

Setoff
Anti-Assignment Acts

In re Miguel and Vicki Medina, - Case No. 693-62021-psh11

10/11/94

PSH

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Debtors were in the business of reforestation and their contracts were primarily with the U.S. Forest Service through the USDA. The reforestation work was performed by a business owned by Miguel dba Medina Reforestation. Before they filed their Chap. 11 petition, Medina Reforestation entered into a number of contracts with the USDA. Thereafter, Medina Reforestation entered into a financing, assignment and security agreement with Offord Financing whereby Medina Reforestation assigned to Offord its right to receive proceeds in the USDA contracts. The security agreement was duly perfected. Prior to the petition date, the IRS had filed a number of tax liens against the debtors for unpaid taxes and also filed a proof of claim in this bankruptcy for unpaid taxes of \$750,492. Offord filed a proof of claim for \$87,662. Certain of the payments under the contracts were paid prepetition to Offord with the remainder held by the USDA and the debtors' attorney awaiting the outcome of this case. The IRS asserts a right to set off the USDA payments assigned to Offord against the debtors' tax debt and moved the court to lift the automatic stay to allow it to do so.

The court analyzed the assignments to Offord vis-a-vis the federal Anti-Assignment Acts (31 U.S.C. § 3727 and 41 U.S.C. § 15) and determined that the assignments were valid. The court also determined that Offord had an enforceable security interest in Medina Reforestation's accounts, but not in the contract payments held by the USDA.

The court examined the common law and statutory basis of the federal government's setoff rights and determined that the IRS has a right to set off taxes owed to it against USDA payments assigned to Offord. Only those taxes found to be liquidated could be set off, however. In addition, the payments actually delivered to Offord are not available for setoff - only the payments held by the USDA and the debtor's attorney. The IRS was also allowed to foreclose the one tax lien which the court determined to be valid. The automatic stay was lifted to allow the IRS to exercise its setoff rights to the extent allowable. Any contract proceeds remaining were ordered paid to Offord.

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

IN RE)
)
MIGUEL MEDINA and) Case No. 693-62021-psh11
VICKI KATHLEEN MEDINA,)
) MEMORANDUM OPINION
)
_____ Debtors.)

Creditor the United States of America through the Internal Revenue Service (hereafter IRS) has moved the court for relief from the automatic stay to apply certain proceeds arising from contracts entered into between Medina Reforestation and the United States Department of Agriculture (hereafter USDA) to the debtors' tax debt. The IRS has waived its right to a final determination within the time otherwise required by 11 U.S.C. § 362(e). Offord Financing, Inc. (hereafter Offord) is claiming priority to these payments. The debtors in possession do not claim the contract proceeds. In conjunction with this contested matter the creditors stipulate to the following facts:

1 1. Prepetition the debtors in possession were in the business
2 of reforestation. Reforestation consists of planting and
3 maintaining trees on forest lands. This service was provided under
4 contracts with third parties, primarily the United States Forest
5 Service through the USDA.

6 2. The debtors are husband and wife. Medina Reforestation is
7 a proprietorship owned solely by Miguel Medina during the periods
8 at issue. Vicki Medina Church Company is a proprietorship owned
9 solely by Vicki Medina during the periods at issue.

10 3. The Medinas filed their Chapter 11 case on May 17, 1993.
11 On June 25, 1993 the IRS filed a timely proof of claim for
12 \$730,120.48.

13 4. The IRS has on file federal tax liens against the debtors
14 as follows:

15

<u>Lien filing</u>	<u>Place of Filing</u>	<u>Amount Due on</u>	<u>Taxpayer</u>
<u>Date</u>		<u>Filing Date</u>	
6/15/92	Oregon Secretary of State	\$18,975.08	Miguel Medina
6/15/92	Oregon Secretary of State	11,025.92	Vicki Medina
6/17/92	Jackson County Clerk	18,975.08	Miguel Medina
6/17/92	Jackson County Clerk	11,025.92	Vicki Medina
1/20/93	Jackson County Clerk	21,436.87	Miguel Medina

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21 The total amount due and secured by these liens as of the petition
22 date was \$47,521.

23 5. On January 27, 1993 the IRS seized a parcel of real estate
24 owned by the Medinas located at 6101 Adams Rd., Talent, Oregon.

25 The following liens on the debtors' Talent property are superior to
26 the lien under which the IRS seized the property:

<u>Lienor</u>	<u>Priority Date</u>	<u>Approximate Balance on January 27, 1993</u>
Trend Colleges, Inc.	10/10/88	\$ 1,561.65
Southern Oregon Credit Service	03/27/91 07/24/91 11/14/91	418.00 2,479.57 4,242.10
Jackson County Tax Warrant	05/07/91	123.33
Jackson County Property Tax	10/01/92	19,981.97
Oregon State Accident Insurance Fund	05/13/91 07/19/91	8,374.58 <u>51,375.43</u>
Approximate Total of Superior Liens		\$ 88,433.30

6. On February 22, 1993 the IRS gave notice of a sealed bid sale on the Talent property. This sale was not consummated due to a Chapter 13 filing by the Medinas. After the Chapter 13 was dismissed, on May 6, 1993 the IRS gave another notice of a sealed bid sale which also was not consummated because of their Chapter 11 filing.

7. After the Medinas dismissed their Chapter 13 filing, on May 3, 1993 the IRS gave notices of levy to the USDA with regard to certain assessed taxes due from the Medinas. The addressees received the notices on May 10, 1993.

8. The Medinas filed their Chapter 11 on May 17, 1993. Before they filed their Chapter 11 petition, Medina Reforestation entered into three separate contracts with the USDA governing tree planting and related reforestation services. The contracts, by number, date of contract and commencement date of work are:

1 A. 52-8462-3-07007, awarded March 16, 1993. Work commenced
2 on April 26, 1993.

3 B. 53-9A28-3-1N21, awarded February 3, 1993. Work commenced
4 on April 22, 1993.

5 C. 43-8462-3-1073, awarded March 16, 1993. Work commenced
6 and completed after May 16, 1993.

7 9. On April 7, 1993 Offord entered into a financing,
8 assignment and security agreement with "Vicki Kathleen or Miguel
9 Medina dba Medina Reforestation." The security agreement was duly
10 perfected by filing on April 16, 1993.

11 10. Medina Reforestation assigned to Offord its right to
12 receive proceeds in the contracts described in paragraph 8 A and B
13 above. On May 13, 1993 the USDA received a notice of assignment
14 regarding Contract Number 53-9A28-3-1N21. On May 14, 1993, the
15 USDA received notice of assignment regarding Contract Number 52-
16 8462-3-07007.

17 11. Pursuant to its agreement with Medina Reforestation,
18 Offord purchased from it certain invoices for work performed on the
19 contract described in paragraph 8 A and B above. The date of the
20 invoices, their amounts, the purchase price paid by Offord to the
21 Medinas, and the current status of the payment on each is:
22

23 A. Contract #52-8462-3-07007:

24 1. Invoice dated May 6, 1993, in the sum of \$19,939.00
25 for work performed from April 26, 1993 to May 5, 1993.
26

1 a. Purchased by Offord on May 14, 1993 for the
2 face amount less 5%, with proceeds paid directly to debtors.

