

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re

TAMMY R. BOWLING,

Debtor.

No. 98-20054
Chapter 7

M E M O R A N D U M

APPEARANCES:

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

This chapter 7 "no asset" case is before the court on the motion of the United States of America to lift the automatic stay in order to allow the Internal Revenue Service ("IRS") to offset the income tax refund due the debtor against the claim of the Department of Housing and Urban Development ("HUD"). As explained below, the court concludes that the motion should be granted because the requirements for setoff under 11 U.S.C. § 553(a) have been met even though the debt is owed by one federal agency and the claim is held by another. Furthermore, the offset is not precluded by the fact that the income tax refund due the debtor arises primarily out of an earned income tax credit. This is a core proceeding. 28 U.S.C. § 157(b)(2)(G) and (O).

I.

On December 20, 1991, the debtor and her then husband purchased a modular home. The purchase was financed by Logan-Laws Financial Corporation ("Logan-Laws"), which took a security interest in the home to secure the debt, and payment was guaranteed by HUD. After the debtor and her husband defaulted on the loan, Logan-Laws repossessed and subsequently sold the home, applying the proceeds to the unpaid balance of the loan. The remaining deficiency was paid by HUD pursuant to its

guaranty, with HUD receiving in exchange an assignment of the debt owed Logan-Laws by the debtor and her former husband. Thereafter, HUD contracted with Nationwide Collection Service, a private collection agency, for collection of the debt and advised the debtor that any future income tax refunds to which she would be entitled would be offset against the obligation.

The debtor commenced the present chapter 7 case on January 13, 1998. Listed in the schedule of unsecured nonpriority debts ("Schedule F") was the HUD obligation in the amount of \$16,224.46. Also scheduled by the debtor was an anticipated 1997 federal income tax refund in the amount of \$2,500.00 which the debtor claimed as exempt pursuant to TENN. CODE ANN. § 26-2-102. On February 23, 1998, the debtor filed an amended Schedule C which increased her claimed exemption in the tax refund to \$2,802.00.

Shortly after the initiation of this case, the debtor filed her 1997 federal income tax return in which she noted total wages of \$16,045.00, federal income tax withheld of \$1,947.00, and an earned income credit of \$1,556.00, entitling the debtor to a refund for overpayment of \$2,802.00. Upon the filing of the return, the IRS notified the debtor that her income tax refund would be applied to her HUD obligation in accordance with 26 U.S.C. § 6402(d) and 26 C.F.R. § 301.6402-6. In order to

effectuate this offset, the United States of America filed on April 1, 1998, the motion presently before the court to which the debtor has objected.

On May 8, 1998, the parties filed a joint motion requesting that the court rule on the stay relief motion without an evidentiary hearing, the parties having agreed that no factual issues were in dispute and that this matter was appropriate for resolution upon the filing of stipulations and memoranda of law. By order entered May 11, the court granted the request, set deadlines for the filing of stipulations and briefs, and directed that the automatic stay remain in effect pending the court's decision. Stipulations and briefs have now been filed, and this issue is ripe for resolution.

The facts set forth above were derived from the stipulations of the parties. In addition, the parties stipulated, *inter alia*, that the amount owed HUD by the debtor and her former husband as of the filing of her petition is \$14,301.00.¹ It is against this amount that HUD seeks to offset the debtor's 1997 income tax refund of \$2,802.00.

¹Although the debtor has stipulated to the amount owed HUD, she also asserts in the stipulations that she disputes that she was notified of the sale of the modular home after it was repossessed. Nonetheless, the debtor stated in her proposed stipulation of facts filed on June 8, 1998, that she does not contest the validity of the debt for purposes of the present motion.

II.

