

§ 553
Setoff
§ 726(a) (4)
§ 724(a)

In re Silver Eagle Co., Case No. 00-34096

4/16/01

ELP

published

The court allowed the IRS to offset its claim for tax penalties against a tax refund it owed to the estate. The chapter 7 trustee asserted that setoff should be denied based on the Bankruptcy Code's unfavorable treatment of non-pecuniary loss penalty claims under §§ 726(a) (4) and 724(a).

The Trustee's position is inconsistent with the statutory scheme set forth in § 553 and with case law holding that the mere fact of subordination does not, by itself, provide a basis to deny setoff. While the right to setoff is discretionary and may be denied in compelling circumstances, no compelling circumstances warranting the denial of setoff are present in this case.

P01-3(8)

1

2

3

4

5

6

7

8

UNITED STATES BANKRUPTCY COURT

9

FOR THE DISTRICT OF OREGON

10

In Re:

) Bankruptcy Case No.

11

SILVER EAGLE COMPANY,

) 300-34096-elp7

)

12

Debtor.

) MEMORANDUM OPINION

)

13

The Internal Revenue Service ("the IRS") seeks relief from

14

the automatic stay in order to set off its claim for tax penalties

15

against a tax refund due to the chapter 7 estate of debtor Silver

16

Eagle Company ("Debtor"). The issue is whether the court should

17

exercise its discretion to deny the setoff based on the Bankruptcy

18

Code's unfavorable treatment of non-pecuniary loss penalty claims in

19

chapter 7 cases. For the reasons discussed below, I will grant the

20

motion for relief from stay to effectuate the setoff.

21

BACKGROUND

22

The parties agree that the facts in this case are as follows.

23

Debtor filed a chapter 7 petition on May 26, 2000. Debtor's estate

24

is owed a refund from the IRS in the amount of \$124,269 as a result

25

of Debtor's overpayment of taxes attributable to the 1998 tax year.

26

The IRS filed a proof of claim in the amount of \$55,218.65. Of this

1 amount, \$23,860.65 is attributable to prepetition tax penalties.

2 The IRS filed a motion for relief from stay asking that it be
3 allowed to set off its entire claim against the refund owed to
4 Debtor. The Trustee objected to the motion insofar as the IRS
5 sought to set off the Debtor's liability for the \$23,860.65
6 attributable to "non-pecuniary loss tax penalties." The Trustee
7 asserts that setoff should be denied because "[t]he estate is
8 insolvent and the IRS' recovery of these penalty claims will occur
9 at the expense of other unsecured creditors who seek recovery for
10 real pecuniary losses." Trustee's Brief on IRS Setoff Against
11 Penalty Claims, page 1, lines 22-24.

12 ISSUE

13 Whether the court should exercise its equitable discretion to
14 deny the IRS's request to set off its claim for prepetition tax
15 penalties against the tax refund owed to Debtor.¹

16 DISCUSSION

17 Section 542(b) provides that "an entity that owes a debt that
18 is property of the estate . . . shall pay such debt to . . . the
19 trustee, except to the extent that such debt may be offset under
20 section 553 of this title against a claim against the debtor."

21 Section 553(a) provides that, with certain exceptions:

22 this title does not affect any right of a creditor to offset
23 a mutual debt owing by such creditor to the debtor that arose
24 before the commencement of the case under this title against

25 ¹ Although this matter arises on a motion for relief from
26 stay, the only defense to relief from stay is the argument raised by
the trustee that setoff should be denied.

1 a claim of such creditor against the debtor that arose before
2 the commencement of the case[.]

3 The exceptions set forth in § 553 are not applicable in this case.

4 The allowance or disallowance of a setoff is a decision which
5 rests within the sound discretion of the trial court. In re Medina,
6 205 B.R. 216, 223 (9th Cir. BAP 1996). However, "the setoff right
7 is an established part of our bankruptcy laws and should be enforced
8 unless compelling circumstances require otherwise." Id. See also
9 In re Buckenmaier, 127 B.R. 233, 237 (9th Cir. BAP 1991) (compelling
10 reasons required to disallow setoff). Setoffs have a long and
11 venerable history and are so favored in bankruptcy that a
12 presumption in favor of their enforcement exists. In re
13 DeLaurentiis Entertainment Group Inc., 963 F.2d 1269, 1277 (9th Cir.
14 1992).

