UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re: PATRICK H O'NEILL, SR., Debtor.	BKY 4-95-1477
JOHN R. STOEBNER, TRUSTEE, Plaintiff,	ADV 4-97-001
-vs.- LEONARD, O'BRIEN, WILFORD, SPENCER & GALE, LTD., f/k/a O'Neill, Burke, O'Neill, Leonard & O'Brien, Ltd., Defendant.	<u>MEMORANDUM ORDER ON CROSS-MOTIONS FOR SUMMARY JUDGMENT</u>

At Minneapolis, Minnesota, September 30, 1997.

The above-entitled adversary proceeding came on for hearing before the undersigned via cross-motions for summary judgment filed by the Plaintiff, John R. Stoebner as trustee of the Debtor's bankruptcy estate (“Trustee”), and the Defendant, the law firm of Leonard, O'Brien, Wilford, Spencer & Gale, Ltd. ("the Law Firm"). Appearances were as noted on the record. After carefully considering the arguments of counsel, the Court has decided that the Plaintiff's motion for summary judgment should be denied and that the Defendant's motion for summary judgment should be granted.

UNDISPUTED FACTS

The facts of this case are undisputed. The Debtor, Patrick H. O'Neill, Sr., was a founding shareholder and employee of the Defendant Law Firm. During the course of his employment relationship with the Law Firm, the Debtor misappropriated various funds belonging to the Law Firm, as well as various funds belonging to the Law Firm's clients. Furthermore, on or about April 8, 1993, the Debtor utilized his position with the Law Firm to induce Tara Schultz, a nonlawyer employee of the Law Firm whose regular job responsibilities included paying the Debtor's personal bills and balancing the Debtor's personal checkbook, to cosign the Debtor's personal credit agreement with Firstar Bank. By November 29, 1994, the Debtor had defaulted on his obligation to the Bank, and the Bank had demanded full payment from Ms. Schultz. In 1994, the Debtor's misconduct was discovered by the Law Firm and the Debtor consequently resigned from his position with the firm. Shortly thereafter, the Law Firm paid to Firstar Bank the full amount owing under the Debtor's personal credit agreement, thereby freeing Ms. Schultz from her obligation to the Bank. The Law Firm had also retained attorney Richard J. Harden to determine whether the Law Firm had an ethical obligation to report the Debtor's misconduct to the Minnesota Lawyers Professional Responsibility Board. The Law Firm paid Attorney Harden a fee of $4,850 in connection with this matter, and upon his advice reported the Debtor's misconduct to the Board.

Based upon these events, the Law Firm asserted various legal claims against the Debtor arising from the Debtor's misconduct. In particular, the Law Firm claimed to hold various claims against the Debtor for damages arising from the Debtor's misappropriation of Law Firm funds, as well as claims against the Debtor for indemnification for any liability incurred by the Law Firm to the Law Firm's clients. The Law Firm also claimed that the Debtor was liable to the Law Firm for the amounts paid to Firstar Bank under the defaulted personal credit agreement and for the cost of attorney fees incurred in reporting the Debtor's misconduct to the Minnesota Lawyers Professional Responsibility Board.

Conversely, upon the Debtor's resignation from the Law Firm, the Debtor claimed to hold various contract claims against the Law Firm. First, the Debtor claimed that his resignation obligated the Law Firm to redeem all of his stock in the firm pursuant to a Stock Redemption Agreement executed by the parties on November 1, 1992. Although the terms of this agreement provided that the Debtor was entitled to redemption only in the event of his death or his retirement at the age of 70 or older, the Debtor took the position that he had a statutory right to redemption pursuant to Minn. Stat. § 319A.12, arguing that this statute requires professional corporations to acquire all shares of stock owned by a shareholder who has lost his license to practice. Second, the Debtor claimed certain rights to compensation under a Deferred Compensation Agreement signed by the Debtor and the Law Firm on June 27, 1989. Under the terms of this agreement, the Debtor's resignation entitled him to payment of deferred compensation in an amount based upon the cash surrender value of a life insurance policy taken out by the Law Firm on the Debtor's life.

Faced with these competing claims, the Law Firm and the Debtor entered into a Purchase and Indemnification Agreement on December 14, 1994. Under the terms of this contract, the parties agreed that the Law Firm would pay the Debtor $117,900 ($68,870 for the Debtor's stock redemption claim and $49,030 for the Debtor's deferred compensation claim) in exchange for a release of the Debtor's stock redemption and deferred compensation claims against the Law Firm, but that against this payment the Law Firm would set off $91,016 in exchange for a release of the Law Firm's claims against the Debtor resulting from the Debtor's misconduct. The Purchase and Indemnification Agreement provided that the Law Firm's setoff of $91,016 would be broken down as follows:

a. Up to $49,000 to be paid by the Firm toward any liability the Firm may have to the successor trustee of the Patricia C. Doten 1984 Trust dated April 3, 1984;

b. Up to $4,500 to be paid by the Firm to the Winter Carnival Association or its successor for the liability of the Firm to the association;