3 b. Invoice being held by USDA awaiting this
4 Court's order concerning disposition.

5 B. Contract #53-9A28-3-1N21:

6 1. Invoice dated April 19, 1993, in the sum of
7 \$11,701.72 for work performed from April 12, 1993 to April 19,
8 1993.

9 a. Purchased by Offord on April 19, 1993 for the face amount
10 less 5%, purchase proceeds paid directly to debtors.

11 b. Invoice was paid in the face amount by USDA directly to
12 debtors on May 17, 1993, before it was administratively
13 able to take notice of the bankruptcy.

14 c. Debtors delivered payment by USDA to Offord after
15 receipt.

16 2. Invoice dated April 26, 1993, in the sum of \$19,449.73 for
17 work performed from April 19, 1993 to April 26, 1993.

18 a. Purchased by Offord on April 26, 1993 for the
19 face amount less 5%, purchase proceeds paid
20 directly to debtors.

21 b. USDA paid the face amount of this invoice
22 directly to debtors on or about May 26, 1993, before it was
23 administratively able to take notice of the bankruptcy.

24 c. Debtors delivered the check that they received
25 to their attorney, Penny Austin, who continues
26

1 to hold the draft awaiting the Court's order
2 concerning disposition.

3 3. Invoice dated April 28, 1993, in the sum of
4 \$16,805.69 for work performed from April 12, 1993 to April 27,
5 1993.

6 a. Purchased by Offord on April 28, 193 for the
7 face amount less 5%, purchase proceeds paid
8 directly to debtors.

9 b. Adjustments to this invoice lowered the amount
10 actually received to the sum of \$16,179.94.

11 c. USDA paid the adjusted amount directly to
12 debtors on or about May 28, 1993 before it was administratively
13 able to take notice of the bankruptcy. Debtors delivered this
14 check to their attorney, Penny Austin. Penny Austin presently
15 holds these funds awaiting this Court's order concerning
16 disposition.
17

18 4. Invoice dated May 14, 1993, in the sum of \$32,056.33
19 for work performed from April 12, 1993 to May 12,
20 1993.

21 a. Purchased by Offord on May 14, 1993 for face
22 amount less 5%, purchase proceeds paid directly
23 to debtors.

24 b. USDA currently holds these funds awaiting this
25 Court's order concerning disposition.
26

1 12. In addition to the foregoing and as it pertains to
2 Contract Number 52-8462-3-07007, Medina Reforestation performed
3 services under that agreement and submitted an invoice dated May
4 18, 1993, in the sum of \$18,899.55, representing work performed
5 from May 10, 1993 to May 16, 1993. This invoice was not purchased
6 by Offord. The USDA has not paid this invoice and the sum is being
7 held by the USDA awaiting this court's order concerning
8 disposition.

9
10 13. Invoices generated by Medina Reforestation on the three
11 contracts described above for work performed by the Medinas
12 postpetition are:

13 A. Contract #52-8462-3-07007:

14 I. Invoice dated June 1, 1993 in the sum of \$19,545.00.

15 B. Contract #53-9A28-1N21:

16 I. Invoice dated June 10, 1993 in the sum of \$1,642.60.

17 C. Contract #43-8462-3-1073:

18 I. Invoice dated June 1, 1993 in the sum of \$11,487.50.

19 These invoices and the invoices described in paragraph 12 were not
20 factored by Offord.

21 14. The invoices described in paragraph 13 have been paid by
22 the USDA (except for the sum of \$850.02 from the invoice dated June
23 10, 1993) and were used by the debtors as cash collateral pursuant
24 to an order of this court.

25 15. Medina Reforestation has fully performed its obligation
26 under the contracts described in paragraph 8 above and the invoices

1 described in paragraphs 11, 12, and 13 above cover all payments
2 earned by the debtors under the contracts.

3 The court makes further findings of fact as follows:

4 16. The United States' June, 1993 proof of claim since has
5 been amended several times. The latest proof is for \$750,491.97.
6 It reflects that the majority of the taxes were assessed for tax
7 years 1988-1992. Offord has filed a timely proof of claim in the
8 amount of \$87,661.60.

9 17. All the USDA contracts contain provisions which allow
10 assignment of the right to be paid amounts due or to become due
11 under the contracts to a bank, trust company, or other financing
12 institution. They do not contain provisions prohibiting setoffs.
13 They were not assigned to more than one party nor further assigned.
14 They did not require posting of a bond.

15 18. The IRS' Notice of Levy received by the USDA on May 10,
16 1993 specified the contracts covered by the notice. The contracts
17 at issue here were not specified.

18 19. On April 12, 1993 Medina Reforestation executed an
19 absolute assignment in favor of Offord of all moneys due or to
20 become due on contract number 53-9A28-3-1N21. At that time
21 payments in the amount of \$47,774.45 had already been made to
22 Medina Forestation for work performed on the contract. Offord was
23 to receive the balance due under the contract. On May 14, 1993
24 Medina Reforestation executed an absolute assignment in favor of
25 Offord of all moneys due or to become due on contract number 52-
26

1 8462-3-07007. After these assignments Offord began to pay to
2 Medina Forestation 95% of the face of invoices arising under the
3 assigned contracts. Medina Reforestation presented invoices at
4 intervals to the USDA for payment as work progressed. The invoices
5 Offord purchased are listed in paragraph 11. Other invoices listed
6 in paragraphs 12 and 13 which Offord did not purchase were
7 submitted under the assigned contracts.
8

9 20. Pursuant to the terms of the agreement dated April 7,
10 1993 between Offord as Factor and Medina Reforestation as Debtor
11 Offord promised to purchase "selected invoices" from Medina
12 Reforestation on a recourse basis. Medina Reforestation guaranteed
13 that all invoices purchased would be paid within 60 days or
14 replaced with other accounts receivable. Paragraph 8 states:

15 In the event anything contained herein is not construed
16 as a purchase of invoices by Factor from Debtor, then and
17 in that case, and as to all such invoices of accounts
18 receivable not directly purchased by Factor from Debtor,
19 Debtor hereby grants to Factor a security agreement [sic]
20 in all such accounts receivable, both those purchased by
21 Factor and so sold and assigned by Debtor, and including
22 those not purchased by Factor which are the property of
23 Debtor, including all future accounts receivable
24 generated by Debtor, including those purchased by Factor
25 which security interest and agreement shall continue
26 until such time as this agreement is terminated pursuant
to the terms hereof. The termination of this agreement
shall not be deemed a termination of the security
interest granted to Factor until such time as Factor has
been paid all sums due Factor pursuant to the terms of
this agreement.

Paragraph 20 states:

Factor is by this agreement granted and given a security
interest in Debtor's accounts, to secure Factor payments
on all accounts assigned and not paid within 60 days, and
specifically is granted a security interest in the same

1 to secure the Debtor's recourse obligations to pay
2 invoices not paid by the account debtor within 60 days.

3 21. The debtors have filed tax returns for Miguel Medina and
4 Medina Reforestation for years 1991 to May, 1993 showing total tax
5 due of \$51,015.61.