11 U.S.C. § 553(a) provides in pertinent part that except for certain exceptions which are inapplicable to the present case "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" Thus, under the language of this provision, in order to demonstrate a valid right to a setoff in a bankruptcy case, a creditor must establish: (1) a debt owed by the creditor to the debtor which arose prior to the commencement of the bankruptcy case; (2) a claim of the creditor against the debtor which arose prior to the commencement of the bankruptcy case; (3) the debt and the claim are mutual obligations; and (4) a right to offset the debts under nonbankruptcy law. See, e.g., *In re Holder*, 182 B.R. 770, 774-75 (Bankr. M.D. Tenn. 1995)(citing *DuVoisin v. Foster (In re Southern Indus. Banking Corp.)* 809 F.2d 329 (6th Cir. 1987)).

The debtor has not challenged the existence of the first two setoff requirements. There is no dispute that both the deficiency claim of HUD and the tax overpayment refund owed by the Internal Revenue Service to the debtor arose prior to the

commencement of the debtor's bankruptcy filing. The debtor denies, however, that these are mutual obligations. She contends that agencies of the United States government should not be treated as a single creditor for mutuality purposes in a bankruptcy case. Mutuality is also absent, argues the debtor, because the parties are not standing in the same capacity in that the debtor's original obligation was to Logan-Laws, not HUD, and Logan-Laws owes no obligation to the debtor. Similarly, the debtor maintains that mutuality is lacking because HUD "transferred" the debt to a collection agency.

The debtor also asserts that the fourth requirement for setoff under § 553(a) has not been met. It is her contention that there is no right to offset the debts under nonbankruptcy law because the tax refund owed her arises primarily from her entitlement to an earned income tax credit. The debtor quotes *Hoffman v. Searles (In re Searles)*, 445 F. Supp. 749 (D. Conn. 1978), for the proposition that "[t]hough given effect through income tax laws, earned income credit is in substance an item of social welfare legislation intended to provide low income families with the means by which to live." The debtor maintains that the federal government would not offset debts against other forms of social welfare such as Social Security, disability income, and food stamps, and therefore "Congress never intended

for this money to be applied for debts." As a corollary to this argument, the debtor asserts that even if all statutory requirements for setoff are met, the court should exercise its equitable powers by denying the request for setoff in light of the tax refund's earned income credit nature and the fact that the debtor has claimed the tax refund exempt, evidencing its necessity for her "fresh start."

III.

Although there is some support for the debtor's argument that separate agencies of the federal government do not constitute the same creditor for offset purposes,² the majority of courts considering the issue have concluded that the United States and its various agencies and departments comprise a single creditor. See 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][b][iii] (15th ed. rev. 1998) and cases cited therein. "It is well settled under the common law that the United States is a unitary creditor, a status which allows mutuality to exist in a

²See, e.g., *Illinois v. Lakeside Community Hosp., Inc.*, 151 B.R. 887 (N.D. Ill. 1993); *Jarboe v. U.S. Small Bus. Admin. (In re Hancock)*, 137 B.R. 835 (Bankr. N.D. Okla. 1992). The bankruptcy case upon which the debtor primarily relies for the proposition that HUD and the IRS should not be treated as one creditor was reversed by the district court. See *Lopes v. U.S. Dep't of Hous. and Urban Dev. (In re Lopes)*, 197 B.R. 15 (Bankr. D.R.I. 1996), *rev'd*, 211 B.R. 443 (D.R.I. 1997).

situation where different government agencies, departments or entities are involved." *Lopes v. U.S. Dep't of Housing and Urban Dev. (In re Lopes)*, 211 B.R. 443, 445 (D.R.I. 1997). See also *In re Holder*, 182 B.R. at 775 ("This court is satisfied that ample authority exists recognizing mutuality between different governmental units."). The recent *Lopes* decision is especially informative on this issue. In *Lopes*, the district court observed that numerous statutory provisions authorize interagency setoffs "demonstrating a Congressional intent that the United States be deemed a unitary creditor for virtually all purposes." *In re Lopes*, 211 B.R. at 445-46. The court also noted that the United States Supreme Court has explicitly recognized that mutuality between different federal agencies or departments exists for setoff purposes under common law. *Id.* (citing *Cherry Cotton Mills, Inc. v. U.S.*, 327 U.S 536, 66 S. Ct. 729 (1946)). The *Lopes* court found no reason to ignore these common law principles in the bankruptcy context, especially since § 553 of the Bankruptcy Code explicitly preserves setoff rights found in nonbankruptcy law. *Id.* at 446 (quoting *Darr v. Muratore*, 8 F.3d 854 (1st Cir. 1993))("Section 553 does not create new substantive law, but incorporates in bankruptcy the common law right of setoff, with a few additional

restrictions.")). This court finds the reasoning and conclusions of *Lopes* and the majority persuasive.

