UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of

PAUL D. LONGFELLOW,
ANITA K. LONGFELLOW,

Debtors.

Case No. 86-2170-W

Adv.Pro.No. 86-0282

Chapter 7

FIRST NATIONAL BANK IN
LENOX,,

Plaintiff,

v.

PAUL D. LONGFELLOW,
ANITA K. LONGFELLOW,

Defendants.

ORDER ON MOTION FOR SUMMARY JUDGMENT

On December 15, 1987 a telephonic hearing on motion for summary judgment filed on behalf of the plaintiff and resistance thereto filed on behalf of the defendants was held before this court in Des Moines, Iowa. Pamela D. Griebel appeared on behalf of the plaintiff, First National Bank in Lenox (Bank). Charles R. Hannan appeared on behalf of the defendants (debtors). The Bank seeks summary judgment on the debtors' counterclaim in this action on the basis that the counterclaim raises the same allegations that were raised in a separate legal action that was voluntarily dismissed by the debtors with prejudice. The debtors resist the Bank's motion on the basis that the counterclaim is

cognizable as a claim in "recoupment" rather than an action for recovery in tort. Since both parties have submitted briefs the matter was considered under advisement on December 15, 1987.

Background

The debtors filed a voluntary petition for relief under Chapter 7 on August 6, 1986. The debtors' schedules list the Bank as a secured creditor with a claim in the amount of $313,451.98. On September 16, 1986 the debtors, the Bank and the Chapter 7 trustee entered into a stipulation and consent decree which provided among other things that:

> 15. The Debtors', subject to consent by the Trustee, agree to dismiss with prejudice their action pending against First National Bank in Lenox pending in Taylor County, Case No. 6683.
>
> 16. Upon the complete and full compliance by the Debtors with each and every provision set forth above, the Bank agrees to withdraw its Motion to Dismiss with Request for Sanctions. It is specifically understood and agreed by and between the parties that nothing contained in this compromise settlement shall effect the right and ability of the Bank to pursue dischargeability issues regarding its debt or dischargeability generally.

The agreement was signed by the debtors, the Bank and the Chapter 7 trustee. An addendum to the stipulation was attached and signed by the debtors' attorney. It stated:

> 1. It is expressly agreed and understood between the parties that the issues raised herein are fully and completely settled and not intended to be raised in discharge or dischargeability complaints which may be filed by Plaintiff against Defendants.

An order approving the parties' stipulation was entered by former Bankruptcy Judge Richard Stageman on September 24, 1986.

On November 3, 1986 the Bank filed a complaint to determine dischargeability of debt, to recover money damages and to object to general discharge. The complaint alleges that in 1984 the debtors provided materially false information for the purpose of inducing the Bank to extend credit. The complaint asserts that the debtors have not accounted for and have converted to their own use proceeds of the Bank's collateral with the intent to deceive the Bank. The complaint further alleges that the debtors have attempted to hide secured collateral and have not disclosed the location of such collateral but have made evasive and false statements under oath regarding the disposition of assets and have failed to keep records and satisfactorily explain the loss of assets. The complaint also contends that the debtors created a leasing scheme in 1985 with a relative with the intent to deceive the Bank. Count I of the complaint seeks to determine that the debt to the Bank is nondischargeable under 11 U.S.C. sections 523(a)(2)(A), 523(a)(2)(B), 523(a)(4) and 523(a)(6). Count II seeks to deny the debtors' general discharge under 11 U.S.C. sections 727(a)(2)(A), 727(a)(3) and 727(a)(5).

On December 5, 1986 the debtors filed an answer and counterclaim. The answer generally denies the allegations contained in the complaint and affirmatively alleges that the Bank by prior conduct waived the prohibition against use

of proceeds from collateral. The debtors further affirmatively allege that the leasing arrangement mentioned in the complaint was necessitated by the Bank's refusal of additional credit. For their counterclaim against the Bank, the debtors assert they relied upon the Bank for continued financial support of their farming operation. The debtors assert that in 1984 the Bank "engaged in the deliberate and systematized attempt to disrupt the normal commercial transaction inherent of Defendant's farming operation" and thereby caused the debtors to suffer substantial economic damage. The counterclaim seeks damages against the Bank to compensate the debtors.

On December 10, 1986 the Bank filed a reply to counterclaim which denied the allegations contained therein. On February 23, 1987 the Bank filed an amendment to reply to counterclaim which alleged that the counterclaim encompassed essentially the same allegations that were set forth in the debtors' state court action and that the action had been dismissed with prejudice on or about December 15, 1986. The reply further asserted that the debtors were estopped and barred from raising the same claims based on issue preclusion and res judicata since the dismissal with prejudice operated as an adjudication on the merits of the debtors' claims. The reply therefore requested that the counterclaim be dismissed.

On April 20, 1987 the Bank filed a motion for summary judgment seeking judgment against the debtors on the debtors'

counterclaim for the same reasons set forth in the Bank's reply. The debtors resisted the Bank's motion for summary judgment on May 1, 1987. The debtors appear to agree that the counterclaim is not available as an affirmative action for recovery in tort. Rather they assert that the counterclaim is cognizable as a claim in "recoupment" to reduce or mitigate any award to the Bank.

Discussion

As noted above the debtors do not appear to dispute the res judicata effect of the dismissal with prejudice of their state court action against the Bank. It is without question that a dismissal with prejudice operates an adjudication on the merits of a claim and is subject to the usual rules of res judicata. 9 C. Wright & A. Miller, Federal Practice and Procedure, 2367 at 184-186 (1971); Ruple v. City of Vermillion, S.D., 714 F.2d 860 (8th Cir. 1983). Examination of the debtors' counterclaim in this adversary complaint and the debtors' recast petition filed in Taylor County clearly reveals that the nature of the claims are identical. Acordingly, by virtue of the dismissal with prejudice the debtors are barred from bringing an action based on the same grounds raised in the Taylor County action.