c. Up to $3,000 to be paid by the Firm to Firstar

Bank for the liability of the Firm to Firstar Bank;

d. $3,500 representing a liability owed to B. John Barry by the Debtor which was paid by the Firm;

e. $9,000 representing fees owing to the Firm by Wrensong, Inc. which were deposited into the Debtor's personal bank account;

f. $10,000 representing fees owing to the Firm by Michael Ebinger which were deposited into the Debtor's personal bank account;

g. $500 representing fees owing to the Firm by Howard Anderson which were deposited into the Debtor's personal bank account;

h. $6,666 representing payments made to the Debtor by the Firm as advances on any claims the Debtor may have against the Firm; and

i. $4,850 representing attorney fees paid by the Firm to Richard J. Harden, who advised the Firm of its obligation to report the Debtor's misconduct under the Minnesota Rules of Professional Responsibility.

Thus, after the total setoff of $91,016, the Firm paid to the Debtor $26,884[1] in satisfaction of all of the Debtor's claims under the Stock Redemption and Deferred Compensation Agreements.

On January 6, 1995, the Debtor filed a voluntary petition for relief under Chapter 7 of the United States Bankruptcy Code. There is no evidence, and the trustee presented none, to suggest that the Firm was instrumental in such filing or even knew it would actually occur.

---

[1]Of this amount, $7,542 was paid to the Debtor in cash and $19,342 was paid to the U.S. and Minnesota governments as payment of the Debtor's withholding taxes.

On January 3, 1997, the Plaintiff, as trustee of the Debtor's bankruptcy estate, commenced the current adversary proceeding to recover the amount of the Law Firm's setoff under the Purchase and Indemnification Agreement, alleging that the setoff constituted an avoidable preference under § 547 of the Bankruptcy Code.[2]

CONCLUSIONS OF LAW

I. SUMMARY JUDGMENT STANDARDS

Summary judgment is governed by Federal Rule of Civil Procedure 56, and is made applicable to this adversary proceeding by Bankruptcy Rule 7056. Federal Rule 56 provides:

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

Fed. R. Civ. P. 56(c). The moving party on summary judgment bears the initial burden of showing that there is an absence of evidence to support the nonmoving party's case. Celotex Corp. v. Catrett, 477 U.S. 317, 325 (1986). If the moving party is the

[2] In his Complaint, the Trustee also included two other grounds for recovery of the December 14, 1994 setoff. Count II sought relief for alleged fraudulent conveyances and Count III sought an accounting. The Trustee has abandoned these alternate theories and now conceded that judgment may be entered against him as to these two Counts.

plaintiff, it carries the additional burden of presenting evidence that establishes all elements of the claim. Id. at 324; United Mortgage Corp. v. Mathern (In re Mathern), 137 B.R. 311, 314 (Bankr. D. Minn. 1992), aff'd, 141 B.R. 667 (D. Minn. 1992). The burden then shifts to the nonmoving party to produce evidence that would support a finding in its favor. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250-52 (1986). This responsive evidence must be probative, and must "do more than simply show that there is some metaphysical doubt as to the material fact." Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986). It is quite clear that the mere existence of cross-motions for summary judgment does not necessarily establish that there are no genuine issues left for trial. Rather, cross-motions for summary judgment must be considered separately and do not relieve the court of its responsibility to determine the appropriateness of a summary disposition. Wermager v. Cormorant Township Bd., 716 F.2d 1211, 1214 (8th Cir. 1983); United States v. Porter, 581 F.2d 698, 703 (8th Cir. 1978).

II. VALIDITY OF THE PREPETITION SETOFF IN BANKRUPTCY

Section 547 of the Bankruptcy Code provides, in part, as follows:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property --
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt

> owned by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made --
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if --
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor had received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547 (1994). By setting off the value of its claims against its payment to the Debtor under the Stock Redemption and Deferred Compensation Agreements, the Law Firm in this case has effectively received full payment on its claims instead of being limited to the amount of the Trustee's pro rata distribution. The Trustee therefore argues that the December 14, 1994 Purchase and Indemnification Agreement constituted an avoidable preference as a transfer of property: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) made while the Debtor was insolvent;[3] (4) made within 90 days before the date of the filing of the Debtor's Chapter 7 petition; and (5) that enabled the Law Firm to receive a greater payment than

[3]For the purposes of § 547 of the Code, the Debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition. 11 U.S.C. § 547(f) (1994). The Law Firm has, moreover, admitted that Debtor was insolvent at the date of transfer.

it would have received if the transfer had not been made and the Firm had instead received payment pursuant to the provisions of Chapter 7 of the Bankruptcy Code. In response, the Law Firm argues that the prepetition setoff in this case is not avoidable by the Trustee because the Law Firm's right of setoff is protected in bankruptcy by § 553 of the Bankruptcy Code.