The debtor's argument that mutuality is lacking because the original loan was made by Logan-Laws rather than HUD and therefore these entities are not acting in the same capacity is simply without merit. Generally, the concept of capacity requires that the parties must each owe the other in his or her own name, rather than as a fiduciary, an agent, or in trust. See 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][c] (15th ed. rev. 1998). There is no indication in the present case that HUD is acting as an agent or fiduciary for Logan-Laws or any other party or that it is acting in anything other than its own behalf. To the contrary, the parties expressly stipulated that upon payment by HUD of the balance of the debtor's unpaid debt, Logan-Laws transferred the debt to HUD and HUD assumed ownership of the obligation, with the result that the debtor is now indebted to HUD rather than Logan-Laws. The fact that HUD was not the original obligee is irrelevant under the facts of this case.³

Similarly, the subsequent involvement by HUD of a collection

³If the debt had been transferred to HUD by Logan-Laws postpetition or within ninety days preceding the debtor's bankruptcy filing while the debtor was insolvent, setoff would not be permitted. See 11 U.S.C. § 553(a)(2). Neither of these circumstances exist in this case. According to the parties' stipulations, Logan-Laws transferred the note to HUD on May 24, 1993.

agency is immaterial. There is no evidence before the court that HUD sold or otherwise transferred the debt to the collection agency. To the contrary, the parties stipulated that HUD contracted with Nationwide Collection Service for collection of the debt, and, as stated above, that the debt in question is owed to HUD. Because HUD retains ownership of the debt and is thus still the creditor, mutuality is unaffected by the collection contract. The debtor cites no legal authority for her assertion that there is no right to setoff under nonbankruptcy law because the nature of the tax refund is an earned income credit and the court has found none that supports her position. Rather, the case law appears otherwise. In *Bosarge v. U.S. Dep't of Educ.*, 5 F.3d 1414 (11th Cir. 1993), *cert. denied* 512 U.S. 1226, 114 S. Ct. 2720 (1994), the Eleventh Circuit Court of Appeals specifically considered the issue of whether there is an exception to the federal income tax offset statutes when the refund consists primarily of an earned income tax credit. Like the debtor in the present case, the taxpayer in *Bosarge* argued that legislative intent would be subverted if a working family could lose its tax credit through an offset. *Id.* at 1420. The *Bosarge* court rejected the argument, observing that the clear language of 26 U.S.C. § 6402(d)(1)(A), which permits the Secretary of the Treasury to redirect "any

overpayment" due a taxpayer to a federal agency to reduce an existing debt, encompasses the earned income tax credit. *Id.* The appellate court also noted that the same policy argument regarding earned income credits was rejected by the United States Supreme Court in *Sorenson v. Secretary of Treasury*, 475 U.S. 851, 106 S. Ct. 1600 (1986), when the court considered a similar statute authorizing the offset of federal income tax refunds to pay past-due child support. The Supreme Court had refused to balance the social goals underlying the earned income tax credit against those underlying the tax refund intercept statute observing that "[t]he ordering of competing social policies is a quintessentially legislative function." *Bosarge*, 5 F.3d at 1420 (citing *Sorenson*, 475 U.S. at 865, 106 S. Ct. at 1609). Based on the foregoing, this court concludes that HUD would be entitled to an offset against the debtor's tax refund under nonbankruptcy law, notwithstanding the refund's earned tax credit nature.

