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Introduction

A debtor healthcare provider without significant resources is unlikely to survive any prolonged disagreement with private or government payors. This challenge may be exacerbated by a debtors' bankruptcy filing if a payor may refuses to make certain payments owed to the debtor. Therefore, whether a payors' withholding of funds owed to a debtor hospital is considered an impermissible setoff or a permissible equitable recoupment is crucial.

This memorandum will explore whether a Medicaid/Medicare payor can withhold payments owed to a debtor, or whether such withholding violates the automatic stay. Part A will discuss withholding in healthcare bankruptcy scenarios generally. Part B will compare and contrast setoff and recoupment. Part C will analyze the two different tests that circuits use in determining whether the "same transaction" requirement of recoupment is satisfied. **Discussion**

A. Withholding in Healthcare Bankruptcy Scenarios

State governments, the federal government, and private payors will often withhold payments to healthcare providers because of a debt owed by the provider.[1] This withheld

[1] *See* Matter of Guiding Light Corp., 213 B.R. 489, 492 (Bankr. E.D. La. 1997).

payment is deducted from the debt the provider owes to the payor.[2] In general, a government payor will enter into an agreement with a Medicare or Medicaid provider, pursuant to which the provider is entitled to reimbursement for a percentage of their costs, subject to certain requirements.[3] The funds that the payor withholds are generally reimbursement payments or Medicare/Medicaid overpayments.[4]

There are two ways in which the payor can withhold owed funds from a healthcare provider that is in bankruptcy. The payor can either setoff an obligation owed to the provider, or the payor can recoup its obligation to pay the providers' claim for funds.[5] Under title 11 of the United States Code (the "Bankruptcy Code"), a payor can reconcile outstanding mutual debts owed between the provider and payor arising out of separate transactions through setoff.[6] Conversely, a payor can utilize recoupment, an equitable defense to paying the full amount of a claim asserted by a provider arising from the same transaction.[7]

B. Setoff and Recoupment Compared

When a payor withholds payments, providers often argue that the withholding was an impermissible setoff and therefore "violated the automatic stay by failing to obtain stay-relief before effectuating the setoff."[8] Conversely, the payor typically argues that the withholding was a permissible recoupment, and therefore did not need to comply with the requirements for automatic stay under the Bankruptcy Code.[9] Whether the withheld payment is considered setoff

[2] *See id.*
[3] *See In re* TLC Hosps., Inc., 224 F.3d 1008, 1010 (9th Cir. 2000).
[4] *See id.*
[5] *See* Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984).
[6] *See* § 11 U.S.C. 553 (2012).
[7] *See* U.S. v. Consumer Health Servs. Of Am., Inc. 108 F.3d 390, 395 (D.C. Cir. 1997).
[8] *In re* Gardens Reg'l Hosp. & Med. Ctr., Inc., 569 B.R. 788, 793 (Bankr. C.D. Cal. 2017).
[9] *See In re* Madigan, 270 B.R. 749, 752 (B.A.P. 9th Cir. 2001) (noting that Aetna, Inc., a health care insurance company, argued that because their rights to payments from the debtor arose from the "same transaction" as the debtors' claim for disability benefits, that equitable recoupment should apply).

or recoupment is critical— it will determine whether or not the provider has to continue making payments to the payor after filing for bankruptcy.

1. Setoff Under the Bankruptcy Code

Setoff is "a right of equitable origin designed to facilitate the adjustment of mutual obligations."[10] As the United States Supreme Court has previously stated, setoff is "grounded on the absurdity of making A pay B when B owes A."[11] As a matter of policy, setoff is favored over independent suit under the law in order to avoid inefficient use of judicial resources, added expense, and inconvenience.[12]

Setoff itself is limited by several provisions of the Bankruptcy Code. Section 553(a) elevates an unsecured claim to secured status, to the extent that there is a mutual debt between the creditor and debtor.[13] While the mutual debts do not need to arise from the same transaction, both of the debts are must originate pre-petition, or before filing for bankruptcy.[14] Additionally, § 506(a) provides that a creditor with a valid right of setoff is to be treated as the holder of a secured claim to the extent of the right.[15] Finally, § 362 provides for an automatic stay upon the filing of bankruptcy.[16]