Section 553 of the Bankruptcy Code provides, in part:

> 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) (1994) (emphasis added). By providing in this section that "*this title* does not affect any right of a creditor to offset," Congress created a specific exception to the Trustee's general avoidance powers for prepetition setoffs that satisfy the specific provisions of § 553. Thus, a showing that a prepetition setoff is valid under § 553 constitutes a complete defense to a Trustee's avoidance action under § 547.[4] Knudson v.

[4]The anti-preference provision of § 547 furthers the fundamental bankruptcy policy of creating equality of distribution among equally situated creditors. By preserving an unsecured creditor's right of setoff in bankruptcy, however, § 553 contravenes this policy, giving certain unsecured creditors priority over others who, aside from the right of setoff, are otherwise equally situated. See John C. McCoid, Setoff: Why Bankruptcy Priority?, 75 VA. L. REV. 15, 18 (1989). Nevertheless, the bankruptcy laws of the United States have specifically provided for a creditor's right of setoff in bankruptcy ever since the first Bankruptcy Act was enacted by Congress in 1800. See Bankruptcy Act of 1800, ch. 19, § 42, 2 Stat. 19, 33

Armstrong (In re Knudson), 929 F.2d 1280, 1285 (8th Cir. 1991), reh'g denied, 943 F.2d 877 (8th Cir. 1991); Durham v. SMI Indus. Corp., 882 F.2d 881, 882 (4th Cir. 1989); Kalenze v. Fed. Crop Ins. Corp. (In re Kalenze), 175 B.R. 35 (Bankr. D.N.D. 1994); Smith v. Worthen Nat'l Bank (In re Smith), 145 B.R. 618, 619 (Bankr. E.D. Ark. 1992); Madcat Two, Inc. v. Commercial Nat'l Bank (In re Madcat Two, Inc.), 127 B.R. 206, 209 n.3 (Bankr. E.D. Ark. 1991). See also Jensen v. State Bank, 518 F.2d 1, 4 (8th Cir. 1975) (reaching same conclusion under the Bankruptcy Act of 1898). When determining whether a prepetition setoff constitutes an avoidable preference, the issue of whether the elements of § 547 exist is reached only if, as a threshold matter, the court finds that the claimed prepetition setoff is not protected by § 553. Durham, 882 F.2d at 882; Kalenze, 175 B.R. at 36.

Section 553 does not create a right of setoff where none exists outside of bankruptcy. Instead, § 553 acts to *preserve* in bankruptcy any right of setoff that exists under applicable nonbankruptcy law, with certain additional limitations.[5]

(repealed 1803).

[5]The full text of § 553 provides:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that--

Therefore, prior to considering the validity of a setoff under § 553, a creditor must first be entitled to setoff under applicable

---

> (1) the claim of such creditor against the debtor is disallowed;
>
> (2) such claim was transferred, by an entity other than the debtor to such creditor--
>
> (A) after the commencement of the case; or
>
> (B) (i) after 90 days before the date of the filing of the petition; and
>
> (ii) while the debtor was insolvent; or
>
> (3) the debt owed to the debtor by such creditor was incurred by such creditor--
>
> (A) after 90 days before the date of the filing of the petition;
>
> (B) while the debtor was insolvent; and
>
> (C) for the purpose of obtaining a right of setoff against the debtor.
>
> (b) (1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of--
>
> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
>
> (2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.
>
> (c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

11 U.S.C. § 553 (1994).

nonbankruptcy law. Citizens Bank v. Strumpf, 116 S. Ct. 286, 289 (1995); Farrell v. Wurm (In re Donnay), 184 B.R. 767, 787 (Bankr. D. Minn. 1995); Photo Mechanical Servs, Inc. v. E.I. DuPont de Nemours & Co., Inc. (In re Photo Mechanical Servs, Inc.), 179 B.R. 604, 615 (Bankr. D. Minn. 1995). See also Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528, 33 S. Ct.806, 808 (1913) (construing § 68a of the Bankruptcy Act of 1898).

A. *Validity of the Prepetition Setoff Under Nonbankruptcy Law*

Under nonbankruptcy law, a creditor's right of setoff[6] is a

---

[6]This case is somewhat complicated by the fact that the general term "setoff" encompasses three related, but nevertheless distinct, concepts. Prior to the union of law and equity in this country, a setoff constituted a procedural device available only in equity proceedings that was similar to the modern day permissive counterclaim. A defendant in equity was allowed to raise as a setoff against the plaintiff any claims that were unrelated to the plaintiff's claim, as long as they were for a liquidated amount or arose out of a contract or judgment. A defendant who successfully asserted a setoff was allowed to apply the amount of the setoff against the amount of the plaintiff's claim, even if this resulted in an affirmative recovery for the defendant. In suits at common law, by contrast, a defendant's claims against a plaintiff were limited to a "recoupment"; i.e. a cross-action arising from the same transaction or occurrence as the plaintiff's claim and used only for the purpose of defeating or diminishing the plaintiff's recovery. To the extent that a defendant in a legal proceeding wanted to assert a claim against the plaintiff that was either unrelated to the plaintiff's complaint or that sought an affirmative recovery, the defendant had to bring a separate action. See CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1401, at 10-11 (2d ed. 1990).

