

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
BEAUMONT DIVISION

EOD
01/10/2005

IN RE:	§	
	§	Case No. 04-10359
PAULA ROSE LEGATE	§	
	§	
Debtor	§	Chapter 7

**ORDER GRANTING MOTION TO APPROVE
SETTLEMENT WITH DEBTOR
FILED BY ELOIS G. QUEBODEAUX**

On December 14, 2004, came on for hearing the “Motion to Approve Settlement and Compromise of Controversy” (the “Motion”) filed by Elois G. Quebodeaux, Individually and as Dependent Administratrix of the Estate of H. J. Quebodeaux, Sr., Deceased (the “Movant”) on November 4, 2004. The Court finds that appropriate notice of the Motion and the hearing was given according to the Federal and Local Rules of Bankruptcy Procedure. J.T. Haynes appeared at the hearing on behalf of the Movant. Stephen J. Zayler appeared at the hearing on behalf of the Chapter 7 Trustee, who filed a limited objection to the Motion.

The Movant is the plaintiff in a dischargeability action filed against the Debtor-Defendant, Paula Rose Legate, which is pending as adversary proceeding no. 04-1069 in this Court. That complaint is based upon an alleged fraud committed by the Debtor-Defendant against the Estate of H.J. Quebodeaux, Sr., Deceased, of which the Movant is the appointed dependent administratrix, and which resulted in the entry of a judgment on December 2, 1998, in favor of the Movant and against the Debtor-Defendant, in the

original amount of \$23,671.79, plus costs of \$448.41, with pre-judgment and post-judgment interest calculated on the judgment at 10% from February 19, 1997. Upon the filing of this bankruptcy case by the Debtor-Defendant, the Movant subsequently initiated adversary proceeding no. 04-1069 in an attempt to render the Debtor's debt to the decedent's estate nondischargeable.

The Movant and the Debtor-Defendant have now reached a settlement, subject to the approval of the Court, whereby the Movant would be allowed to setoff the Debtor-Defendant's right to a 1/8th distribution from the decedent's estate, which is comprised almost exclusively of asbestosis litigation proceeds,¹ against the amount she owes to the decedent's estate pursuant to the state court judgment. Under the proposed settlement, such setoff would continue as the litigation proceeds are received and distributed until such time as the state court judgment is paid in full. At that point, any further proceeds otherwise owing to the Debtor-Defendant would be paid to Stephen Zayler, as trustee of the Chapter 7 bankruptcy estate of Paula Rose Legate, until all claims filed in the bankruptcy case were fully satisfied, with any residual funds to be paid to the Debtor-Defendant.

Stephen Zayler, as the Trustee of the Chapter 7 bankruptcy estate for the Debtor-Defendant, filed a limited objection to the proposed distribution of sums under the settlement agreement. The Trustee asserts that all of the sums should be tendered to the

¹ The Jefferson County Court at Law #1 currently holds all litigation proceeds in its registry. Those proceeds totaled \$25,591.69 as of January 22, 2004.

bankruptcy estate, notwithstanding the entry of a judgment in favor of the Movant and the subsequent abstracting of that judgment, since that abstract did not constitute a lien under Texas law on the personal property of the Debtor held in the court registry. The Trustee further denies that the Movant holds any equitable lien or any right of setoff. Therefore, the Movant, according to the Trustee, is merely one of a number of unsecured creditors and, contrary to the proposed distribution scheme under the settlement agreement, is entitled only to a *pro rata* share of the litigation proceeds.

The Bankruptcy Code preserves any right of setoff which any creditor possesses under applicable state law on the date of the order for relief.² A right of setoff under Texas law is “a form of equitable counterclaim which brings together obligations of parties opposing each other and, by judicial action, makes each obligation extinguish the other.” *Capital Concepts Properties 85-1 v. Mutual First, Inc.*, 35 F.3d 170, 174-75 (5th Cir. 1994). Its object is “to adjust the demands between the parties and allow a recovery of only the balance that is due.” *Anderson v. Vinson Exploration, Inc.*, 832 S.W.2d 657, 666 (Tex. App. – El Paso 1992, writ denied) (*citing CPS Int’l, Inc. v. Harris & Westmoreland*, 784 S.W.2d 538, 544 (Tex. App. — Texarkana 1990, no writ). As an early bankruptcy decision stated,

² 11 U.S.C. §553(a) states that:

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. . . .

Although the right of setoff is at odds with the fundamental bankruptcy principle of equality of distribution among creditors because it permits a creditor to obtain full satisfaction of a debt by extinguishing an equal amount of the creditor's obligation to the debtor, setoff has long been permitted in bankruptcy courts. In the absence of a recognition of the right to a setoff, a creditor might be forced to pay in full the amount owed to the debtor, but be limited to no more than a pro rata recovery of its claim against the debtor. The process of imposing this loss on an otherwise innocent party has historically thought to be improper.