Collection efforts that are subject to the automatic stay under § 362(a)(7) include "the setoff of any debt owed to the debtor that arose before the commencement of the case under this title against any claim against the debtor."[17] Because the automatic stay limits the creditors' setoff rights, creditors must seek relief from the bankruptcy courts before asserting these rights.[18]

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[10] 5 COLLIER ON BANKRUPTCY ¶ 553.01 (Richard Levin & Henry J. Sommer eds., 16th ed. 2018).
[11] Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913).
[12] *See* N. Chi. Rolling Mill Co. v. St. Louis Ore & Steel Co., 152 U.S. 596 (1894).
[13] *See* 11 U.S.C. § 553(a).
[14] *See id.*
[15] *See* 11 U.S.C. § 506(a) (2012).
[16] *See* 11 U.S.C. § 362 (2012).
[17] 11 U.S.C. § 362(a)(7).
[18] *See* U.S. on Behalf of I.R.S. v. Norton, 717 F.2d 767, 771 (3d Cir. 1983).

2. The Equitable Doctrine of Recoupment

Separate and distinct from setoff, courts have established the equitable doctrine of recoupment.[19] Recoupment allows the creditor to assert that certain mutual claims extinguish one another in bankruptcy, despite the fact that they could not be setoff under 11 U.S.C. § 553.[20] Recoupment "exempts a debt from the automatic stay when the debt is inextricably tied up in the post-petition claim."[21] Unlike setoff which is limited to pre-petition claims, recoupment can be used to recover across the petition date.[22] Furthermore, also unlike setoff, recoupment is not subject to automatic stay under § 362(a)(7).[23] The limitation on recoupment is that the creditors' claim against the debtor must arise from the "same transaction" as the debtors' claim.[24]

C. The Two Tests Utilized in Determining Whether the "Same Transaction" Requirement is Satisfied

The rights of setoff and recoupment originated in common law and equity. Unlike setoff, recoupment is not referred to in the Bankruptcy Code.[25] Recoupment is limited by the common law rule that the relevant obligations constitute part of the "same transaction."[26] However, courts have been reluctant to establish a precise definition of what constitutes the same transaction, instead focusing on a fact intensive analysis of each individual case. One common theme among the courts is that the same transaction requirement is satisfied when the corresponding liabilities arise under the same contract, or provider agreement.[27]

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[19] *See* COLLIER ON BANKRUPTCY ¶ 553.10[1] (Richard Levin & Henry J. Sommer eds., 16th ed. 2018).
[20] *See id.*
[21] Consumer Health Servs. Of Am., Inc., 108 F.3d at 395.
[22] *See In re* TLC Hosps., Inc., 224 F.3d at 1011.
[23] *See* 11 U.S.C. § 362(a)(7).
[24] *Schweiker*, 739 F.2d at 875.
[25] *See* NORTON BANKR. L & PRAC. 3d § 73:2 (William L. Norton, Jr. 2018).
[26] *Schweiker*, 739 F.2d at 875.
[27] *See id.* ("In bankruptcy, the recoupment doctrine has been applied primarily where the creditor's claim against the debtor and the debtor's claim against the creditor arise out of the same contract.").

