

A Practitioner's Guide to Set-Off and Recoupment

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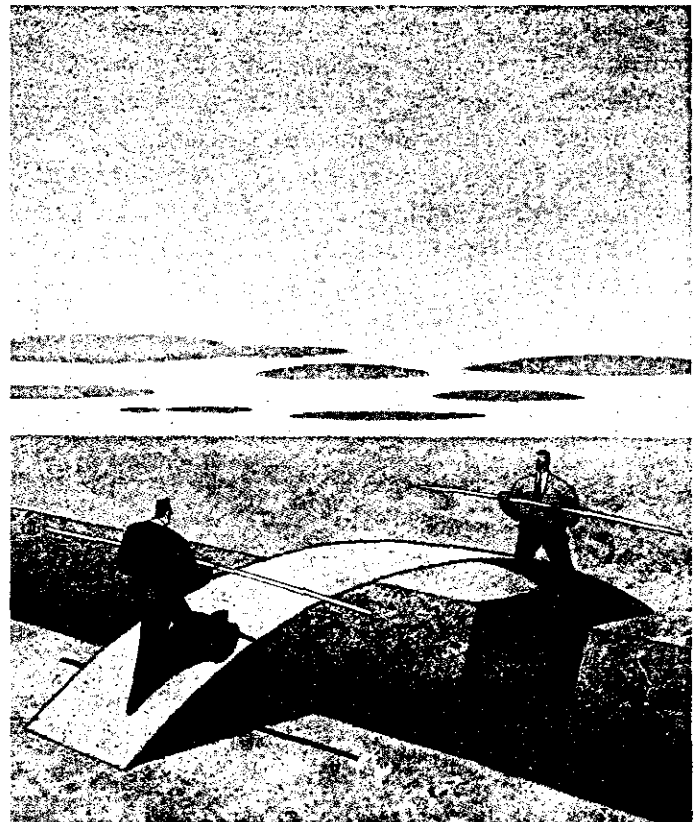
Susan Smith, a long-time client and president of ABC Manufacturing & Sales Corp., comes into your office and informs you that a former customer is suing ABC for \$100,000 arising from an alleged breach of a long-term requirements contract. She further informs you that seven years ago that same customer failed to make a payment in the amount of \$25,000 on the same requirements contract because of a minor dispute involving timely delivery of goods. ABC enjoyed a long-standing business relationship with the customer, who also was a consistent source of referrals, so it never sued over the old default. Now, of course, ABC wishes it had not let the matter slide.

This scenario, although subject to some factual variation, is fairly common. Most attorneys will file this background information away and, in preparing an answer to the complaint, will assert *pro forma* defenses of both recoupment and set-off in an effort to reduce a client's potential damages. But why assert both of these legal theories? Do most practitioners really understand the difference? And, can either concept be useful as something more than a formulaic defense or tool in negotiating settlements?

Although the terms may be, and often are, used interchangeably, and despite certain conceptual similarities, set-off and recoupment differ in application and effect. The knowledgeable attorney is not only aware of the differences between the two, but also is able to use the distinctions to revive a client's otherwise time-barred action.

The Pragmatic Distinctions Between Set-Off and Recoupment

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Galpen,² the Chancery Division analogized set-off as “[a] right ... exist[ing] between two parties each of whom under an independent contract owes an ascertained amount to the other and a claim for payment is made permitting each party to set-off his respective debt by way of mutual deduction against such a claim.”³

In practice, attorneys often refer to any competing claim a defendant may have as a set-off and, indeed, courts also use the term in its most general sense. To be strictly accurate, however, the affirmative defense of set-off applies only to claims arising from a distinctly separate underlying transaction. Thus, in the opening example, the fictional ABC Manufacturing & Sales Corp. would have a valid set-off defense if the prior default by its customer had been on a different contract than the one giving rise to its current suit. Under the facts of the example, however, ABC’s actual defense is recoupment.

Recoupment, as distinguished from the modern concept of set-off, originally was employed in England as a defense to allegations of fraud or deception. The doctrine eventually grew to include a common defense to claims arising from breach of contract, as well as various theories of negligence.⁴ The original theory of recoupment permitted a defendant to assert a claim for damages owed to him or her by the plaintiff, even though the claim did not necessarily arise out of the same transaction as the plaintiff’s underlying claim. Under modern American practices, the old recoupment defense has evolved into the

more familiar counterclaim and, ironically, set-off. However, when asserted as a defense, recoupment still has one significant advantage over the modern counterclaim.

The term recoupment now generally refers to an affirmative defense that may be asserted by a defendant whose claim is based upon the same transaction that is the subject of the plaintiff’s suit. The New Jersey Supreme Court, in *Beneficial Finance Co. v. Swaggerty*,⁵ reasoned that “[t]he underlying policy [of recoupment] is ‘to permit a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.’”⁶ Thus, a successful recoupment defense, while effectuating the reduction of a plaintiff’s demand based upon a defendant’s offsetting claim, allows for judicial efficiency by equitably reconciling the demands of the competing parties, whose claims are based upon the same legal transaction.