The debtors assert that their counterclaim is not raised for the purpose of affirmative recovery in tort but rather as a claim in recoupment for the purpose of reducing or mitigating any award to the Bank. The debtors argue that the allegations contained in the counterclaim will enable

the court to fully understand the facts surrounding their alleged actions relied on by the Bank to bar their discharge. Accordingly, the court will examine the debtors' counterclaim under the recoupment doctrine.

Procedurally, recoupment is a defensive measure, not an independent cause of action. In re H. Wolfe Iron & Metal Co., 64 B.R. 754, 758 (Bankr. W.D. Pa. 1986). At common law the term "recoupment" described a claim that a defendant could assert against a plaintiff only if it arose from the same transaction as the plaintiff's claim. 6 C. Wright & A. Miller, Federal Practice & Procedure, § 1401 at p. 8 (1971). It was purely defensive in character and could be used only to defeat or to diminish a plaintiff's recovery; recoupment could not be the basis for affirmative relief. Id. at 8-9. Under the doctrine of recoupment the defendant's 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 re American Cent. Airlines, Inc., 60 B.R. 587, 590 (Bankr. N.D. Iowa 1986); In re Clowards, Inc., 42 B.R. 627, 628 (Bankr. D. Idaho 1984); see also Crossett Lumber Co. v. United States, 87 F.2d 930, 932 (8th Cir. 1937).

To determine whether the debtor's counterclaim is a proper claim for recoupment, the nature of the Bank's adversary complaint must be examined. It is instantly apparent that Count II of the Bank's complaint does not seek a

money recovery. Rather, Count II seeks to deny the debtors a general discharge under the provisions of 11 U.S.C. sections 727(6)(2), 727(a)(3) and 727(a)(5). Accordingly, the allegations contained in the debtors' counterclaim would not defeat or diminish the plaintiff's recovery on this claim as no dollar recovery would be granted.

Count I of the Bank's complaint seeks a determination that the debtors' debt to the Bank is nondischargeable under 11 U.S.C. sections 523(a)(2), 523(a)(4) and 523(a)(6). Section 523(a)(2) excepts from discharge debts for money, property, or extension of credit obtained by false pretenses, false representation or actual fraud. Section 523(a)(4) excepts from discharge debts for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny. Section 523(a)(6) excepts from discharge debts for wilful and malicious injury by the debtor to another entity or to the property of another entity. Essentially the Bank asserts that debtors made misrepresentations to the Bank in order to induce the Bank to extend credit and thereafter committed various acts with regard to the Bank's collateral which the Bank contends evidenced intent to deceive and to defraud and malicious injury to the Bank's property.

The debtors' counterclaim asserts that they had relied on the Bank for continued financial support of their farming operation and in 1984 the Bank failed to honor its previous obligations (presumably to continue lending). The debtors assert that these actions caused them to suffer a loss of

credit within the community and necessitated the third party lease of their property in 1985. They contend that the Bank's actions caused substantial economic damage and forced them to file bankruptcy.

A virtually identical factual situation existed in In re Yagow, 53 B.R. 737 (Bankr. D. N.D. 1985). In that case the PCA commenced an adversary complaint alleging that the debtors' indebtedness to PCA was nondischargeable by virtue of sections 523(a)(2), (a)(4) and (a)(6). The debtors filed a counterclaim premissed upon the assertion that the PCA breached a financing commitment which forced the debtors into bankruptcy and rendered them unable to obtain 1985 operational financing. Id. at 738. The court found that the counterclaim was permissive rather then compulsory in nature because it did not arise out of the transaction or occurrence that was the subject matter of the plaintiff's complaint. The court stated:

> The bases for PCA's cause of action are alleged actions of the debtors in obtaining loans--actions which occurred long before the 1985 crop season, and--long before the bankruptcy filing and, indeed--long before the cessation of lending by Production Credit Association. On the other hand, it is the wrongful cessation of lending on the part of PCA which forms the gravamen of the Debtors' Counterclaim. The failure to continue lending can hardly be said to arise out of the same transaction or occurrence which led to PCA making the very loans which they now seek to have declared nondischargeable. The nature of the Debtors' cause of action, as formed by its Counterclaim, is not directed towards the impropriety or illegality of the lending practices

> which gave rise to PCA's cause of action but rather is rooted in some later event, the result of which was the cessation of lending by PCA.

Id. at 738-39.

In this case the Bank's failure to continue lending is not the same transaction or occurrence which forms the basis of the Bank's adversary complaint. The complaint is founded on a loan that was made, the circumstances surrounding that loan and the debtors' subsequent conduct regarding collateral securing the loan. At best the debtors' counterclaim interposes a justification or excuse for certain conduct that might otherwise be wilful or malicious. Such affirmative allegations, however, are contained in the debtors' answer. They do not establish a claim in "recoupment" so as to specifically reduce or mitigate the Bank's potential dollar recovery.

WHEREFORE, based on the foregoing discussion, the debtors' counterclaim for affirmative relief is barred by virtue of the dismissal with prejudice of their state court action. Furthermore, the debtors have failed to establish a proper claim for recoupment.

THEREFORE, the motion for summary judgment on the debtors' counterclaim filed on behalf of First National Bank in Lenox is hereby granted.

Signed and filed this 18th day of April, 1988.

LEE M. JACKWIG

CHIEF U.S. BANKRUPTCY JUDGE