Today, after the merger of law and equity and the abolition of common law forms of action, the procedural devices of setoff and recoupment were replaced by the modern day counterclaim. Nevertheless, the common law terms of "setoff" and "recoupment" are still sometimes used to describe the type of counterclaim doctrine of equitable origin that allows entities that owe each other money to apply their mutual debts against each other. Strumpf, 116 S. Ct. at 289. Specifically, the right of setoff is an extrajudicial right held by mutually indebted parties under which either party may unilaterally reduce the amount owed to the other by applying the other person's debt against his own. Once either of the parties: (1) decides to effectuate a setoff, (2) takes action accomplishing the setoff, and (3) records the setoff, the amount of the parties' debts is reduced leaving only the net difference to be paid. Id. Probably the most well-known definition of the right of setoff was articulated by the United States Supreme Court in 1913:

> But, broadly speaking, [the doctrine of setoff] represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other. That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against

---

being asserted. Under modern law, therefore, a setoff is a counterclaim raised by the defendant that is unrelated to the subject matter of the plaintiff's complaint and may be asserted for the purpose of obtaining affirmative relief; i.e. a permissive counterclaim. O'Brien v. Kemper, 276 Minn. 202, 209 (1967); Imperial Elevator Co. v. Hartford Accident & Indem. Co., 163 Minn. 481, 484 (1925). A recoupment, in turn, is a compulsory counterclaim that arises out of the same transaction as the plaintiff's complaint and that is asserted only for the purpose of reducing the plaintiff's recovery. See Koehler v. Iowa College Student Aid Comm'n (In re Koehler), 204 B.R. 210, 220 (Bankr. D. Minn. 1997). Because a recoupment arises out of the same transaction as the plaintiff's complaint, and because no affirmative relief is sought, it is functionally equivalent to a defense in that it acts solely to diminish the plaintiff's claim.

Finally, the term "setoff" stands for the extrajudicial creditor's remedy described in the text.

> another. If the parties have not voluntarily made the entries, and suit is brought by one against the other, the defendant, to avoid a circuity of action, may interpose his mutual claim by way of defense, and if it exceeds that of the plaintiff, may recover for the difference. Such counterclaim can be asserted as a defense or by the voluntary act of the parties, because it is grounded on the absurdity of making A pay B when B owes A.

Studley, 229 U.S. at 528, 33 S. Ct. at 808. Thus, the doctrine of setoff is grounded in the "natural equity" that one should not be compelled to pay one moment what one will be entitled to recover back the next. William H. Loyd, The Development of Set-Off, 64 U. PA. L. REV. 541 (1916).

The doctrine of equitable setoff exists under Minnesota law. See Nietzel v. Farmers and Merchants State Bank, 238 N.W.2d 437, 438 (1976); St. Paul & M. Trust Co. v. Leck, 57 Minn. 87, 91 (1894); Laybourn v. Seymour, 53 Minn. 105, 109 (1893); Firstar Eagan Bank v. Marquette Bank, 466 N.W.2d 8, 12 (Minn. App. 1991); B & S Rigging & Erection, Inc. v. Wydella, 353 N.W.2d 163, 167 (Minn. App. 1984). Although equitable setoff arises most frequently in the context of competing claims between a bank and its depositors, see, e.g., Nietzel, 238 N.W.2d at 438, it exists outside of the banking context as well. See, e.g., Laybourn, 563 Minn. at 109. As an equitable remedy, the doctrine of equitable setoff is available to a creditor only in those cases where the creditor's remedy at law (i.e., suing the debtor for damages) is for some reason inadequate. Becker v. Northway, 44 Minn. 61, 63 (1890) (quoting Lindsay v. Jackson, 2 Paige (N.Y.) 581, 582

(1831)). Therefore, although the remedy of equitable setoff is unavailable in most cases, it has been widely held that the bankruptcy or insolvency of a party against whom the setoff is claimed constitutes a sufficient ground for the exercise of equitable setoff. Leck, 57 Minn. at 91; Becker, 44 Minn. at 63; B & S Rigging, 353 N.W.2d at 167. See Lindsay, 2 Paige at 582. Indeed, even where the creditor's claims have not yet matured, an equitable setoff is permissible where mutual demands exist and insolvency has intervened. 20 AM. JUR.2D *Counterclaim, Recoupment, and Setoff* § 19 (1964).

The Trustee argues in this case that the Purchase and Indemnification Agreement between the Law Firm and the Debtor cannot constitute a valid setoff because tort claims cannot be set off against contract claims under Minnesota law.[7] As a historical matter, the Trustee's contention that equity jurisprudence generally did not allow tort claims to be set off against unrelated contract claims is true. See, e.g., Downing v.

[7]In support of this proposition, the Trustee principally relies on three decisions by the Supreme Court of Minnesota: Henderson v. Northwest Airlines, Inc., 231 Minn. 503, 43 N.W.2d 786 (1950), Becker v. Northway, 44 Minn. 61, 46 N.W. 210 (1890), and Folsom v. Carli, 6 Minn. 420, 6 Gil. 284 (1861). As a preliminary matter, however, it must be noted that the Trustee's reliance on the Henderson and Folsom cases is misplaced. Although these cases state the proposition that a "setoff" of claims arising *ex delicto* is not allowed under Minnesota law, the holdings of these cases do not pertain to the availability of the equitable setoff under Minnesota law but rather to the ability of a defendant to file a counterclaim under a pleading statute that was repealed in Minnesota in 1952. As a result, these cases are inapposite to the case at bar.

Wilcox, 80 A 288, 290 (Conn. 1911) ("The right of set-off, whether legal or equitable, has always been confined to rights of action arising from contract."); Braithwaite v. Aiken, 56 N.W. 133, 137-38 (N.D. 1893) ("The doctrine of set-off, as applied in equity, relates only to claims arising on contract. Equity has never set off a cause of action for tort against a debt."); Chambers v. Wright, 52 Ala. 444 ("Mere unliquidated damages from a tort will not be set off in equity."), quoted in JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1869, at 470-71 n.6 (14th ed. 1918). See also 80 C.J.S. Set-Off and Counterclaim § 41 (1953) ("In equity damages arising out of tort are not ordinarily the subject of set-off."). But see Andresen v. Thompson, 56 F.2d 642, 644 (D. Minn. 1932) (stating that, where the right to offset arises in equity, the character of claims as tort or contract is unimportant); Hilton v. Rogers, 111 S.E. 33, 33-34 (Ga. 1922) (defendant sued at law upon a cause of action arising *ex contractu* may, in equity, set off damages arising *ex delicto* when plaintiff is insolvent or a nonresident). Notwithstanding this deep historical background, however, this Court concludes that the rigid tort vs. contract distinction advocated by the Trustee is an outdated and unduly formalistic rule that did not survive the adoption of the Minnesota Rules of Civil Procedure.

Prior to the adoption of the Rules of Civil Procedure, a defendant's ability to assert a tort counterclaim against the plaintiff was greatly restricted under both the common law and code systems of pleading. For example, the Minnesota counterclaim statute in effect in 1950 provided that a defendant was allowed to file a counterclaim in only two situations: (1) where the counterclaim asserted a cause of action arising out of the same contract or transaction comprising the foundation of the plaintiff's claim; or (2) in an action on contract, where the counterclaim asserted a cause of action that was unrelated to the plaintiff's complaint but that also arose on contract. See Henderson, 231 Minn. at 508-09. Under this procedural statute, counterclaims grounded in tort were generally not allowed in actions grounded in contract.

The corresponding application of this distinction between tort and contract to the doctrine of equitable setoff is attributable to the fundamental equity maxim that, as a general rule, "courts of equity follow the rule of law." Applying this principle to the doctrine of equitable setoff, the early courts held that, in the absence of special circumstances, courts of equity would not allow a setoff in equity where the setoff would not be permitted at law. Becker, 44 Minn. at 63-64. See Braithwaite, 134 N.W. at 138 ("Set-off in equity is allowed upon the same principles as at law."); Lindsay, 2 Paige at 582 ("As a general rule, the court of chancery followed the rule of law; and after the statute had permitted set-offs to a certain extent, in suits at law, this court also adopted and acted upon that principle."); STORY, supra, at 470 (stating that equity generally follows the law as to setoff). Accordingly, prior to the adoption of the Rules of Civil Procedure, tort claims were not the proper subject for a setoff either in law or in equity. Ever since the adoption of the permissive counterclaim standard contained in Rule 13, however, the legal distinction between tort and contract has lost all significance for counterclaim purposes. It therefore follows that the distinction between tort and contract has been eliminated for purposes of equitable setoff as well. Under modern practice, it would be truly anomalous to allow a creditor to freely file a counterclaim for tort damages when sued by an insolvent debtor, but to prohibit a setoff of the same debt for purely formalistic reasons under the supposedly more flexible doctrine of equity.[8] For this reason, the Court holds that the Law Firm's setoff of its tort claims under the Purchase and Indemnification Agreement was a valid exercise of its equitable right to set off mutual claims under Minnesota law.

Moreover, even if the Trustee were correct in his assertion that tort claims (as, for example, for conversion) cannot be set off against contract claims under Minnesota law, the Law Firm’s tort claims against the Debtor could alternatively be framed as claims for the breach of an implied contract and thus be the basis for a valid setoff. <u>See</u> <u>Becker</u>, 46 N.W. at 211. It is

[8]This conclusion is supported by the complete absence of case law relying on a distinction between tort and contract for setoff purposes subsequent to the adoption of the Minnesota Rules of Civil Procedure in 1952.

undisputed in this case that the Debtor was a lawyer, an employee and/or partner of the Law Firm and that he illegally misappropriated funds belonging to the Law Firm and the Law Firm's clients. The Law Firm correctly argues that its claims against the Debtor could, thus, alternatively be pleaded as claims for the breach of an implied-in-fact contract; i.e., the contract between lawyers who practice together that they will not appropriate client funds for their own separate case and would not steal from each other.

A contract implied in fact is in all respects a true contract requiring a meeting of the minds. Roberge v. Cambridge Co-op Creamery Co., 248 Minn. 184 (1956); Gryc v. Lewis, 410 N.W.2d 888, 890 (Minn. App. 1987). Such a contract differs from an express contract mainly in that mutual assent is inferred from the circumstances and conduct of the parties. Gryc, 410 N.W.2d at 890. It is so obvious as to need no proof that a promise by a lawyer who is an employer or partner in a law firm not to steal Law Firm and client funds is part of an employment or partnership agreement between a law firm and its partners and lawyer-employees. The Rules of Professional Conduct, which all practicing lawyers must abide, as well as law itself, forbids theft of client funds and recompense to clients as well as non-consenting partners for the same. Such tortious conduct gives rise to a breach of the very essence of one lawyer's employment contract with the other. See, e.g., Whittaker v. __________, 34

Minn. 299, 300, 25 N.W. 632 (1985); Lloyd v. Farmers Cooperative Store v. _____________, 197 Minn. 387, 267 N.W. 204 (1936); Lynch v. Bermen, 131 Minn. 136, 154 N.W. 795 (1915).[9]

As stated above, it is undisputed in this case that the Debtor illegally misappropriated funds belonging to the Law Firm and the Law Firm's clients. At the time of the Debtor's tortious conduct, the Debtor became unjustly enriched at the expense of the Law Firm and the Law Firm's clients. First Nat'l Bank v. Ramier, 311 N.W.2d 502, 504 (Minn. 1981) ("Unjust enrichment claims do not lie simply because one party benefits from the efforts or obligations of others, but instead it must be shown that a party was unjustly enriched in the sense that the term 'unjustly' could mean illegally or unlawfully."). In this situation, where a party has committed the unlawful act of conversion, it is clear that the wrongdoer has been unjustly enriched and that the law will imply a promise to repay to the extent of the unjust enrichment received. Burleson v. Langdon, 174 Minn. 264, 268 (1928); Downs, 58 Minn. at 118-19; McArthur v. Murphy, 74 Minn. 53, 54-55 (1898).

[9]Even if the Trustee were correct in his assertion that no implied-in-fact contract exists between the parties, the Law Firm's claims against the Debtor could also be framed as claims for money ____________________________, a form of quasi-contract. Under Minnesota law, it is well settled that such a cause of action exists to recover money received through conversion. Libby v. Johnson, 33 N.W. 783 (Minn. 1887); see also, Kubat v. Zika, 242 N.W. 477 (Minn. 1932).

Thus, on these two alternative grounds,[10] the Law Firm was entitled to the setoffs, with respect to the former as to all setoffs, and with respect to the latter as to stolen client funds.[11]

B. *Validity of the Prepetition Setoff Under § 553*

Because the Court has determined that setoff is available under nonbankruptcy law, the next inquiry is whether setoff is available under § 553 of the Code.

1. The Validity of the Setoff of the Debtor's Stock Redemption Claims Under § 553(a)(3)

The Trustee argues that the prepetition setoff of the Debtor's claims against the Law Firm for redemption of his stock violated the provisions of § 553(a)(3). Under § 553(a)(3), an otherwise valid setoff of mutual debts between a debtor and a creditor is not allowed in bankruptcy to the extent that the debt owed to the creditor was incurred by such creditor: (1) within 90

---

[10]And, perhaps, others.

[11]The trustee argues that at the time the Law Firm exercised its right of setoff the Law Firm claims were unmatured and contingent and thus not subject to setoff, citing 20 Am. Jur. 2d, Counterclaim, Recoupment, and Setoff, § 19. To the contrary, once the theft of client funds occurred, the Law Firm was exposed to immediate liability in its own right. This was true with respect to the Tara Schultz claim also. See discussion, infra. Moreover, setoff is appropriate where mutual claimants, through ___________ lust and ______________ has intervened. See discussion, supra.

days prior to the date of the filing of the petition; (2) while the debtor was insolvent; and (3) for the purpose of obtaining a right of setoff against the debtor. The Trustee argues that, since the Law Firm was not obligated under the 1992 Stock Redemption Agreement to redeem the Debtor's shares until the Debtor's death or upon his retirement after the age of 70, the Law Firm's obligation to redeem did not arise until the parties executed the 1994 Purchase and Indemnification Agreement. Therefore, the Trustee argues, the prepetition setoff of the Debtor's stock redemption claims violated § 553(a)(3) because the 1994 Purchase and Indemnification Agreement was executed: (1) within 90 days of the filing of the petition; (2) while the debtor was insolvent; and (3) for the purpose of obtaining a right of setoff against the Debtor.

The Court concludes that this argument must fail. The record in this case indicates that the Debtor based his claim for redemption on the Minnesota Professional Corporation Law, Minn. Stat. §§ 319A.01-319A.22 (1996), arguing that the provisions of this statute required the Law Firm to redeem the Debtor's stock upon his resignation. The undisputed evidence is that, while the Firm disputed the applicability of this new statute, its counsel had privately determined that debtor's claim for immediate redemption under the statute "had a substantial possibility of success." Although this statutory claim against the Law Firm arose during the 90-day preference period, at a time when debtor was insolvent, it cannot be seriously argued, and the Trustee does not argue, that this claim for statutory redemption was "incurred" by the Law Firm "for the purpose of obtaining a right of setoff against the debtor." The claim the debtor asserted and the Law Firm ___________, was "incurred" as a result of low response time of any preference issues. Accordingly, the setoff of the stock redemption claims in this case does not violate the provisions of § 553(a)(3).

2. The Validity of the Law Firm's Indemnification Claims for the Payment to Tara Schultz

The Trustee next argues that the Law Firm's claim against the Debtor for indemnification for its payment to Firstar Bank on behalf of Tara Schultz violated the provisions of § 553(a)(2). Under § 553(a)(2), a creditor's right to set off a mutual debt owed by the creditor against the creditor's claim against the debtor is preserved in bankruptcy except to the extent that:

> (2) such claim was transferred, by an entity other than the debtor, to such creditor--
> (A) after the commencement of the case; or
> (B) (i) after 90 days before the date of the filing of the petition; and
> (ii) while the debtor was insolvent.

The Trustee argues that the Debtor's conduct did not obligate the Law Firm to make payment to the Bank on behalf of Ms. Schultz, and that the Law Firm had no legal obligation to do so until it voluntarily agreed to assume her debt. Therefore, the Trustee contends, the Law Firm's assumption of Ms. Schultz' debt constituted a "transfer" of the debt to the Law Firm which occurred within the 90-day preference period, in violation of § 553(a)(2). The Law Firm, on the other hand, argues that the Debtor's tortious conduct against Ms. Schultz exposed the Law Firm to both direct and vicarious liability under the theories of *respondeat superior* and negligent hiring and retention, and that its payment to the Bank constituted a settlement of any liability to Ms. Schultz it may have incurred. Under the Law Firm's argument, the Law Firm's claims against the Debtor were not "transferred" from Ms. Schultz, but that they arose at the moment of Ms. Schultz' injury, well before the 90-day preference period.

The Court concludes that the better argument is that the Law Firm's indemnification claim against the Debtor for the Firstar Bank payment was not "transferred" within the meaning of § 553(a)(2). At the time of the Debtor's tortious misconduct against Ms. Schultz, the Debtor was employed by the Law Firm in a supervisory capacity. The record in this case indicates that the Debtor coerced Ms. Schultz into cosigning the obligation to Firstar Bank by abusing his position of authority with the Law Firm and threatening her employment. Based upon this evidence, Tara Schultz held a claim against the Law Firm, under the theory of *respondeat superior*, for damages resulting from the Debtor's intentional torts occurring within the scope of his employment. Under Minnesota law, the doctrine of *respondeat superior* imposes liability on an employer for the tortious acts of its employees, not because the employer is at fault, but instead as a matter of public policy. Lange v. National Biscuit Co., 211 N.W.2d 783, 785 (Minn. 1973); Oelschlager v. Magnuson, 528 N.W.2d 895, 899 (Minn. App. 1995). This vicarious liability of the employer extends to both negligent and intentional torts committed by an employee during the course of his employment. See Lange, 211 N.W.2d at 786. As stated by a leading commentator:

> Early decisions, adhering to the fiction of an "implied command" of the master, refused to hold [the master] liable for intentional or "willful" wrongdoing on the part of the servant, on the ground that it could not be implied that such conduct was ever authorized. Under modern theories of allocation of the risk of the servant's misbehavior, however, it has been recognized that even intentional torts may be so reasonably connected with the employment as to be within its "scope," and the present tendency is to extend the employer's responsibility for such conduct.

W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 70, at 505 (5th ed. 1984). It is also clear under Minnesota law that the Law Firm is not ultimately responsible for Ms. Schultz' damages. An employer is entitled to full reimbursement from the employee who caused the plaintiff's injuries for any damages paid under *respondeat superior*. Oelschlager, 528 N.W.2d at 899. Because the Law Firm incurred liability as a direct result of the Debtor's tortious conduct, the Law Firm held a claim against the Debtor for indemnification in its own right. For this reason, the Court concludes that the Law Firm's claim against the Debtor was not "transferred" to the Law Firm by Ms. Schultz, but rather it originated in the Law Firm itself at the moment the Law Firm was exposed to liability caused by the Debtor's tortious conduct. As a result, the setoff of the Law Firm's claim against the Debtor for the Firstar Bank payment does not violate the provisions of § 553(a)(2).