Williams v. American Bank (In re Williams), 61 B.R. 567 (Bankr. N.D. Tex. 1986) (citations omitted); *see also generally, Bandy v. First State Bank*, 835 S.W.2d 609, 618-19 (Tex. 1992). Though whether a creditor possesses a right of setoff is again determined by state law, the right is strictly construed under the Bankruptcy Code and a creditor must demonstrate the existence of all applicable requirements in order for any setoff right to be preserved. *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996); *In re Georgetown Steel Co., LLC*, 2004 WL 2861766 at *12 (Bankr. D.S.C. 2004).

For any creditor to assert successfully a right of setoff, it must demonstrate by a preponderance of the evidence that the requirements of "timing" and "mutuality" exist. *F.D.I.C. v. Projects American Corp.*, 828 S.W.2d 771 (Tex. App. — Texarkana 1992, writ denied); *Dallas/Fort Worth Airport Bank v. Dallas Bank & Trust Co.*, 667 S.W.2d 572 (Tex. App. — Dallas 1984, no writ); *In re Lessig Const., Inc.*, 67 B.R. 436, 441 (Bankr. E. D. Pa. 1986). "Timing" requires the existence of a debt owed by the creditor to the debtor and a claim by the creditor against the debtor, both of which arose before

the filing of the bankruptcy petition. The “mutuality” requirement demands that the debt and the claim to be offset exist between the same parties standing in the same capacities. *In re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990). The evidence in this case conclusively establishes that the timing and mutuality requirements were met prior to the commencement of the bankruptcy case.

Yet the Trustee asserts that the right of setoff must be affirmatively exercised in order to become effective. That statement is true. To accomplish a setoff of a debt, Texas law requires the party seeking a setoff to: (1) decide that it wishes to exercise the right of setoff; (2) take an action to accomplish such a setoff; and (3) make a record which verifies that the setoff has been taken. *Shearson Lehman Bros., Inc. v. Resolution Trust Corp.*, 1994 WL 60907 at *3 (Tex. App – Dallas 1994, no writ); *In re Archer*, 34 B.R. 28, 30 (Bankr. N.D. Tex. 1983). In this context, the facts clearly demonstrate that the Movant possessed a right to a setoff against the distribution otherwise owed to the Debtor on the petition date, though it had not been exercised at that point.

The Trustee erroneously believes that the Movant’s failure to exercise her setoff right prior to the petition date constitutes a forfeiture of that right in favor of the bankruptcy estate and the principle of equal distribution. However, §506(a) clearly preserves that right for the benefit of the Movant. §506(a) states that:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, *or that is subject to setoff under Section 553 of this title*, is a secured claim to the extent of the value of such creditor’s interest

in the estate's interest in such property, *or to the extent of the amount subject to setoff*, as the case may be. . . .

Thus, §553 recognizes and preserves the existence of a pending right to setoff, though it has not yet been exercised as of the petition date, by providing that such a right constitutes an allowed secured claim in the bankruptcy proceeding.

In the present context, the Movant possesses a claim secured by the setoff amount as articulated in its proof of claim which is superior in right to any claim which the Trustee or the unsecured creditors of the bankruptcy estate might otherwise assert against those funds. Accordingly, the Court concludes that the distribution of litigation funds as set forth in the proposed settlement accurately reflects the distribution scheme contemplated by the Bankruptcy Code in this context and should be approved.

Additionally, the Trustee has failed to show any ability to provide adequate protection of the Movant's interests in the registry funds or to provide any other justification to delay or defer the exercise of the offset by the Movant and thus the Court finds that just cause exists for the entry of an order modifying the automatic stay in order to permit the Movant to proceed to exercise her setoff rights against the funds in the state court registry. For the foregoing reasons, the Court finds that just cause exists for the entry of the following order.

IT IS THEREFORE ORDERED that the Motion to Approve Settlement and Compromise of Controversy filed by Elois G. Quebodeaux, Individually and as the Dependent Administratrix of the Estate of H. J. Quebodeaux, Sr., Deceased, on

November 4, 2004, is **GRANTED**; that the distribution scheme contemplated by the proposed settlement is **APPROVED**; that the automatic stay is hereby **MODIFIED** as to allow Elois G. Quebodeaux to exercise her right of setoff against the portion of asbestosis proceeds otherwise due and owing to the Debtor, Paula Rose Legate, until such time as the state court judgment is paid in full; with any further proceeds to be paid to Stephen J. Zayler, as trustee of the Chapter 7 bankruptcy estate of Paula Rose Legate, until all claims filed in the bankruptcy case have been fully satisfied, with any funds obtained thereafter to be paid to the Debtor-Defendant, Paula Rose Legate.

IT IS FURTHER ORDERED that the Plaintiff-Movant, Elois G. Quebodeaux, shall tender to the Court either: (1) a proposed agreed judgment form for adversary proceeding no. 04-1069 which shall implement the approved settlement agreement; or (2) a motion to dismiss adversary proceeding no. 04-1069, within fifteen (15) days of the entry of this Order.

Signed on 1/10/2005

A handwritten signature in cursive script, appearing to read "Bill Parker", is written over a horizontal line.

THE HONORABLE BILL PARKER
CHIEF UNITED STATES BANKRUPTCY JUDGE