6 22. Under oath debtor Vicki Medina placed a fair market value
7 of \$175,000 on the real property located at 6101 Adams Road,
8 Talent, Oregon.

9 Analysis of Offord's Interest in Contract Payments

10 1. Assignment

11 Offord relies primarily on its assignments in asserting its
12 priority over the IRS. 31 U.S.C. § 3727 and 41 U.S.C. § 15 are
13 known as the Anti-Assignment Acts. The former regulates assignment
14 of claims against the government; 41 U.S.C. § 15 is narrower,
15 addressing assignment of interests in government contracts. The
16 language of the statutes is largely identical. Generally, it
17 prohibits assignment.¹ The following language appears as an
18 exception to the prohibition:
19

20 The provisions of the preceding paragraph shall not
21 apply in any case in which the moneys due or to become
22 due from the United States or from any agency or
23 department thereof, under a contract providing for
24 payments aggregating \$1,000 or more, are assigned to a
bank, trust company, or other financing institution,
including any Federal lending agency: Provided,

25 ¹ These statutes were passed to protect the government from
26 harassment through multiplication of the number of persons with
whom it had to deal. It was determined the government must always
know with whom it was dealing until settlement is made. United
States v. Aetna Casualty & Surety Co., 338 U.S. 366, 371, 70 S.Ct.
207, 210, 94 L.Ed. 171 (1949).

1 1. That in the case of any contract entered into
2 prior to October 9, 1940, no claim shall be assigned
3 without the consent of the head of the department or
4 agency concerned;

5 2. That in the case of any contract entered into
6 after October 9, 1940, no claim shall be assigned if it
7 arises under a contract which forbids such assignment;

8 3. That unless otherwise expressly permitted by
9 such contract any such assignment shall cover all amounts
10 payable under such contract and not already paid, shall
11 not be made to more than one party, and shall not be
12 subject to further assignment, except that any such
13 assignment may be made to one party as agent or trustee
14 for two or more parties participating in such financing;

15 4. That in the event of any such assignment, the
16 assignee thereof shall file written notice of the
17 assignment together with a true copy of the instrument of
18 assignment with (a) the contracting officer or the head
19 of his department or agency; (b) the surety or sureties
20 upon the bond or bonds, if any, in connection with such
21 contract; and (c) the disbursing officer, if any,
22 designated in such contract to make payment. 41 U.S.C.
23 § 15.²

24 If Offord has not met all of the conditions of the exception
25 its assignments would not be valid and the United States would
26 prevail. The facts demonstrate that Offord has met all statutory
27 conditions. Offord, as the Medinas' factor, is a "financing
28 institution" within the meaning of these provisions.³ The USDA
29 contracts each provided for aggregate payments in excess of \$1,000,
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32 ² The purpose of this subsection was to "make it easier for
33 government contractors to secure financing for carrying out
34 obligations to the Government to the end that government contracts
35 might be speedily and effectively performed." Waxman v. United
36 States, 112 F.Supp. 570, 588, 125 Ct.Cl. 464, 500 (1958).
37 Additionally, the act implemented the Congressional preference that
38 Federal contracts be financed by private rather than public
39 capital. Chelsea Factors, Inc. v. United States, 181 F.Supp. 685,
40 690, 149 Ct.Cl. 202, 210 (1960). Similar language appears in 31
41 U.S.C. § 3727(c).

42 ³ United California Discount Corporation v. United States, 19
43 Cl.Ct. 504 (1990).

1 the USDA contracts assigned expressly permit assignment
2 (subparagraph 2), they were not assigned to more than one party and
3 were not further assigned (subparagraph 3). Offord promptly filed
4 written notice of its assignment, on standard government forms,
5 with the contracting and disbursing officers. There was no bond
6 required (subparagraph 4).

7
8 The IRS asserts that the assignments are ineffective because
9 Offord provided financing through purchase of only certain of the
10 invoices arising from the contracts (see fact paragraph 11).
11 Therefore the requirement of subparagraph 3 that the assignments
12 cover all amounts payable under any contract was not met. This
13 argument ignores the fact that, prior to any financing being
14 provided, Offord received an unconditional absolute assignment of
15 the balance of the then unpaid amounts due under the assigned
16 contracts. The fact that it subsequently chose to wait to provide
17 financing through invoice purchase until it saw invoices for work
18 actually performed under the contracts does not diminish the
19 binding effect of the assignments.

20 The court also notes that the statutory language in
21 subparagraph 3 recognizes that such an assignment is effective as
22 to the government although, prior to the assignment, certain
23 contract payments may have been made to another, as were in this
24 case made to Medina Reforestation. The court concludes that Offord
25 has met the requirement of subparagraph 3 that the assignments
26 cover all amounts payable under the contracts.

1 The government also asserts that Offord has not met the
2 conditions listed in 31 U.S.C. § 3727(b). The court concurs that
3 these conditions have not been met. It is clear that if under 31
4 U.S.C. § 3727(c) and 41 U.S.C. § 15 Offord has met the conditions
5 of the quoted exception its assignment is valid notwithstanding §
6 3727(b).⁴

7
8 2. Security Interest

9 Offord claims a prior ownership interest in contract numbers
10 52-8462-3-07007 and 53-9A28-3-1N21 through the April 12, 1993 and
11 May 14, 1993 assignments and a prior perfected security interest in
12 contract number 43-8462-3-1073 through the April 7, 1993 financing
13 agreement and the financing statement filed April 16, 1993. The
14 documents show Offord actually has an absolute assignment of
15 interest in contract numbers 52-8462-3-07007 and 53-9A28-3-1N21 and
16 a security interest in all the debtors' accounts.

17 31 U.S.C. § 3727 and 41 U.S.C. § 15 state generally that with
18 regard to the government any "transfer" of an interest in a
19 government contract is void as to the United States. Cases brought
20 under these provisions and their predecessors have found that a
21 "transfer" refers not only to the transfer of an ownership interest
22 in a contract but also transfer of a lien interest therein.⁵ The
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25 ⁴ 41 U.S.C. § 15 states: "Notwithstanding any law to the
26 contrary governing the validity of assignments, any assignment
pursuant to this section, shall constitute a valid assignment for
all purposes."

⁵ Nutt v. Knut, Miss., 200 U.S. 13, 26 S.Ct. 216, 50 L.Ed.
(continued...)

1 financing agreement which granted a security interest⁶ to Offord in
2 all the debtor's accounts does not meet the statutory exception
3 established for financing companies and therefore is void as to the
4 United States. In foreclosing on its security interest Offord
5 would be unable to collect the proceeds on any of the contracts
6 directly from the USDA. However, it could enforce its security
7 interest in all the debtors' accounts (including those from all
8 three contracts) against Medina Forestation after Medina
9 Forestation received any proceeds from the contracts.
10

11 Analysis of IRS' Interests in Contract Payments

12 1. Setoff

13 A. Common Law

14 In claiming priority over Offord to the USDA contract proceeds
15 the IRS relies primarily on a right of setoff. It is clear that in
16 relation to a debtor the United States has the same right to set
17 off mutual debts under the common law as do other creditors. "The
18 government has the same right which belongs to every creditor, to
19 apply the unappropriated moneys of his debtor, in his hands, in
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24 (...continued)

25 348 (1906); Malman v. U.S., 202 F.2d 483, rehearing denied 207 F.2d
26 897 (C.A.N.Y. 1953); Lindberg v. Humphrey, 289 F.901 (D.C. Cir.
1923); Brooks v. Mandel-Witte Co., Inc., 54 F.2d 992 (2nd Cir.
1932); Dorr-Oliver, Inc. v. United States, 432 F.2d 447 (1970).