As the above discussion indicates, HUD has satisfied the setoff requirements of § 553(a). Nonetheless, "[i]t is well understood ... that the application of setoff is permissible, not mandatory, and lies within the equitable discretion of the court." *In re Holder*, 182 B.R. at 776 (citing *In re Southern Indus. Banking Corp*, 809 F.2d at 332). This discretion,

however, is not unbridled. "[T]he right of setoff is of ancient derivation and has been embodied in every bankruptcy law the United States has enacted." *Big Bear Super Mkt. No. 3 v. Princess Baking Corp. (In re Princess Baking Corp.)*, 5 B.R. 587, 589 (Bankr. S.D. Cal. 1980). Given the Congressional preference of permitting setoff as incorporated in § 553 of the Code, setoffs in bankruptcy are "generally favored" and "a presumption in favor of their enforcement exists." *Carolco Television Inc. v. National Broadcasting Co. (In re De Laurentis Entertainment Group Inc.)*, 963 F.2d 1269, 1277 (9th Cir. 1992), cert. denied 506 U.S. 918, 113 S. Ct. 330 (1992). Courts are not free to preclude setoff simply because the result would be "unjust." *Burton v. U.S. (In re Selma Apparel Corp.)*, 155 B.R. 241, 243 n.3 (Bankr. S.D. Ala. 1992)(citing *In re Applied Logic*, 576 F.2d 952, 957 (2d Cir. 1978)). See also *In re Princess Baking Corp.*, 5 B.R. at 589; *Blanton v. Prudential-Bache Sec., Inc. (In re Blanton)*, 105 B.R. 321, 337 (Bankr. E.D. Va. 1989). "[S]etoff must be allowed unless its allowance would not be consistent with the provisions of the Bankruptcy Act as a whole.'" *In re Blanton*, 105 B.R. at 337 (quoting *Bohack Corp. v. Borden, Inc.*, 599 F.2d 1160, 1165 (2d Cir. 1979)). Cases where setoff has been denied outright generally have fallen into two categories:

the creditor engaged in illegal or fraudulent conduct or the funds were essential to the debtor's reorganization efforts. *In re Blanton*, 105 B.R. at 337. A few courts have taken a less restrictive view of their setoff discretion and have denied setoff if the rights of those other than the debtor and the creditor are affected by the act. *See, e.g., U.S. v. Maxwell (In re Pyramid Indus., Inc.)*, 210 B.R. 445, 451 (N.D. Ill. 1997)(because of the special considerations bearing on setoff as it arises in the bankruptcy context, courts should take into account the effect setoff may have on innocent third parties and disallow setoff if the interests of other creditors are adversely affected).

Regardless of whether this court espouses a liberal or conservative view of the scope of its discretion, none of the circumstances used by other courts as bases to preclude setoff is present in the instant case. There is no allegation that HUD has acted inequitably, this is liquidation case—not a reorganization proceeding, and other creditors will not be impacted or affected in any way by the setoff as this is a “no asset” case in which the debtor has claimed the tax refund exempt.

Furthermore, the court is not persuaded that the equities lie in favor of the debtor in this instance simply because her

tax refund is derived from an earned income tax credit which she has claimed exempt. To the contrary, to disallow setoff under the facts of this case would result in an injustice which the equitable doctrine of setoff was designed to remedy: a creditor who has no hope of repayment would be compelled to pay an obligation to the very entity who owes it money. Denial of setoff in this situation would also have the effect of encouraging bankruptcy since offset is available to the United States outside of bankruptcy, regardless of the debtor's exemption claim and the earned income credit nature of the tax refund. See *Bosarge*, 5 F.3d at 1419 (exempt status under state law does not preclude interception of debtor's federal income tax refund to pay debt to federal agency).

IV.

The court having concluded that the requirements for setoff under 11 U.S.C. § 553(a) have been met and that it is not appropriate under the facts of this case for the court to exercise its equitable powers to preclude setoff, setoff will be permitted. An order will be entered in accordance with this memorandum opinion granting the United States' motion for relief from automatic stay to allow the offset of the debtor's 1997 federal income tax refund in the amount of \$2,802.00 against the

obligation of the debtor to HUD.

FILED: July 2, 1998

BY THE COURT

MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE