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In *U.S. v. White*, 365 B.R. 457 (Bankr. M.D. Pa. 2007), the U.S. Bankruptcy Court for the Middle District of Pennsylvania addressed the issue of whether the Internal Revenue Service ("IRS") may setoff the entire pre-petition debt against pre-petition claims that have been declared exempt, or whether the IRS is only allowed to setoff up to the amount of the priority claim. The court held that the IRS may setoff the entire debt and is not limited to the amount of the priority claim.

The proper treatment of the IRS' setoff right in bankruptcy is unclear because of a possible conflict between sections 522(c) and section 553 of the Bankruptcy Code. Outside of bankruptcy, the IRS may normally offset tax overpayments (tax refunds) against a debtor's outstanding tax liability. *See* 26 U.S.C. § 6402(a) (2006). This right is typically protected in bankruptcy by the operation of section 553, which provides that Title 11 "does not affect any right of a creditor to offset a mutual debt" that arose before the commencement of the case against a claim that also arose before the commencement of the case. *See* 11 U.S.C. § 553 (2006). However, in an effort to ensure that a debtor in a bankruptcy proceeding has the ability make a fresh start, section 522 provides that certain assets may be declared exempt, protecting them from the reach of creditors. *See* 11 U.S.C. § 522 (2006). In order to protect these exempt assets from creditors, section 522(c) provides that exempt assets may not be "liable" during or after the bankruptcy proceedings for any debt that arose before the case, with some limited

exceptions. *Id.* One of these exceptions "specifically subjects these exemptions to pre-petition, priority claims," *White,* 365 B.R. at 459, which is why priority debt is not barred from setoff by section 522.

The source of the conflict is that it is unclear how these two statutes work together when there is a pre-existing right to setoff against assets the debtor has declared exempt. If the IRS would have a valid right to offset the debt outside bankruptcy, but the debtor has declared the overpayment exempt, section 522(c) dictates that the IRS could not take more than the amount of priority debt. However, section 553 dictates that the bankruptcy code cannot alter the IRS' right to setoff. Whether the right of setoff of exempted assets is limited to the amount of the priority debt or whether it is allowed up to the full amount of overpayment is dependant on whether the court gives preference to section 553 or to section 522.

In *U.S. v. White*, the court acknowledged a split of authority regarding whether the IRS' right to setoff non-priority debt is allowed against exempt assets of the debtor or whether its right to setoff is limited to the amount of the priority claim, 365 B.R. at 461, but found the reasoning behind the cases allowing setoff of the entire overpayment more compelling, *id.* at 463. In *White*, a debtor owed $8,922.40 to the IRS, $1,780.52 of which was considered priority debt. *Id.* The debtor filed for chapter 13 bankruptcy in February of 2004 and claimed as exempt a $3,148 tax overpayment for the 2003 tax year. *Id.* The IRS moved to lift the automatic stay in order to allow it to setoff the entire 2003 overpayment against its pre-petition tax claim. *Id.* In the decision appealed from, the Pennsylvania bankruptcy court allowed the IRS to setoff only to the extent of the priority debt, requiring the remainder of the overpayment to be returned to the debtor as a tax refund. *Id.* at 458–59. The district court reversed, holding that the IRS could setoff the entire 2003 overpayment. *Id.* at 463.

The court in *White* provides a brief overview of the reasoning used by both lines of cases. The next sections will elaborate on the summaries provided by the court and will more fully explore the arguments on both sides of the issue. While both lines of cases make arguments using statutory interpretation, plain meaning and congressional intent, the arguments favoring setoff are more compelling. After the examination of the two lines of reasoning, further examination is made of the case *In re* Gould, a recent decision by the 9th Circuit Bankruptcy Appellate Pannell. *See* Gould v. Gould (*In re* Gould), No. 05-50292, 2009 WL 465599 (9th Cir. BAP Feb. 11, 2009). The 9th Circuit is the highest court to speak on the matter and provides further compelling support in favor of setoff. Finally, in conclusion it is determined that giving preference to setoff over exemption by favoring section 553 over section 522 is most consistent with the plain meaning of the words, furthers the goals of the bankruptcy code and is a better approximation of congressional intent.

Decisions favoring Exemption

The majority of courts give section 522 preference over section 553 and therefore allow setoff only to the extent of the priority debt. When there are mutual obligations that would normally permit setoff but the debt has been declared exempt, many courts find that there is a direct conflict between sections 553 and 522, which cannot resolved by looking at the plain meaning of the statutes. *In re* Jones, 230 B.R. 875 (Bankr. M.D. Ala. 1999) ("There is . . . an apparent conflict between § 522(c) and § 553(a)."). *But see In re Kitty Hawk, Inc.*, 255 B.R. at 427 (suggesting there is no conflict between sections 522 and 553). Because there is no plain meaning, these courts examine the conflict with tools of statutory interpretation, considers the

congressional intent as indicated by the legislative history of these sections and examines relevant public policy considerations.

First, since there is no clear plain meaning, upholding the pre-existing right of setoff is at the discretion of the court. *See In re* Tarbuck, 318 B.R. 78, 85 (Bankr. W.D. Pa. 2004) ("It is within this court's discretion whether to permit setoff."); *In re Pace*, 257 B.R. at 919 (explaining that section 553's application ''rests in the discretion of [the] court"); *In re* Alexander, 225 B.R. 145, 147 (Bankr. W.D. Ky. 1998) (stating section 553 is applied at discretion of the court). These courts argue that section 553 has been construed as being "permissive in nature, rather than mandatory." *In re* Alexander, 225 B.R. at 147. The court is therefore permitted to use its equitable discretion to determine whether to apply section 553. *In re* Pace, 257 B.R. at 919 (Bankr. W.D. Mo. 2000). Further, these courts would argue that even in cases where the requirements of setoff are met, the court should not allow the setoff if it would result in inequity or if it would be against public policy. *See* FDIC v. Bank of Am. Nat'l Trust and Sav., 701 F.2d 831, 836–37 (9th Cir.1983).

The second argument used in favor of exemption is based on congressional intent. The Senate version of section 522 specifically allowed for exempted property to remain liable for discharged tax debts, but this wording was dropped before the law was enacted. *In re Alexander*, 225 B.R. at 150. Courts favoring exemption suggest that this would have provided a clear answer to the dilemma, and that the purposeful removal of this language indicates a clear congressional intent that exempt property would not be liable for the payment of dischargeable tax debts. *Id. But see In re* Gould 389 B.R. 105, 113 (Bankr. N.D. Cal. 2008) (suggesting that the language of the senate version describes a process distinct from setoff, discussed below).

Thirdly, courts favoring exemption utilize tools of statutory interpretation to justify favoring section 522 over section 553. These courts look to the presumption that statutes should be interpreted in a way that does not leave part of the act meaningless. This means that when there are two equally plausible interpretations of sections of a statute or act, and one interpretation would render one portion of the statute meaningless, but the other would give meaning to both, the latter is preferred. These courts suggest that allowing setoff of exempt assets would nullify section 522. *See, e.g.*, *In re Alexander*, 225 B.R. at 149. To favor section 553 over section 522, these courts argue, would leave a debtor without any ability to exempt assets from reach by any creditor with a pre existing right to offset. This seems to be a particularly weak argument for two reasons. First, there are five exceptions to section 522 given in the statute itself, but these exceptions do not make the statute meaningless. Second, a determination of whether a statute is a nullified by an interpretation must be based on whether it has meaning in any situation rater than whether it has meaning in this specific situation. Even if section 522 does not protect exempt assets from setoff, it still protects the exempt assets against any creditor that does not have a valid pre-existing right of setoff. By logic employed by these courts, any section containing any exception would be held to be a nullity. A provision that protects exempt assets from all but a small subset of creditors should not be seen as a nullity.

Finally, courts limiting setoff rights focus on the section 522 policy of providing a fresh start to debtors declaring bankruptcy by allowing some property to be off limits, ensuring that the debtor emerges from bankruptcy with the basic means to survive and the ability to make a fresh start. *See White*, 365 B.R. at 461. This fresh start policy is at the core of the purpose of bankruptcy law and should be protected.

Decisions favoring Setoff

Courts permitting setoff on non-priority debt argue that the plain meaning of section 553 means it should override section 522(c). Section 553 provides that Title 11 "does not affect any right of a creditor to offset a mutual debt . . ." provided that the debts arose before the commencement of the case against a claim that also arose before the commencement of the case. Section 522 is a "section of the code" as described in section 553. Therefore, these courts reason that "the clear and unambiguous language of [section] 553(a)," *In re* Kitty Hawk, Inc., 255 B.R. 424, 427 (Bankr. N.D. Tex. 2000), mandates that no section of the Code, including section 522(c), should affect the IRS' pre-existing right to setoff.

Courts favoring setoff use several methods of statutory interpretation to both support their argument and to counter the arguments made by the courts favoring exemption. According to the plain meaning of section 522, allowing setoff of exempted debts would not render either section meaningless or a nullity; section 522 is still effective against any creditor that does not possess a right to offset the debt. A right of offset has fairly stringent requirements. It requires a mutuality of parties, mutuality of obligation and for both to have arisen pre-petition. This means that section 522 is far from a nullity, and instead is effective against any creditor that does not meet these stringent requirements. *See In Re* Bourne, 262 B.R. 745 (Bankr. E.D. Tenn. 2001).

A second tool utilized by some courts is a presumption in favor of setoff. Setoff rights in bankruptcy are "'generally favored,' and a presumption in favor of their enforcement exists." *In re* Gould 389 B.R. 105, 113 (Bankr. N.D. Cal. 2008) (quoting *In re* De Laurentiis Ent. Group, Inc., 963 F.2d 1269, 1277 (9th Cir.1992)). Such a presumption favors the interpretation that setoff should be permitted up to the whole claim.

Further support for the presumption in favor of setoff is found in section 542(b) of the Bankruptcy Code, which provides that "an entity that owes a debt that is property of the estate . . . shall pay such debt . . . except to the extent that such debt may be offset under section 553 of this title." 11 U.S.C. 542(b) (2006). This provision does not directly address the address the issue at hand because exempt property is not necessarily "property of the estate" and thus may not fall under section 542. *See White*, 365 B.R. at 462.

The decisions favoring setoff utilize legislative history for two purposes. First, these courts challenge the assertion made by courts favoring exemption that there is a clear congressional intent based on the elimination of portions of the Senate version of section 522. Second, these courts look to legislative history surrounding section 553 for support that congress favored setoff over exemption.

First, courts favoring setoff indicate that the legislative history to section 522 does not indicate any congressional intent regarding the issue of exception verses setoff. Although the legislative history indicated that a provision that specifically allowed for exempted property to remain liable for discharged tax debts was removed from the Senate version of section 522, the provision and surrounding discussion addressed debts in general and did not specifically mention setoff rights. The collection a unilateral debt is different than the offset of a mutual obligation and even clear congressional intent on the former does not mean that Congress also meant to address the latter or to influence the contest between sections 553 and 522. *See In re* Gould 389 B.R. at 123.

Even if the provision had been on point, the mere failure to enact a provision found in a preliminary version is not a clear indication of congressional intent. The courts favoring setoff suggest that Congress did not prohibit the setoff of exempt property, and thus the removal of

the restriction is not a clear indication of congressional intent. *In re Martinez*, 258 B.R. at 367. There is only so much that can be made out of congressional inaction. While Congress did not enact the version that that would have explicitly allowed exempt property to remain liable for discharged taxes, the fact that this specific language was omitted is not conclusive evidence that congress intended the opposite. The court in Martinez suggests that where a plain meaning is present it trumps legislative history, which provides only a "cloudy" view of congressional intent. *Id.*

Second, the legislative history of § 553 "supports a reading giving general primacy to setoffs." *U.S. v. White*, 365 B.R. 457, 462 (Bankr. M.D. Pa. 2007). The history here reiterates the plain meaning of section 553; nothing in the bankruptcy code should affect a creditor's pre-existing right to setoff mutual debt. This legislative history lends further support to a presumption in favor of setoff.