3. The Validity of the Law Firm's Claims Against the Debtor for the Attorney Fees of Richard J. Harden

The Trustee next argues that the Law Firm's setoff of its claim for indemnification for the attorney fees of Richard J. Hardin violates the provisions of § 553(a). In order for a prepetition setoff to be valid in bankruptcy, § 553(a) requires that: (1) the creditor owe a debt to the debtor arising prepetition; (2) the creditor hold a claim against the debtor arising prepetition; and (3) both the debt and the claim be mutual obligations. United States v. Gerth, 991 F.2d 1428, 1431 (8th Cir. 1993); Donnay, 184 B.R. at 787; Photo Mechanical Services, Inc., 179 B.R. at 615. The Trustee argues that the Law Firm's claim against the Debtor for indemnification for the amounts paid to Richard J. Harden as attorney fees is invalid under Minnesota law, and that § 553(a)'s requirement that the debts be "mutual" is therefore not satisfied in this case.[12] In

[12]The Trustee mischaracterizes his argument as one pertaining to "mutuality." More specifically, however, the Trustee's argument appears to challenge the validity of the Law Firm's claim for attorney fees under state law rather than the mutuality of the claimed offset. Because § 553(a) presupposes the existence of valid claims, however, this mischaracterization does not change the outcome of the analysis under § 553(a).

response to this argument, the Law Firm argues that, pursuant to Rule 8.3 of the Minnesota Rules of Professional Responsibility, the Law Firm was ethically obligated to report the Debtor's tortious misconduct to the Minnesota Lawyers Professional Responsibility Board, and that it is entitled to the cost of attorney fees associated with taking that action as compensatory damages proximately caused by the Debtor's conduct.

As a basic rule of tort law, it is true that a tortfeasor is liable for all the damages legally caused by his or her tort. Notwithstanding this rule, however, attorney fees and litigation costs are not ordinarily included in amounts awarded as compensatory damages. Prior Lake State Bank v. Groth, 259 Minn. 495, 499 (1961); Osborne v. Chapman, 562 N.W.2d 1, 4 (Minn. App. 1997). The Law Firm argues that "where the natural and proximate consequence of a person's tortious act projects another into litigation with a third person, attorneys' fees and expenses reasonably incurred by the injured party in such litigation may be recovered from the one guilty of the tortious conduct." Groth, 259 Minn. at 499. Therefore, the Law Firm concludes, the attorney fees incurred by the Law Firm as a natural and proximate consequence of the Debtor's intentional torts in this case are recoverable by the Law Firm. Although the Law Firm's statement of the Minnesota law on this subject is correct, the Court believes that the Law Firm's conclusion is flawed under the facts of this case. In the absence of statutory authorization, Minnesota law allows an injured party to recover attorney fees from a defendant as compensatory damages only to the extent that the wrongful act of the defendant "thrusts the plaintiff into litigation with a third person." Groth, 259 Minn at 499; Osborne, 562 N.W.2d at 4. See also RESTATEMENT (SECOND) OF TORTS § 914 (1979). In this case, the Law Firm retained Richard J. Harden for the purpose of determining whether it had an obligation to report the Debtor's misconduct to the Minnesota Lawyers Professional Responsibility Board. Unlike the situations described in the Groth and Osborne cases, the attorney fees claimed by the Law Firm in this case were not incurred "in litigation" caused by the Debtor's misconduct. Therefore, the Court holds that the Law Firm's claim against the Debtor for indemnification for attorney fees was invalid under Minnesota law and cannot be the basis for a setoff under § 553(a).

C. *Whether the Prepetition Setoff Against the Law Firm's Claim for Attorney Fees Constituted an Avoidable Preference*

In light of the Court's holding that the Law Firm's claim against the Debtor for indemnification for the attorney fees paid to Richard J. Harden was invalid under Minnesota law and thus not protected by § 553, the Court must proceed to scrutinize this portion of the setoff transaction under the avoidance provisions of the Bankruptcy Code. It is clear from the Court's holding that this transaction cannot constitute a preference under § 547. For an avoidable preference to exist, § 547(b)(2) requires that the transfer of property to the creditor be "for or on account of an antecedent debt owed by the debtor before such transfer was made." Because the Law Firm's indemnification claim against the Debtor for attorney fees has been determined to be without any basis in Minnesota law, this requirement cannot be satisfied in this case. Pursuant to § 101(12), the term "debt" is defined as "liability on a claim." Clearly, therefore, § 547(b)(2) presupposes the existence of a valid claim held by a creditor against the debtor. Because the elements of § 547 cannot be satisfied in this case, the Trustee's preference action cannot succeed.[13]

Based on the foregoing, IT IS HEREBY ORDERED THAT:

1. Plaintiff's motion for summary judgment is DENIED;

2. Defendant's motion for summary judgment is GRANTED;

3. Defendant shall have judgment against the Plaintiff on all claims and causes of action asserted in the Complaint.

4. The order having resolved all claims between the parties,

LET JUDGMENT BE ENTERED ACCORDINGLY.

---

[13]The trustee has withdrawn Counts II and III of its Complaint. This waiver was made clear in the Trustee's papers and at oral argument. Accordingly, the only Count I, preference, is before the Court and since there is no preference,

Nancy C. Dreher
United States Bankruptcy Judge