section 553 superiority also provides an argument for section 1141 and section 524 preeminence.

The legislative history of section 553 does not support the conclusion that Congress intended to subordinate confirmation and discharge to setoff. Instead, the legislative history illustrates Congress merely intended to include setoff doctrine in the new Code. Nothing supports the argument that Congress wrote the provisions of section 553 with intent to supersede all other sections. Further, the legislative history explaining the exceptions to discharge shows that the primary focus of Congress was to attack setoff "preferences." Thus, the limited scope of the enumerated exceptions to section 553 was the result of an intent to deal with the specific problem of setoff preferences, and is not indicative of a broad congressional purpose regarding the predominance of setoff rights.

A careful textual reading of all three applicable sections supports the conclusion that confirmation and discharge should trump setoff rights. Section 1141(c) provides that once a plan is confirmed, all property of the debtor is free and clear of all creditors' claims and interests except as provided in the plan.¹²³ By discharging the debtor's debts, 1141 triggers section 524, which explicitly prevents creditors from attempting to offset against property of the debtor, unless the reorganization plan

117. These two provisions are written in conflicting absolute terms. *See* 11 U.S.C. §§ 553, 1141 (1988).

118. *See* 11 U.S.C. § 553(b)-(c) (1988 & Supp. III 1991).

119. 963 F.2d at 1276-77.

120. *See* 11 U.S.C. §§ 524, 1141(d)(2)-(3) (1988).

121. *See* 11 U.S.C. § 1141(d)(2)-(3) (1988).

122. *See* 11 U.S.C. § 523 (1988).

123. 11 U.S.C. § 1141(c) (1988).

so provides.¹²⁴ The Ninth Circuit overlooked this textual support for holding section 1141 superior to section 553 setoff rights.

B. ERRONEOUS USE OF PRECEDENT

The Ninth Circuit cited only two Chapter 11 cases treating the conflict between sections 553 and 1141. The court provided no basis for distinguishing these cases from the DEG situation other than to call one dictum and to note the limited discussion of the issue in the other case. The Ninth Circuit thus did little to explain or criticize the existing precedents under Chapter 11 which deal with sections 553 and 1141. Instead of offering some analytical basis for distinguishing the cases, the Ninth Circuit immediately turned to cases under analogous chapters of the code to support its decision.

Several precedents under Chapter 11 support the denial of setoff rights after confirmation of a reorganization plan. These cases rely on the policies underlying sections 1141 and 524, and the doctrine of *res judicata*. They hold that granting confirmation and discharge superiority to setoff rights protects the interests of both the debtor and its creditors and effectuates the policies behind the doctrine of *res judicata*. The Ninth Circuit failed to explain why these policies do not control in the DEG context.

Another Chapter 11 precedent relied on the absolute wording of section 553 to uphold setoff even after confirmation. Although the *In re De Laurentiis Entertainment Group* court did not cite this case, it advanced the same argument. Reliance on the absolute wording of section 553 ignores the text of section 524 which explicitly states that discharge prevents setoffs.

The court did cite several Chapter 13 cases holding that creditors who fail to assert their setoff rights in a timely manner at the confirmation hearing should not be able to jeopardize the reorganization by subsequently asserting their setoffs. After mentioning these cases, however, the court ignored them, despite Chapter 13's similarity to Chapter 11. Structurally, Chapter 13 closely resembles Chapter 11 because both involve reorganization plans subject to confirmation, and both chapters contain nearly identical language concerning the effect of confirmation. Despite the similarities between the two chapters, the Ninth Circuit did nothing to distinguish or criticize the

124. 11 U.S.C. § 524 (1988).

Chapter 13 precedents, and relied instead on less analogous cases under other chapters of the Bankruptcy Code.

The Ninth Circuit completely ignored any Chapter 12 precedents regarding conflicts between confirmation and setoff rights. In the two existing Chapter 12 precedents on point, the courts held that the failure to object to a plan at the confirmation hearing precluded assertion of setoffs not included in the reorganization plan. Chapter 12 precedents that addressed provisions which closely tracked section 1141 and involved confirmation of a reorganization plan which discharged debts thus provide additional support for granting section 1141 superiority to section 553.

The Ninth Circuit's discussion of similar cases under Chapter 7 was marred by its misconception of section 524 and its failure to consider the reasoning employed in those cases.¹²⁵ Although the Ninth Circuit correctly noted that a majority of courts hold that in the Chapter 7 context discharge does not preclude later assertion of setoff rights, the court failed to appreciate these courts' analysis. The courts in the Chapter 7 cases were concerned about the due process rights of creditors who may lack notice and an opportunity to assert setoff rights prior to discharge. This concern does not arise in the Chapter 11 context because a hearing is required when the reorganization plan is put forth. Chapter 7 cases are distinguishable from those arising in a Chapter 11 setting, and thus do not apply to the kind of problem posed in *In re De Laurentiis*.

The Ninth Circuit also relied on cases under the analogous provisions of the old Bankruptcy Act. While the legislative history of section 553 states an intent to preserve the right to setoff as it previously existed, the Ninth Circuit's argument that section 553 closely tracks the old Act is incorrect.¹²⁶ The analogy between section 1141 and the other confirmation provisions in the Code is much closer than that in the Act.

C. POLICY CONSIDERATIONS

The Ninth Circuit's argument that section 553 would be rendered meaningless if subordinated to section 1141 is incorrect. The legislative history of section 553 illustrates that Congress intended to include the doctrine of setoff within the new

125. The Ninth Circuit mistakenly placed all cases involving § 524 under the Chapter 7 analogy, believing that § 524 only applied under Chapter 7.

126. Section 553 adopts an entirely different construction of setoff rights than does § 68 of the old Bankruptcy Act.

Bankruptcy Code. This purpose is achieved even if setoffs must be included in reorganization plans prior to confirmation. Further, section 553 provides useful restrictions on acquiring claims for the purpose of setoff prior to bankruptcy.

The Ninth Circuit misstated traditional setoff doctrine in bankruptcy when it argued that denying setoff after confirmation would conflict with a bankruptcy policy in favor of setoff. The Supreme Court has held that setoffs are *disfavored* in bankruptcy.¹²⁷ The notion of setoff conflicts with the policy of granting equal treatment to creditors because it allows the creditor holding the setoff rights priority over other creditors. The result benefits one creditor only at the expense of all others. Thus, the court's concern to treat the individual creditor equitably is inconsistent with general bankruptcy policy.

The Ninth Circuit's sympathy for NBC is also misplaced. To argue that NBC diligently pursued its claim before the bankruptcy court is to ignore NBC's silence in the confirmation hearing despite its knowledge that the plan did not provide for its setoff rights. The court also believed that NBC would be unfairly denied its setoff right only because its quantum meruit claim was not reduced to judgment prior to confirmation. This need not have affected NBC, however, because NBC should have objected to the confirmation of a plan that did not account for its potential setoff. An objection based on the possibility of setoff would have delayed confirmation until resolution of this contingency.¹²⁸

NBC's conduct also may be contrary to the policy underlying the exceptions to section 553. These exceptions seek to prevent creditors from manipulating claims so as to acquire setoff rights that improve their positions with respect to other creditors. That NBC brought a quantum meruit claim against DEG rather than pursuing BBDO suggests that NBC manipulated claims to achieve setoff. NBC probably did so to insure that the advertising debt was paid ahead of other debts. Thus, fairness to other creditors should have precluded NBC from exercising setoff in this case.

Most importantly, the policy behind *res judicata* requires confirmation and discharge to supersede setoff rights. *Res judi-*

127. *Baker v. Gold Seal Liquors*, 417 U.S. 467, 474 (1974).

128. *See, e.g., In re Lund*, 136 B.R. 237, 241 (Bankr. D.N.D. 1990) (denying confirmation of a plan which did not provide for the setoff of a debt even though the amount of liability depended on resolution of exact contract damages).

cata policy insures fairness to parties who rely on a judgment which was not directly appealed. Giving confirmation and discharge their full res judicata effect yields fair treatment for all parties involved. The many other creditors who do not hold setoff rights can thereby make informed decisions about the reorganization process and its effect on their operations, including how they will vote on the reorganization plan.

The Ninth Circuit's ruling further undermines the essential purpose of Chapter 11. The reorganized debtor's search for additional capital, vital to a successful reorganization, is hampered if the confirmed plan is not given a full res judicata effect. Given the odds against a successful reorganization, to pose yet another obstacle conflicts with the purpose of Chapter 11. The only difficulty in granting confirmation primacy is the requirement that a creditor who wishes to assert setoff rights do so prior to confirmation. A bright line rule would protect the rights of all involved, and realize Chapter 11's goal of allowing struggling businesses to reorganize.

CONCLUSION

In *In re De Laurentiis Entertainment Group*, the Ninth Circuit held that creditors who did not object to the confirmation of a Chapter 11 plan nonetheless could subsequently assert setoff rights for which the plan did not provide. It determined that the absolute language of section 553 setoff rights trumps the absolute wording in the provisions of sections 1141 and 524 regarding confirmation and discharge. This ruling undermines the ability of the reorganized debtor and other creditors to rely on a final bankruptcy court judgment confirming the plan and discharging the underlying debts, and runs counter to precedent and bankruptcy policy. This Comment argues that bankruptcy and res judicata policies require that sections 1141 and 524 should take precedence over section 553 setoff rights.