While acknowledging that a fresh start is an important goal of bankruptcy courts, courts in favor of setoff note that there are many other exceptions to the debtor's exemption rights and that the fresh start policy is "not always paramount and is often subordinated to other social and economic concerns and objectives." *See In re Bourne*, 262 B.R. at 757. The Bankruptcy Code reflects a balance between the fresh start for the debtor and providing a fair distribution of assets to creditors, and section 553 demonstrates that the fresh start policy does not "trump the common law rights of creditors of setoff of mutual debts." *In re Martinez,* 258 B.R. at 367.

***In re* Gould**

A few months after *White* was decided, the U.S. Bankruptcy Court for the Northern District of California decided *In re Gould*, 385 B.R. 713 (Bankr. N.D. Cal. 2008). *In Re Gould*

was decided in favor of exemption as taking precedence over setoff, placing it at odds with *White*. Subsequently, however, *In re* Gould was withdrawn and amended. It was re-issued two months later, but it still favored exemption over setoff. However, on February 11, the Bankruptcy Appellate Pannell of the Ninth Circuit overruled the district court, holding that the specific facts of the case did not lead to a conflict between section 553 and 522. *See* Gould v. Gould (*In re* Gould), No. 05-50292, 2009 WL 465599, at *8 (9th Cir. BAP Feb. 11, 2009). The Ninth Circuit goes on to suggest in dicta that in a case where a conflict between 553 and 522 does arise, 553 would be given preference. Doing so they present three further arguments not found in the other cases favoring setoff.

The first argument used is the presumption against interpretations that nullify sections of a statute. Section 553 does not create a right of setoff; it merely protects that right in bankruptcy when it is pre-existing. *Id at *9*. If section 553 is taken to mean that the right is protected at the discretion of the court then it has no meaning. It would merely suggest that the court should allow a right that already exists if it wants to. *See id.*

The second argument presented by the Ninth Circuit in *In re Gould* is that the language of section 553 is itself an indication of congressional intent that it controls. It is very sweeping language, and it shows that Congress intended to preserve the long-standing tradition of favoring exemption rights. *See id.*

Finally, the court provides another policy consideration in favor of setoff. If courts favor exemption over setoff, then creditors who have a right of setoff will need to challenge exemption filings in order to protect their interests. This would lead to excess litigation over exemptions that may have gone through unchallenged if creditors with a setoff right was not forced to challenge. *See id.*

Conclusion

Both lines of cases present comprehensive arguments based on judicial precedent, statutory interpretation, congressional intent and public policy. Yet the arguments in favor of setoff seem distinctly stronger and more compelling. Both lines of cases use a rule against nullification, but it seems that rule 522 would still have significant meaning even if it were not effective against creditors with a right of setoff. On the other hand, rule 553 preserves a right, and if it were held to be preserved merely at the discretion of the court, then section 553 may as well not have been included as the result would be the same.

Many courts will not look at congressional intent if the plain text o the statute is clear. And it seems to several courts that the working of the two statutes is clear. Even if it were unclear enough that congressional intent and legislative history are appropriate, there is evidence of congressional intent going both ways. Some intent may be drawn from the act of removing language that may have offered guidance in the mater from the senate version of the bill, but there is dispute as to the relevance of the removed language in this dispute. Further, intent can be drawn in favor of setoff by a history of interpretation favoring setoff, the broad language of section 553 and even the legislative history of section 553 itself.

Both sides also claim compelling policy arguments. Bankruptcy is about providing a fresh start to debtors while providing some relief to creditors. The courts favoring exemption emphasize the fresh start policy whereas those favoring setoff emphasize relief to creditors. On top of this is that the practical considerations, and the Ninth Circuit at least suggests that setoff would result in greater judicial efficiency through less challenges to exemptions when creditors possess a right of setoff.

Although the line of cases favoring exemption is the majority rule, it seems clear that there is a definite trend away from the majority rule favoring exemption and towards the rule favoring setoff, which will now likely be further boosted by a favorable ruling by the Ninth Circuit Bankruptcy Appellate Pannell.