15 Section 553 "is not an independent source of law governing
16 setoff[.]" Newberry Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392,
17 1398 (9th Cir. 1996) (quoting In re Cascade Roads, Inc., 34 F.3d 756,
18 763 (9th Cir. 1994)). Rather, it preserves a creditor's right to
19 setoff under nonbankruptcy law. In re HAL, Inc., 122 F.3d 851, 852
20 (9th Cir. 1997); Newberry, 95 F.3d at 1398.

21 To enforce a setoff right, a creditor must establish that it
22 has a right of setoff under nonbankruptcy law and that the
23 requirements of § 553 are met. In re Luz Int'l, Ltd., 219 B.R. 837,
24 843 (9th Cir. BAP 1998).

25 In determining whether the right to setoff should be
26 preserved in bankruptcy under § 553, the party asserting
setoff must demonstrate the following: (1) the debtor owes

1 the creditor a prepetition debt; (2) the creditor owes the
2 debtor a prepetition debt; and (3) the debts are mutual.

3 Id.

4 The Trustee does not dispute that the IRS is entitled to
5 offset its claim under federal statutory and common law, see 26
6 U.S.C. § 6402² and United States v. Munsey Trust Co., 332 U.S. 234
7 (1947), or that the requirements of § 553 are met. Instead, he
8 contends that the court should exercise its equitable power under
9 § 105(a)³ and deny the requested setoff solely because of the
10 Bankruptcy Code's unfavorable treatment of non-pecuniary loss
11 penalties under §§ 724(a) and 726(a)(4). Section 726(a)(4) provides
12 that a claim for a non-pecuniary loss penalty is subordinate to most
13 other types of claims for purposes of distribution of estate assets
14 in a chapter 7 case. Under § 724(a), a chapter 7 trustee may avoid
15 a lien securing a claim of a kind specified in § 726(a)(4).⁴

16
17 ² 26 U.S.C. § 6402 provides as follows:

18 (a) General rule.--In the case of any overpayment, the
19 Secretary, within the applicable period of limitations, may
20 credit the amount of such overpayment, including any interest
21 allowed thereon, against any liability in respect of an
22 internal revenue tax on the part of the person who made the
23 overpayment

24
25 ³ Section 105(a) states in part that "[t]he court may issue
26 any order, process, or judgment that is necessary or appropriate to
carry out the provisions of this title."

27
28 ⁴ The right to setoff, although often analogized to a
29 security interest or a lien, is in reality a defense to payment.
30 See BLACK'S LAW DICTIONARY 1376 (7th ed. 1999) (defining a setoff as a
31 (continued...)

1 I am not persuaded by the Trustee's argument. The Trustee
2 purports to base his request for denial of the setoff on the court's
3 discretionary power to deny setoff based on general equitable
4 principles. However, this case does not have the type of facts or
5 the procedural posture that provide a sufficient basis for the court
6 to exercise its discretion to overcome the statutory presumption
7 favoring preservation of setoff rights.⁵

8 In reality, the Trustee is not requesting that the court
9 exercise its discretion to deny the requested setoff based on
10 general equitable principles. Instead, he is advocating adoption of
11 a rule of law that would deny the offset of subordinated penalty
12 claims in chapter 7 cases. The problem with the Trustee's argument
13

14 ⁴(...continued)
15 debtor's right to reduce the amount of a debt by any sum the
16 creditor owes the debtor).

17 ⁵ The Trustee cites In re Cascade Roads, Inc., 34 F.3d 756
18 (9th Cir. 1994), and In re Moore, 200 B.R. 687 (Bankr. D. Or. 1996),
19 both of which presented compelling circumstances warranting the
20 denial of setoff based on general equitable principles. In Cascade
21 Roads, the court noted that a court may exercise its discretion to
22 deny setoff under general equitable principles. 34 F.3d at 363.
23 The court affirmed the bankruptcy court's denial of setoff based
24 upon the fact that the case was "replete with inequitable conduct"
25 on the part of the party seeking setoff. Id. at 762. In this case,
26 there is no allegation that the IRS has acted improperly or
inequitably. In Moore, the bankruptcy court allowed the IRS to
offset its claim against a tax refund due to the chapter 13 debtors.
However, in order to insure the feasibility of the debtors' chapter
13 plan, the court required the IRS to allocate the funds set off to
the portion of the claim entitled to priority. 200 B.R. at 690. In
contrast, this case is a chapter 7 liquidation, and plan feasibility
is not a consideration.

1 is that it is inconsistent with the statutory scheme set forth in
2 § 553.