⁶ Although the agreement at one point grants a "security agreement" in the proceeds, other sections of the agreement refer to a "security interest."

1 extinguishment of the debts due to him." United States v. Munsey
2 Trust Co. of Washington, D.C., 332 U.S. 234, 67 S.Ct. 1599, 91
3 L.Ed. 2022 (1947) (citing Gratiot v. United States, 40 U.S. 336,
4 370, 10 L.Ed. 759 (1841); McKnight v. United States, 98 U.S. 179,
5 186, 25 L.Ed. 115 (1878)).

6 The Court of Claims has held that this common law right exists
7 independent of and is unaffected by the provisions of 26 U.S.C. §
8 6323, which statute establishes the validity and priority of tax
9 liens on property as against others with interests in the property.
10 Aetna Insurance Company v. United States, 456 F.2d 773 (1972).
11 This court has read Aetna. Although 26 U.S.C. § 6323 has been
12 amended since 1972 in minor ways, nothing in those amendments
13 affects the validity of the basis upon which the court reached its
14 holding. This court agrees with the holding. First, as the Aetna
15 court stated, the statutory language of § 6323 clearly applies only
16 with respect to the lien created under § 6321. Second, the
17 legislative history of the amendments to § 6323 suggests that there
18 was no intent to abrogate the Munsey holding.

19
20 There has been only one case brought to this court's attention
21 which has held that the government may not exercise any right to
22 set off taxes owing the United States. Home Indemnity Company v.
23 United States, 313 F.Supp. 212 (W.D. Mo. 1970). The authorities
24 the Home court cites for this proposition are 20 AM.JUR.2d.
25 Counterclaim, Recoupment and Setoff § 112 at 328, and United States
26 v. O'Grady, 89 U.S. 641, 22 L.Ed. 772 (1874). This court has read

1 O'Grady. That case does not stand for the proposition for which it
2 is cited. In that case the Supreme Court applied the doctrine of
3 res judicata to prevent the government, after a case had been fully
4 litigated, from attempting to exercise a right of setoff which had
5 not been raised as a defense in the court case.

6 The court concludes that as against the debtor the IRS, as an
7 agency of the United States, does have a common law right of
8 setoff.

9
10 B. Statutory

11 Neither 31 U.S.C. § 3727 nor 41 U.S.C. § 15 contains language
12 which specifically authorizes the government to exercise a right of
13 setoff against an assignee.⁷ However, by negative implication the
14 statutory language generally recognizes this right, not only by
15 expressly removing the right as against funds previously paid to an
16 assignee but also by specifically authorizing that in time of
17 national emergency government contracts may provide for prohibition
18 of the right of setoff to collect from assignees for, among other
19 specified debts of the assignor, taxes.⁸ See, Arlington Trust
20

21 ⁷ The provisions of 31 U.S.C. § 3716 specifically allow for a
22 right of setoff against a claim against the government. It is not
23 clear to what extent this statute applies to assignees.
24 Interestingly, however, its provisions do not apply to a tax debt.
25 31 U.S.C. § 3701(d). 31 U.S.C. § 3727, on the other hand, alludes
26 to setoff only in the negative by stating circumstances under which
an assignee is not subject to setoff.

⁸ This language was added to the statute in 1951 because of
uneasiness among lenders that the government could offset a debt
the assignor owed to the government on account of other,
independent transactions. Central Bank v. United States, 345 U.S.
639, 73 S.Ct. 917 (1953).

1 Company v. United States, 139 F.Supp. 556 (1956); First Nat. Bank
2 of Birmingham v. United States, 117 F.Supp. 486 (D.C. Ala. 1953).

3 Regulations promulgated under 31 U.S.C. § 3727⁹ specifically
4 recognize that absent these statutory exceptions the government may
5 exercise its right of setoff against payments to an assignee under
6 certain conditions. See 48 CFR 32.803(e).

7 41 U.S.C. § 15 states in part:

8
9 In any case in which moneys due or to become due under
10 any contract are or have been assigned pursuant to this
11 section, no liability of any nature of the assignor to
12 the United States or any department or agency thereof,
13 whether arising from or independently of such contract,
14 shall create or impose any liability on the part of the
15 assignee to make restitution, refund, or repayment to the
16 United States of any amount heretofore since July 1,
17 1950, or hereafter received under the assignment.

(Emphasis added)

18 31 U.S.C. § 3727 has similar language. Regulations promulgated
19 under 31 U.S.C. § 3727 state: "No payments made by the government
20 to the assignee under any contract assigned in accordance with the
21 act may be recovered on account of any liability of the contractor
22 to the government" 48 C.F.R. § 32.804(a). The IRS argues
23 that as the USDA made none of the payments under the assigned
24 contracts directly to Offord it is not precluded by the statutory
25 language from demanding repayment of all amounts distributed.

26 Although the parties have not stipulated to the name of the payee
on any of the issued USDA checks, the facts show that the amount of
\$11,701.72 which Offord received arose out of contract number 53-

⁹ These regulations have also been found by the courts to be applicable with regard to 41 U.S.C. § 15.

1 9A28-1N21 through an invoice dated April 19, 1993. The USDA
2 received notice of assignment of this contract on May 13, 1993.
3 Therefore Offord could not have been a named payee on that check.
4 However, after they received this check from the government the
5 debtors paid this money to Offord.

6 Given the legislative history of that portion of the statute
7 which authorizes assignments under certain conditions (see footnote
8 2) this court rejects the government's interpretation that the
9 regulation authorizes the government to demand repayment by a
10 legitimate assignee of funds it has received any time the payment
11 flows to it from the government through the assignor. This
12 interpretation defeats the purpose of encouraging private
13 financing. It would also require assignees to repay funds in
14 circumstances where the government, having received a notice of
15 assignment, erred and thereafter named the assignor as payee on
16 contract checks. The court concludes that as to the amount of
17 \$11,701.72 the government may not exercise any right of setoff.
18

19 With the exceptions already noted, nothing in 31 U.S.C. § 3727
20 or 41 U.S.C. § 15 prohibits the government from exercising its
21 right of setoff against assignees of government contracts if not
22 prohibited by the contract.
23

24 C. 11 U.S.C. § 553(a)

25 (a) Liquidity
26

1 To be set off the debts must be valid, enforceable and
2 mutual. Offord takes the position that, in addition, the debts
3 must be liquidated. It asserts that certain of the taxes alleged
4 to be owing are unliquidated; as to those the remedy of setoff is
5 unavailable. This court agrees with this position.¹⁰ The debtors
6 have filed income tax returns for Miquel Medina and Medina
7 Reforestation for taxes accruing prepetition for the years in
8 question showing amounts due of \$51,015.61. As to these amounts
9 the taxes are liquidated. The IRS has made no showing that the
10 balance of taxes shown on its proof of claim are liquidated. The
11 proof of claim shows that a large bulk of the taxes alleged are
12 those where there have been no tax returns filed and no assessments
13 made.
14