Courts have established two different tests in determining whether a claim arises out of the same transaction or a single contract: the "logical relationship test" and the "single integrated transaction test."[28] Under the broader logical relationship test, a transaction may include "a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship."[29] Conversely, under the more restrictive single integrated transaction test, "both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations."[30]

1. **Applying the Flexible "Logical Relationship Test" to Health Care Provider Agreements**

The logical relationship test is more flexible than the single integrated transaction test.[31] Applying the logical relationship test, "courts 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."[32]

The term transaction is given a flexible meaning within the logical relationship test, but the term should not be "applied so loosely that multiple occurrences in any one continuous commercial relationship would constitute one transaction . . . ."[33] Acknowledging that there are limits to what constitutes a transaction, the court in *In re TLC Hospitals* held that the doctrine of recoupment was applicable in the Medicare context because of the existence of a provider

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[28] *In re* Madigan, 270 B.R. at 755.
[29] *In re* TLC Hosp., 224 F.3d at 1008.
[30] Univ. Med. Ctr. v. Sullivan (*In re* Univ. Med. Ctr.), 973 F.2d 1065,1081 (3d Cir. 1992).
[31] *See In re* Madigan, 270 B.R. at 755 (explaining that courts utilizing the logical relationship test use the same definition of "transaction or occurrence" in determining whether a counterclaim is compulsory).
[32] *Id.*
[33] *In re* TLC Hosps., Inc., 224 F.3d at 1011.

agreement and the ongoing relationship between Medicare and its providers.[34] Specifically, the court held that the government may recoup Medicare or Medicaid overpayments to providers from any cost year against any and all subsequent payments, including reimbursements for future services.[35]

The Ninth Circuit in *In re Gardens* also applied the logical relationship test and held that the doctrine of equitable recoupment permitted California's Medicaid administrator to withhold funds owed to a bankrupt hospital in order to recover fees that the state was owed.[36] Because the hospital's obligation to pay fees was "logically related" to the administrator's obligation to make the payments, it therefore arose out of the same "transaction or occurrence," making the state's recoupment permissible.[37] The court found that that there was a logical relationship because the debtor-hospital and Medicaid administrator had a provider agreement that stated if the hospital failed to pay its fees to the state, the state could deduct the fee from any payments owed to the hospital.[38] The court explained that when there is a contract, such as this provider agreement, the issue is not enforceability, but whether the agreement created a relationship between the fee owed and the debtors' entitlement to payments.[39] In that instance, had the debtor-hospital "not agreed to [the Medicaid administrator's] recoupment rights, the debtor would never have been eligible to perform the services entitling it to Medi-Cal payments."[40] Therefore, the debtor-hospital's debt was "inextricably tied up" in its claim for funds and recoupment applies.[41]

Recoupment is not automatic when relevant obligations arise under a single contract, but when a Medicaid provider agreement creates a relationship between fees owed and entitlement to

[34] *See id.*
[35] *See id.*
[36] *See* 569 B.R. at 788.
[37] *Id.* at 794.
[38] *See id.* at 796.
[39] *See id.* at 796–797.
[40] *Id.* at 797.
[41] *Id.*

payment, the payors' offset rights are those of recoupment rather than setoff.[42] This interpretation of what satisfies the same transaction requirement of recoupment is consistent with the development of the equitable recoupment doctrine. In particular, the First, Seventh, Ninth, and District of Columbia Circuits follow the broad logical relationship test and have found that pre-petition Medicare payments to a health care entity and subsequent post-petition adjustments are all part of the same transaction.[43]

2. Applying the Narrow "Integrated Transaction Test" to Healthcare Provider Agreements

Many circuits follow the logical relationship test in determining whether a claim arises out of the same transaction, but the Third Circuit in particular has adopted the stricter integrated transaction test.[44] Under the integrated transaction test, the Third Circuit has held that a state agency's withholding was an impermissible setoff in violation of the automatic stay, notwithstanding the presence of a provider agreement.[45]

The Third Circuit in *University Medical Center* stated that "[f]or 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 necessarily mean that the two arose from the same transaction."[46] Instead, the court urged that both debts must come from a single integrated transaction, making it inequitable for the debtor to appreciate the value of the transaction without also meeting its obligations to the creditor.[47] Under this single integrated transaction approach to evaluating what satisfies the same transaction