3 Section 553(a) states that "this title does not affect any
4 right of a creditor to offset" The "title" referenced in
5 § 553(a) includes §§ 724 and 726 upon which the Trustee relies. If
6 Congress had wanted to deny a right to setoff for debts of a type
7 specified under §§ 724 and 726, it would have included such debts
8 among those specifically excepted from the scope of § 553(a). The
9 language of § 553 establishes a right to setoff subject only to the
10 exceptions enumerated in that section and is intended to "control
11 notwithstanding any other provision of the Bankruptcy Code."
12 DeLaurentiis, 963 F.2d at 1277 (resolving conflict between § 553 and
13 § 1141 in favor of supremacy of § 553). See also In re Padilla, 222
14 F.3d 1184, 1192 (9th Cir. 2000) (where both a specific and a general
15 statute address the same subject matter, the specific statute takes
16 precedence).

17 Case law holds that the mere fact of subordination does not,
18 by itself, provide a basis to deny setoff. In In re Alliance Health
19 of Fort Worth, Inc., 240 B.R. 699, 704-05 (N.D. Tex. 1999), aff'd,
20 200 F.3d 816 (5th Cir. 1999) (table), which involved the relative
21 rights of a secured creditor and the IRS, the district court
22 reversed the bankruptcy court's denial of a creditor's motion to
23 lift the automatic stay to permit setoff. The court rejected the
24 argument that setoff should be denied because the claim, which was
25 comprised of tax penalties, would be subordinated to the claims of
26 other creditors under § 726. The court concluded that, because the

1 right to setoff is not affected by bankruptcy, the fact that a claim
2 would be subordinated under § 726 has no relevance to the
3 determination of whether to allow setoff.⁶ 240 B.R. at 705.

4 The court's decision in Alliance Health is consistent with
5 numerous cases allowing setoff in connection with subordinated
6 claims. See Hayden v. Standard Accident Ins. Co., 316 F.2d 598, 601
7 (9th Cir. 1963) (Act case); Rochelle v. United States, 521 F.2d 844,
8 855 (5th Cir. 1975) (Act case), modified on other grounds, 526 F.2d
9 405 (5th Cir. 1976); In re Sound Emporium, Inc., 70 B.R. 22, 24
10 (W.D. Tex. 1987). See also Lawrence P. King et al., COLLIER ON
11 BANKRUPTCY ¶ 553.03[3][e][vi] (15th ed. Rev. 2000) ("In general, the
12 priority of a claim is irrelevant under section 553, and
13 subordinated claims are eligible for setoff notwithstanding the
14 subordination.").

15 The heart of the Trustee's argument is that the IRS's motion
16 should be denied because allowing the setoff would unfairly prefer
17 the IRS over other unsecured creditors. The Trustee is correct that
18 setoffs run contrary to the fundamental bankruptcy policy of equal
19 treatment of creditors by preserving "serendipitous advantages
20 accruing to creditors who happen to hold mutual obligations, thus
21 disfavoring other equally-deserving creditors" Newberry, 95
22

23 ⁶ The issue of the impact of § 726 on the decision of
24 whether to allow setoff was specifically addressed in Alliance
25 Health. In other cases, courts have allowed setoff of tax penalty
26 claims without discussing the possible impact of §§ 724 and 726.
See, e.g., In re IML Freight, Inc., 65 B.R. 788 (Bankr. D. Utah
1986).

1 F.3d at 1399 (quoting In re Orange County, 183 B.R. 609, 615 (Bankr.
2 C.D. Cal. 1995)). See also In re Whimsy, 221 B.R. 69, 75 (S.D.N.Y.
3 1998) (“[I]nequality among creditors is inherent in the very nature
4 of setoff.”). Whatever the merits of the Trustee’s argument as a
5 matter of policy, the statutory structure of § 553 makes it clear
6 that Congress generally intended to preserve the right to setoff in
7 bankruptcy subject to the limitations set forth in that section.
8 See DeLaurentiis, 963 F.2d at 1277 n. 18. The court’s discretion to
9 deny setoff does not provide a basis for creating the new legal rule
10 advocated by the Trustee.

11 CONCLUSION

12 For the reasons set forth above, I will grant the motion for
13 relief from stay to allow the IRS to offset its claim for tax
14 penalties against the refund owed to Debtor’s estate. Counsel for
15 the IRS shall submit an order within 10 days of the date this
16 Memorandum Opinion is docketed.

17
18
19 _____
ELIZABETH L. PERRIS
Bankruptcy Judge

20 cc: Jeffrey M. Wong
21 Ralph W. Jones
22 Robert K. Morrow
U. S. Trustee