15 (b) Mutuality

16 The concept of mutuality contains several elements. To be
17 mutual the debts must be in the same right and between the same
18 parties, standing in the same capacity. 4 COLLIERS ON BANKRUPTCY ¶
19 553.04[2] at 553-22 (15th ed. 1994). These elements can best be
20 described by example. First, something must be owed on each side
21 but the nature of the debt need not be identical. Second, one
22 cannot set off one debt against a debt the debtor owes to another.
23
24

25 ¹⁰ "[S]ince setoff is a sort of judicial accounting among
26 potential judgments, it requires definite amounts to be used in
computation of a net figure--hence the traditional requirement of
setoff that debts be 'liquidated'." In re Hancock, 137 B.R. 835
(Bankr. N.D. Okla. 1992). This case contains a studious and
through discussion of setoff.

1 Third, the debts must arise between parties acting in the same
2 capacity. For example, an ordinary debt may not be set off against
3 funds held in trust for the other. In bankruptcy debts arising
4 prepetition may not be set off against debts arising postpetition.

5 Courts are divided as to whether debts arise between the
6 parties acting in the same capacity when two different agencies are
7 involved in the transactions before the court.¹¹ This court has
8 concluded that the parties have acted in the same capacity, that
9 for that purpose mutuality exists and setoff is available.

10 The federal government's common law right of setoff is
11 exactly that. It belongs to the United States. Historically it
12 has been exercised against anyone who has a "claim" against the
13 government. United States v. Tafoya, 803 F.2d 140 (5th Cir. 1986).
14 Mutuality is not destroyed simply because a claim arose against the
15 debtor in one agency of the executive branch while the debtor is
16 owed an amount from a different agency. See e.g., Cherry Cotton
17 Mills, 327 U.S. 536 (1946).¹²

18
19
20
21 ¹¹ United States ex rel. Small Business Admin. v. Rinehart,
22 88 B.R. 1014 (D. S.D. 1988), aff'd in part, rev'd in part 887 F.2d
23 165 (8th Cir. 1989); In re Britton, 83 B.R. 914 (Bankr. E.D. N.C.
24 1988); In re Sound Emporium, Inc., 48 B.R. 1 (Bankr. W.D. Tex.
25 1984), aff'd 70 B.R. 22 (W.D. Tex. 1987); Matter of Butz, 154 B.R.
26 541 (S.D. Iowa 1993); In re Thomas, 84 B.R. 438 (Bankr. N.D. Tex.
1988); In re Mohar, 140 B.R. 273 (mutuality exists); In re
Ionosphere Clubs, Inc., 164 B.R. 839 (Bankr. S.D. N.Y. 1994);
Illinois v. Lakeside Community Hosp., Inc., 151 B.R. 887 (N.D. Ill.
1993); In re Hancock, 137 B.R. 835 (Bankr. N.D. Okla. 1992); In re
Pyramid Industries, Inc., 1994 WL 454802 (Bankr. N.D. Ill. 1994)
(mutuality does not exist).

¹² For an in depth discussion on this point see this court's
opinion In re Gibson, ___ B.R. ___ (Bankr. D. Or. 1994).

1 Although acknowledging this, Offord alleges that the IRS
2 does not meet the mutuality requirements in other ways. It claims
3 amounts owed to Miguel Medina dba Medina Reforestation cannot be
4 set off against any tax debt owed by Vicki Medina or by Miguel
5 Medina and Vicki Medina jointly. The IRS' proof of claim does not
6 indicate the name of the taxpayer for each of the numerous types
7 and years of taxes shown owing. From the notices of tax lien this
8 court knows that at least some of the taxes arose separately
9 against Vicki Medina dba Vicki Medina Church Company and against
10 Miguel Medina dba Medina Reforestation. The court concurs that
11 mutuality is lacking for setoff of any amounts due to Medina
12 Reforestation against the tax debt due from Vicki Medina dba Vicki
13 Medina Church Co. However, courts have divided over whether an
14 individual debt may be set off against a joint debt. In deciding
15 this point this court must examine the equities in light of the
16 particular facts of the individual case.

17
18 Under our facts the answer lies in the direction given by
19 the court in Rochelle v. United States, 521 F.2d 844 (5th Cir.
20 1975). There the Court considered the possibility of authorizing
21 an offset of a government's claim against a partnership against its
22 debt to one of the partners. In finding the offset met the
23 requirements of mutuality the court stated that the government
24 could not complain about any loss of its claim against the other
25 partners as it was the entity seeking the setoff. Further, the
26 partner has no right to complain as he was severally as well as

1 jointly liable for the partnership debt. Such are our facts.
2 Miguel Medina has joint and several liability for any tax debt
3 arising from tax returns filed with Vicki Medina. 26 U.S.C. §
4 6013(d)(3). Further, the IRS, requesting setoff, cannot complain.
5 The court concludes that under our facts mutuality is not destroyed
6 by offset of the government's claim for any taxes jointly owed by
7 Miguel Medina and Vicki Medina against the amounts owed by the
8 government to Miguel Medina dba Medina Reforestation under the
9 contracts.

10
11 Offord argues that setoff is not mutual because the debt
12 from USDA is owed to it, not to Medina Reforestation. In making
13 this argument, Offord overlooks the fact that under certain
14 circumstances assignees take subject to the right of setoff held by
15 a creditor of the assignor. It also argues that this setoff would
16 violate § 553(b). This is incorrect; § 553(b) applies only to
17 prepetition setoffs.

18 The facts indicate that certain of the USDA payments were
19 made postpetition. May these amounts be set off against a
20 prepetition debt? My conclusion is that they may. Under the terms
21 of the reforestation contracts the government's obligation to pay
22 for the reforestation services arose at the time the contracts were
23 executed although the contract was wholly executory.¹³

24 (b) Waiver
25
26

¹³ See, Moratzka v. United States, 63 B.R. 56 (D. Minn. 1986).

1 The right to set off is an equitable remedy which arises
2 when the intent to set off is asserted. If it is not asserted it
3 may be lost. If a creditor's conduct is inconsistent with a
4 subsequent claim of setoff he will be held to have waived it.

5 Cumberland Glass Manufacturing Company v. DeWitt and Company, 237
6 U.S. 447, 35 S.Ct. 456, 69 L.Ed. 870 (1915).¹⁴

7 Between the Medinas' Chapter 13 filing and their Chapter
8 11 filing the IRS had issued a notice of levy pursuant to 26 U.S.C.
9 § 6331. However, this notice did not cover the contracts before
10 this court. In addition, the effect of a levy is simply to secure
11 the property levied upon until further steps are taken to determine
12 final disposition of the property. Conversely, exercise of any
13 right of setoff results in elimination of all rights the debtor had
14 in the property set off in exchange for a credit against amounts
15 due the exercising creditor. Consequently, issuance of the notice
16 cannot reasonably be interpreted as assertion of a right of setoff.