Set-off and recoupment may be distinguished further not only with respect to their applicability to a particular defendant’s claims, but by the affirmative recovery a defendant may realize as well. The court in *Gibbins v. Kosuga*⁷ articulated these distinctions, as follows:

Recoupment differs from set off mainly in that the claim must grow out of the identical transaction that furnishes the plaintiff’s cause of action and, being in the nature of a claim of right to reduce the amount demanded, can be had only to an extent sufficient to satisfy the plaintiff’s

claim. In other words, recoupment goes to the justice of the plaintiff’s claim, and no affirmative judgment can be had thereon, while set off is not necessarily confined to the justice of such particular claim, and an affirmative judgment may be had for any amount to which the defendant established his right over and above the amount to which the plaintiff has proved he is entitled.⁸

Accordingly, although recoupment may be employed to decrease or extinguish a plaintiff’s demand, set-off may be awarded for any amount to which the defendant is entitled.⁹

Recoupment: A Legal Strategy to Revive a Time-Barred Claim

The rigidity of statutes of limitations is “designed to bar stale claims; to require parties to assert their demands within a fixed time, in order to avoid losing witnesses or evidence that the opposing party ordinarily might have had except for the inordinate passage of time from the inception of the cause of action.”¹⁰

While every attorney understands the importance of the statute of limitations, most clients have only a cursory understanding of the concept. In fact, in commercial settings, clients often may forego legal action in an effort to preserve profitable business relationships, considering litigation only when the relationship cannot be salvaged.

When the business relationship finally breaks down to the point where litigation is necessary or inevitable, one side, or both sides, usually dredges up every past wrong, no matter how stale. Although these prior disputes often are time-barred, it may be possible to revive such claims using the theory of recoupment.

Indeed, one of the most significant distinctions between set-off and recoupment is that a claim of recoupment is immune from the effects of an expired

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limitations period. An important *caveat*, however, is that the plaintiff's underlying action must be timely filed. Properly asserted, recoupment serves as a judicial device employed to avoid the strict and sometimes egregious results stemming from the application of a limitations statute.¹¹ Set-off, conversely, is premised upon the notion of two separate and independent transactions. Accordingly, a set-off is vulnerable to a statutory limitations period, as it applies to the claim raised by the set-off, and is largely ineffective as a tool for reviving a stale claim.

As mentioned, if the principal action is timely filed, a counterclaim setting forth recoupment as an affirmative defense is permissible even if it would have been precluded by a statute of limitations in an independent action. For example, in *Gibbins*, the court was faced with an issue concerning whether an otherwise time-barred claim could be used in a recoupment action if the claim was stale at the inception of the primary action. The court held that the defendants could assert the nonpayment of a promissory note given as part of the transaction in issue as a recoupment claim, despite the fact that such a claim would otherwise be time-barred. The court further reasoned:

The fact that recoupment seeks the reduction of a claim because of an offsetting claim arising out of the same transaction would seem in logic and in equity to justify treating it differently than a set-off which seeks a reduction because of an offsetting claim arising out of a totally unrelated transaction. To hold differently

would be to permit the inequity of one party to a transaction demanding full performance from the other while refusing to perform fully itself.¹²

Similarly, in *Midlantic Nat'l Bank v. Georgian, Ltd.*,¹³ a bank brought an action to recover money lent. The defendant debtors set forth a counterclaim for equitable recoupment based upon forged checks that had been drawn on their account at Midlantic. Midlantic filed a motion for summary judgment seeking to dismiss the counterclaim as time-barred, due to the expiration of the one-year statute of limitations period. In denying Midlantic's motion, the court established that "[a]lthough the defendants may not raise this cause of action as a sword against Midlantic, they may raise it as a shield by way of counterclaim if the counterclaim sets forth a cause of action in equitable recoupment."¹⁴

Using the Shield as a Sword

Sometimes, the best defense is a good offense. Accordingly, recoupment may allow the savvy practitioner to turn a defensive shield into an offensive weapon. Even the inexperienced attorney can use a potential set-off as leverage in settlement negotiations. The experienced litigator, however, will recognize the value of an otherwise time-barred claim. In commercial cases, bad blood often builds up over a period of years. Given enough information about prior dealings between the parties, it is often possible to assert a valid recoupment defense that could virtually extinguish your client's damages exposure.

In the hands of the knowledgeable practitioner, set-off and recoupment possess real practicality, and can be more than dusty equitable theories or *pro forma* defenses. Thus, when evaluating a client's defenses, be sure to consider the breadth of the shield's capabilities. ☞

Endnotes

1. *Atlantic City Hosp. v. Finkle*, 110 N.J. Super. 435, 439 (Law Div. 1970).
2. 221 N.J. Super. 532 (Ch. Div. 1987).
3. *Id.* at 538 (citing *Keegan v. Keegan's Estate*, 179 N.J. Super. 242, 246 (Ch. Div. 1981)); 6 Am.Jur.2d, Attachment and Garnishment § 372.
4. *See generally*, Thomas W. Waterman, *A Treatise on the Law of Set-off, Recoupment, and Counterclaim* (2d ed. 1872).
5. 86 N.J. 602 (1981).
6. *Id.* at 609 (quoting *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 299 (1946)).
7. 121 N.J. Super. 252 (Law Div. 1972).
8. *Id.* at 256 (quoting *Grand Rapids v. McCurdy*, 136 F.2d 615 (6th Cir. 1943)).
9. *Id.*
10. *Trenton v. Fowler-Thorne Co.*, 57 N.J. Super. 196 (App. Div. 1959), *aff'd*, 32 N.J. 256 (1960).
11. *Midlantic Nat'l Bank v. Georgian, Ltd.*, 233 N.J. Super. 621, 626 (Law Div. 1989).
12. 121 N.J. Super. at 257.
13. 233 N.J. Super. at 621.
14. *Id.* at 625.

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