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[42] *See* COLLIER ON BANKRUPTCY ¶ 553.10[1]; *In re Gardens*, 569 B.R. at 797.
[43] *See* Slater Health Ctr., Inc. v. United States (*In re* Slater Health Ctr., Inc.), 398 F.3d 98, 105 (1st Cir. 2005); *In re* Health Mgmt. Ltd. P'ship, 336 B.R. 392, 397 (Bankr. C.D. III. 2005); *In re* Gardens 529 B.R. at 597; *Consumer Health Servs. Of Am. Inc.*, 108 F.3d at 390.
[44] *See In re* Univ. Med. Ctr., 973 F.2d at 1081.
[45] *See id.*
[46] *Id.* (internal citations omitted).
[47] *See id*.

requirement for purposes of recoupment, the court noted that recoupment "as a non-statutory, equitable exception to the automatic stay, should be narrowly construed."[48] Emphasizing that recoupment should be narrowly construed, the court held that overpayment debts owed by the debtor-hospital were "distinct from and [bore] no direct relation to the particular claims for reimbursement for services performed post-petition."[49] Consequently, the government's withholding of the debtor-hospital's post-petition reimbursements was an impermissible setoff that violated automatic stay.[50]

The issue with the integrated transaction test as applied in *University Medical Center* is that it can be used to deny recoupment in nearly every case.[51] The court noted that recoupment may be denied as long as the amount of the relevant obligations to be recouped can be "independently determinable."[52] However, "corresponding obligations are always 'independently determinable' to some degree; otherwise there would be no occasion to reduce one on account of the other."[53]

Conclusion

As jurisprudence develops, courts are moving in the direction of applying the logical relationship test to determine whether the "same transaction" requirement is satisfied, especially in Medicaid bankruptcy scenarios where there is a provider-agreement.[54] This is reflected in the *In re Gardens* decision, where the court held that when there is a contractual provider agreement that creates a relationship between fees owed and entitlement to payment, recoupment permits

[48] *Id.*
[49] *Id.* at 1081.
[50] *Id*.
[51] *See* 5 COLLIER ON BANKRUPTCY ¶ 553.10[1].
[52] *In re* Univ. Med. Ctr., 973 F.2d at 1081; *see In re* Gardens*,* 569 B.R. at 793 (stating that the debtor-hospital argued the state's withholding was a setoff, not recoupment, because their fee liability to the state existed regardless of whether it participated in the Medi-Cal program).
[53] 5 COLLIER ON BANKRUPTCY ¶ 553.10.
[54] *See In re* Slater Health Ctr., Inc., 398 F.3d at 105; *In re* Health Mgmt. Ltd. P'ship, 336 B.R. at 397; *In re* Gardens 529 B.R. at 597; *Consumer Health Servs. Of Am. Inc.*, 108 F.3d at 390.

the state agency to withhold funds owed.[55] The application of the recoupment doctrine to healthcare bankruptcy scenarios where there is a provider agreement is consistent with the increasingly broad interpretation of what constitutes a "transaction" in the recoupment context.[56]

Conversely, applying the integrated transaction test to these provider agreements is inconsistent with the fact that Ninth Circuit courts have given "transaction" a "liberal and flexible construction, . . . requiring only that the obligations be sufficiently interconnected so that it would be unjust to insist one party fulfill its obligation without requiring the same of the other party."[57] Furthermore, applying the single integrated transaction test to Medicaid provider agreements undermines the purpose and policies of the Medicare system, which requires a constant balancing between payments and reimbursements.[58]

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[55] *See In re* Gardens 569 B.R. at 800.
[56] *See id.*
[57] *In re* Gardens*,* 569 B.R. at 795 (citing *In re* Madigan, 270 B.R. at 755).
[58] *In re* Dist. Mem'l Hosp. of, Sw. N. Carolina, Inc.*,* 297 B.R. 451, 455 (Bankr. W.D.N.C. 200) ("[T]his court finds that the distinctive Medicare and Medicaid systems of estimated payments and later adjustments do constitute a single transaction for recoupment purposes. Such an exchange of funds may stretch over an extended period of time, reflecting a continuous balancing process between the parties.").