17
18
19 Under contract number 52-8462-3-07007 the debtors earned a
20 total of \$58,383.55 of which \$38,838.55 is being held by the USDA
21 and \$19,545 of which was distributed by the USDA directly to the
22 debtors and used as cash collateral under order of the court.
23 Under contract number 53-9A28-3-1N21 the debtors ultimately earned
24 a total of \$81,030.32 of which \$47,331.39 was distributed by the

25
26

¹⁴ See also First National Bank of Portland v. Dudley, 231
F.2d 396 (9th Cir. 1956).

1 USDA prepetition directly to the debtors, (of this latter amount,
2 \$35,629.67 is represented by nonnegotiated drafts held by the
3 Medinas' attorney and \$11,701.72 is represented by a draft which
4 was negotiated and proceeds from which were paid by the debtors to
5 Offord), \$32,056.33 is being held by the USDA and \$1,642.60 was
6 distributed by the USDA postpetition directly to the debtors and
7 used as cash collateral under order of the court (with the
8 exception of \$850.02). Under contract number 43-8462-3-1073 the
9 debtors earned a total of \$11,487.50 which was all distributed by
10 the USDA postpetition directly to the debtors and used as cash
11 collateral under order of the court. The court finds that the IRS
12 has not waived the government's right of setoff as to the contract
13 funds still held by the USDA (\$70,894.88) and the funds represented
14 by the nonnegotiated checks (\$35,629.67).¹⁵ Certainly the
15 automatic stay did not eliminate any right of setoff held by the
16 government and post-petition it quickly asserted that right through
17 filing its motion for relief.
18

19 Postpetition, on June 14, 1993 the IRS filed a Notice of
20 and Motion to Deny Use of Cash Collateral, alleging a tax lien on
21 all the debtors' cash collateral, including accounts receivable
22

23
24 ¹⁵ In U.S. v. Trinity Universal Insurance Co., 249 F.2d 350
25 (5th Cir. 1957), the court held that the government had not waived
26 its right to set off tax debt where, although it had issued its
check to the contractor, the check had not been cashed and was
being held pending outcome of the case. The court agrees with the
U.S. v. Trinity holding. The funds represented by the
nonnegotiated checks are still within the control of the government
through the USDA.

1 arising out of the USDA contracts at issue herein. Simultaneously
2 it filed a motion to lift the automatic stay in order to set off
3 amounts owed against the amounts due Medina Reforestation under the
4 USDA contracts and to complete the sale of debtors' Talent real
5 estate. Shortly thereafter the debtors in possession filed a
6 motion to use cash collateral in the form of payments made
7 postpetition by the USDA on the contracts. Subsequently the Service
8 withdrew its motion for relief as to the sale of the property and
9 entered into a stipulation with the debtors in possession and
10 Offord for use of cash collateral pending a decision on its motion
11 to lift stay for purposes of setting off. Pursuant to this
12 stipulation the court entered an order which authorized the debtors
13 in possession to use cash collateral flowing from the USDA
14 contracts in the amount of \$31,825. This amount is represented by
15 an invoice dated June 1, 1993 for \$11,487.50 and an invoice dated
16 June 2, 1993 for \$19,545 arising from contract number 52-8462-3-
17 07007 and an invoice dated June 10, 1993 for \$1,642.60 (less
18 \$850.02) under contract number 53-9A28-3-1N21. (There is an
19 unexplained discrepancy of \$200.10 between the amount of cash
20 collateral authorized for use under the order and the invoice
21 amounts.) The stipulated order continues:
22

23
24 As adequate protection for the use by DIP of cash
25 collateral in which IRS and Offord Finance, Inc. claim a
26 security interest, IRS and Offord Finance, Inc. are
hereby granted the following: (a) For the purpose of
securing the impairment of the value of either IRS's and
Offord Finance, Inc.'s alleged security claim or both
resulting from the use of cash collateral, IRS and Offord
Finance, Inc. shall be granted a security in real

1 property owned by DIP located at 6101 Adams Road, Talent,
2 Jackson County, Oregon, 97540. The obligation of DIP
3 shall be evidenced by a Promissory Note in the sum of
4 \$31,825.00 made payable jointly to IRS and Offord
5 Finance, Inc., and secured by a Trust Deed on the real
6 property referred to above with IRS and Offord Finance,
7 Inc. as joint beneficiaries

8 By allowing the debtor-in-possession's use of the cash
9 collateral it is clear that the IRS waived its right of setoff
10 against those funds.¹⁶ The court will address adequate protection
11 if necessary through future court order.

12 2. Tax Lien

13 The IRS asserts priority to the contract payments through its
14 filed tax liens. The government's lien for taxes attaches upon
15 assessment of the underlying tax. With minor exceptions this lien
16 attaches to all the taxpayers' property. 26 U.S.C. § 6321. Offord
17 asserts that the United States' tax lien could not attach to
18 accounts it was assigned, citing In re Halprin, 280 F.2d 407 (3rd
19 Cir. 1960).¹⁷ In Halprin, the court held that the tax lien arising
20 under 26 U.S.C. § 6321 does not attach to a wholly executory

21 ¹⁶ It is not clear whether the parties to the stipulation
22 intended the note and trust deed to provide adequate protection to
23 the IRS for those amounts it had claimed through assertion of its
24 right of setoff as well as those amounts it claimed through its tax
25 lien. The right to set off had been early and adamantly asserted.
26 It constitutes a form of charge against property which gives the
holder a status similar to that of a creditor secured by lien. The
court concludes that, despite the use in the quoted order of the
ambiguous term "security interest", that the parties intended that
the note and trust deed provide the IRS with adequate protection of
its interest in the USDA contract proceeds through its asserted
right of setoff as well as its interest therein through its tax
lien.

¹⁷ See also U.S. v. Long Island Drug Co., 115 F.2d 983 (2nd
Cir. 1940).

1 promise to pay which is contingent upon an exchanged performance.
2 Halprin has been criticized by commentators.¹⁸ This court believes
3 that the better view is that the term "all property and rights to
4 property . . ." in 26 U.S.C. § 6321 should be interpreted to
5 include contingent contract rights. In Seaboard Surety Co. v.
6 United States the Ninth Circuit, in a case on all fours, held that
7 the tax lien attached to the taxpayer's interest in the contract on
8 the date of the contract award. 306 F.2d 855 (9th Cir. 1962).

9
10 26 U.S.C. § 6323(a) provides generally that the lien which
11 arises on behalf of the United States at the time of assessment
12 under 26 U.S.C. § 6321 is not valid against third parties until
13 notice thereof is filed of record. 26 U.S.C. § 6323(f)(1)(A)(ii)
14 states that with regard to personal property, whether tangible or
15 intangible, this notice shall be filed in the office within the
16 state which is designated for such filing by the laws of that state
17 in which the property is situated.¹⁹ For Oregon the place so
18 designated is the office of the Secretary of State in which the
19 property is situated. Therefore the notice of tax liens marked
20 Exhibits C, D, and E filed with the Jackson County Clerk did not
21

22
23
24 ¹⁸ Young, Priority of the Federal Tax Lien, 34 U.Chi.L.Rev.
25 723, 745 (1967); Coogan, The Effect of the Federal Tax Lien Act of
26 1966 upon Security Interests Created under the Uniform Commercial
Code, 81 Harv.L.Rev. 1369, 1373 (1968).

¹⁹ 26 U.S.C § 6323(2)(B) states that in the case of personal property the situs of the property is deemed to be at the residence of the taxpayer at the time of the filing. Under our facts it was Oregon.

1 provide constructive notice to third parties of the United States'
2 lien on any of the Medinas' personal property interests.

3 The agreed facts show that the United States filed two notices
4 of tax lien with the Secretary of State for certain taxes assessed
5 in 1990, 1991 and 1992 against Vicki Medina and Miguel Medina as
6 shown in paragraph number 4. The lien listed as Exhibit B was
7 filed against "Vicki Medina [and] Vicki Medina Church Co." and the
8 lien listed as Exhibit A was filed against "Miguel Medina [and]
9 Medina Reforestation." The USDA contract receivables at issue are
10 payable to Medina Reforestation. Exhibit B does not give
11 constructive notice to third parties of the government's lien on
12 the USDA contracts as Vicki Medina had no interest in Medina
13 Reforestation. This court concludes that the United States holds
14 only a validly perfected tax lien as to the USDA contracts for
15 \$18,975.08 through the notice of tax lien marked as Exhibit A.²⁰

17 Rights of Priority

18 The court must still address to what extent the United States
19 may claim a prior right in the debtor's funds under either its
20 claim for setoff or its tax lien to those of a third party which
21 claims priority through an absolute assignment and a perfected
22 security interest. On this issue the Munsey court holding that the
23 United States has a general right of setoff is not helpful. See,
24 U.S. v. Munsey Trust Co., 332 U.S. 234, 67 S.Ct. 1599 (1947). In
25

26 ²⁰ Exhibit A is notice of a lien arising from the amounts
stated therein which were duly assessed at the time of the filing.
It cannot be notice for taxes not yet assessed.

1 Munsey a contractor's surety was attempting to obtain funds from
2 the United States for payments it had made to subcontractors. The
3 surety could not recover as subrogee of the subcontractors because
4 the latter do not have enforceable rights against the United States
5 for their compensation. The surety under a payment bond did not
6 have rights of its own in the funds held by the government.
7 Finally, although the surety would be subrogated to any rights of
8 the contractor, under the facts the contractor had none. Here
9 Offord claims a right to the funds through its contracts of
10 assignment and security with Medina Reforestation, the party
11 contracting with the government, which right this court has
12 validated.
13

14 1. Tax Lien

15 The priority of the government's tax lien arising out of
16 Exhibit A over Offord's interest in all accounts, as well as over
17 its absolute assignment of contract numbers 52-8462-3-07007 and 53-
18 9A28-3-1N21 is not determined under the Anti-Assignment Acts but
19 rather under 26 U.S.C. § 6323. 26 U.S.C. § 6323(b), (c), and (d)
20 provide protection for certain interests despite duly filed notice
21 of the tax lien. None of these subsections provide Offord, as
22 assignee, protection from the government's lien on contract numbers
23 52-8462-3-07007 and 53-9A28-3-1N21. Subsection (c)(1)(A) is the
24 only provision under which Offord might receive protection for its
25 security interest in the debtors' accounts. It applies if the
26

1 following requisites are met: 1) the security interest²¹ stems
2 from a written agreement which (a) was entered into before the tax
3 lien was filed, and (b) qualifies as a "commercial transactions
4 financing agreement" under that section; 2) the loans were made
5 pursuant to the written agreement within 45 days of the tax lien
6 filing or, if earlier, prior to receiving actual notice or
7 knowledge that the tax lien had been filed; 3) the written
8 agreement covered "qualified property" which was "acquired" by the
9 taxpayer within 45 days of the tax lien filing; and 4) state law
10 gives the security interest holder priority over a judgment lien by
11 an unsecured creditor as of the time the tax lien is filed.

12 Atlantic National Bank v. United States, 536 F.2d 1354, 1358

13 (Ct.Cl. 1976) (citing Donald v. Madison Industries, Inc., 483 F.2d

14 837, 842 (10th Cir. 1973)). Offord's financing agreement was not
15 executed before the notice of tax lien marked Exhibit A was filed.

16 Therefore, this tax lien, as to the assessed amounts shown therein,
17 is prior to Offord's security interest in all the debtors'
18 accounts.

19

20 2. Setoff

21 A. Common Law

22

23 ²¹ 26 U.S.C. § 6323(h)(1) defines a security interest as
24 any interest in property acquired by contract for the
25 purpose of securing payment or performance of an
26 obligation or indemnifying against loss. A security
interest exists at any time (A) if, at such time, the
property is in existence and the interest has become
protected under local law against a subsequent judgment
lien arising out of an unsecured obligation, and (B) to
the extent that, at such time, the holder has parted with
money or money's worth.

1 At common law generally a right of setoff which arises out of
2 the same transaction as that by which the claim of the assignee was
3 created is usable against the assignee in precisely the same cases
4 that it would be in reducing the assignor's remedy. ARTHUR CORBIN,
5 4 CORBIN ON CONTRACTS § 896 at 596 (1951 & Supp. 1993). If the
6 claim of setoff arises out of a collateral transaction it is
7 available against the assignee if it existed as a matured claim at
8 the time of the assignment. It is not available against the
9 assignee if the claim was acquired after notice of the assignment.
10 Id. § 897 at 600-601.²²

11
12
13
14 B. Code of Federal Regulations

15 Except for the language regarding amounts previously paid to
16 assignees and the national emergency language quoted below, the
17 statutes do not address the issue of priorities between assignees
18 and the government's exercise of the right of setoff. Certain
19 priorities, however, are established by 48 CFR 32.803(e). It
20 states:

21 (e) When an assigned contract does not include a no-
22 setoff commitment, the Government may apply against
23 payments to the assignee any liability of the contractor
24 to the Government arising independently of the assigned
25 contract if the liability existed at the time notice of
26 the assignment was received even though that liability
had not yet matured so as to be due and payable.

²² In Oregon, as in many states, these rules have become statutory. See O.R.S. 79.3180 and O.R.S. 80.020.

1 The regulatory language reflects the same distinction made at
2 common law between liabilities arising out of the same transaction
3 and those that do not.

4 Within another context, this distinction is reflected by the
5 language of the statute. Prior to amendment in 1951 the Assignment
6 of Claims Act stated in part, and with reference to contracts
7 entered into during times of war or national emergency, that
8 "payments to an assignee of any claim arising under such contract
9 shall not be subject to reduction or set-off." 31 U.S.C. § 203.
10 This language was amended in 1951 to read ". . . whether arising
11 from or independently of such contract." Central Bank v. United
12 States, 345 U.S. 639, 643 (1953).

13
14 In a case interpreting the former language which involved the
15 attempted setoff of a contractor's taxes against proceeds of an
16 assigned contract the Supreme Court held that the contractor's
17 indebtedness to the United States for taxes arose "independently"
18 of his governmental contract. The government could not exercise
19 setoff. Central Bank v. United States, 345 U.S. 639 (1953). The
20 IRS's claim for taxes arose out of a transaction "collateral" or
21 "independent" to that out of which Offord's claim arose. At
22 common law the government may set off against a debt arising out of
23 a collateral transaction if it existed as a matured claim at time
24 of assignment. Under 48 CFR 32.803(e) it may set off if the
25 "liability existed at the time notice of the assignment was
26 received even though that liability had not yet matured"

1 (Emphasis added.) The liquidated taxes shown in the proof of claim
2 are all for tax periods prior to May, 1993 when Offord had acquired
3 any rights in the contracts with the exception of a FUTA tax in the
4 amount of \$491.72 for the period ending December 31, 1993 and
5 payroll taxes in the amount of \$12,565.78 for the quarter ending
6 June 30, 1993. For these exceptions the debtors had no liability
7 as of May, 1993. The IRS held a matured claim against the debtors
8 for the balance of the liquidated taxes. Therefore, as to those
9 taxes for which setoff is otherwise available under nonbankruptcy
10 law, the IRS has priority over Offord as assignee.
11

12 Offord points out that under these regulations "assignment of
13 claims" is defined as "the transfer or making over by the
14 contractor to a bank, trust company, or other financing
15 institution, as security for a loan to the contractor, of its right
16 to be paid by the Government for contract performance." 48 CFR
17 32.801. It argues that it did not take its assignments as security
18 for a loan. Rather, it received absolute assignments. Therefore
19 the regulations do not authorize setoff against it.

20 The court notes that the statutory definition of "assignment"
21 is "(1) a transfer or assignment of any part of a claim against the
22 United States Government or of an interest in the claim; or (2) the
23 authorization to receive payment for any part of the claim." 31
24 U.S.C. § 3727(a). The court must attempt, when able, to interpret
25 regulatory language in a manner which is consistent with its
26 related statute. See, Helvering v. Sabine Transp. Co., 318 U.S.

1 306, 63 S.Ct. 569 (1943). If the two cannot be reconciled the
2 statutory language prevails. Id. The regulatory language places a
3 limitation on the definition of "assignment" which is not present
4 in the statutory language. To that extent 48 CFR 32.801 is deemed
5 inapplicable.²³

6 3. 11 U.S.C. § 553(a)

7 Under our facts, § 553(a) plays no role with regard to
8 contract numbers 52-8462-3-07007 and 53-9A28-3-1N21. This section
9 applies to setoff of debts between a creditor and the debtor. The
10 debtor no longer has any interest in those contracts. The court
11 has determined that the assignments to Offord are valid. Under
12 these contracts, therefore, the USDA owes its payments to Offord.
13 Any priorities between the IRS and Offord as to these payments is
14 not determined under § 553(a).

15
16 11 U.S.C. § 553(a) is applicable as to those contracts not
17 assigned prepetition to Offord, but in which it took only a
18 security interest. In bankruptcy, exercise of setoff postpetition
19 is discretionary with the court and is based on equitable
20 principles. Section 553 does not enlarge any right of setoff a
21 creditor has under nonbankruptcy law. Rather, it allows for its
22 exercise if the conditions for setoff are present. Sitting in
23 equity, the court should ask whether setoff would result in a
24

25
26 ²³ It is interesting to note that if the regulatory
definition of "assignment of claims" were deemed a correct
interpretation of the statute's applicability Offord's assignment
would be void as not an assignment for security.

1 priority of payment which otherwise is not recognized under the
2 Bankruptcy Code and which would harm unsecured creditors.

3 Allowing setoff under our facts is not inequitable to
4 unsecured creditors. Under both bankruptcy and nonbankruptcy law
5 the funds at issue will be distributed in full to either the IRS or
6 Offord. They would never have been available for distribution to
7 the general unsecured creditors. As for Offord, when neither the
8 debtor nor the estate's general unsecured creditors are implicated,
9 nothing in § 553(a) authorizes this court to ignore the priorities
10 between rival creditors to the fund which are established by
11 nonbankruptcy law.
12

13 Marshalling

14 Offord has requested that if this court determines that the
15 IRS has priority to the USDA contract payments it apply the
16 doctrine of marshalling to require the IRS first to apply any
17 proceeds it receives from sale of the real property located at 6101
18 Adams Road, Talent, Oregon to the debtors' tax debt.

19 The doctrine of marshalling is an equitable remedy which the
20 bankruptcy court may apply in its discretion. In Oregon it has
21 been defined as a "basic principle of equity that where a senior
22 creditor has recourse to two funds and a junior creditor has
23 recourse to but one of them, the senior creditor must seek to
24 satisfy itself first out of the fund in which the junior creditor
25 has no interest." Community Bank v. Jones, 278 Or. 647, 678, 566
26 P.2d, 470, 488 (1977).

1 This court is not in a position to apply the doctrine because
2 it does not yet know the amount of the government's allowed tax
3 claim. It notes that if the tax claim, as allowed, is close to the
4 size stated in the government's proof of claim, depending on the
5 number and value of assets otherwise available to the IRS to
6 satisfy the debt, marshalling might be a useless act. Under those
7 circumstances, the amount the government would receive from both
8 the USDA payments and proceeds from such sale would not be
9 sufficient to pay the tax claim in full. Under those circumstances
10 Offord would not benefit from application of the doctrine.
11

12 Conclusion

13 Subtracting the amount used by the debtors as cash collateral,
14 the amount in controversy between the parties is \$106,524.55. Of
15 this amount, \$11,701.72, having been paid to Offord, is not
16 available for setoff. Of the total amount shown on the IRS's proof
17 of claim, the amount of \$51,021.58 (taxes of \$51,015.61 and related
18 interest of \$5.97) is liquidated and may be set off. In addition,
19 the IRS has a valid tax lien in the amount of \$18,975.08. As this
20 lien is for taxes other than the taxes determined to be liquidated,
21 it may be foreclosed for the amount secured.
22

23 The Internal Revenue Service will be granted relief from the
24 automatic stay to set off the amount of \$51,021.58 against the
25 contract payments being held by the USDA as well as, to the extent
26 necessary, the contract amounts paid to Medina Reforestation which
are represented by checks being held in trust by the debtors'

1 attorney. It will also be granted relief to foreclose its tax lien
2 marked Exhibit A. The balance of the payments due under the
3 contracts shall be paid to Offord. After its setoff is completed,
4 the IRS will be required to file an accounting with Offord and the
5 court showing application of amounts set off and application of
6 amounts from any other collateral which secures the tax debt. The
7 court will then determine the extent to which the estate must
8 provide adequate protection to either the IRS or to Offord for use
9 of their cash collateral.
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11 This Memorandum Opinion contains the court's findings of fact
12 and conclusions of law and pursuant to Bankruptcy Rule 9014, which
13 incorporates Rule 7052, they will not be separately stated. An
14 order consistent herewith shall be entered.
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17 POLLY S. HIGDON
18 Bankruptcy Judge
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