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Sections 522(c) and 553(a): The Tide Is Turning

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Sections 522(c) and 553(a) of the Bankruptcy Code contain dueling provisions that have long been the subject of conflict and resulting judicial interpretation. Unless a case is dismissed or one of four exceptions applies, § 522(c) provides that exempted property is not liable during or after the case for any debt of the debtor that arose before commencement of the case. In contrast, § 553(a) states, subject to three limited exceptions, that title 11 does not affect any right of a creditor to offset a mutual debt owing by such creditor arising before commencement of the case against such claim of the creditor also arising before commencement of the case.

With repeated references to providing debtors with a fresh start, a majority of the courts that have addressed this conflict between Code provisions have ruled that a creditor cannot offset pre-petition debt against exempt property. In a well-reasoned opinion by Hon. Barbara Keenan, the Fourth Circuit has now helped to swing the pendulum in the opposite direction with its decision in *Copley v. United States of America*.[2] Interestingly, the Code provisions interpreted anew by *Copley*, namely §§ 522 and 553, have not changed since the development of the majority view's interpretation.

The Internal Revenue Service (IRS) has often played the role of a creditor in these cases, seeking to offset its claim against an exempted property right of the debtor. *Copley* is no exception. The undisputed facts of *Copley* involved a married couple who filed for relief under chapter 7, claiming an exemption in a $3,200 federal income tax refund that they expected to receive post-petition based on pre-petition taxes paid. The IRS approved the refund, but then asserted a right to offset the refund against an unpaid pre-petition tax debt of $13,500.

In response, the debtors initiated an adversary proceeding asking the court to determine that they were entitled to the refund. The bankruptcy court ruled for the debtors, finding that exempt property is not liable for any debt arising before the bankruptcy filing pursuant to § 522(c). After the district court affirmed the bankruptcy court's decision on its initial appeal, the IRS appealed again to the Fourth Circuit.

The government challenged two legal conclusions made by both the bankruptcy and district courts: (1) that the Copleys' tax overpayment became part of their bankruptcy estate upon filing; and (2) that the Copleys' right to exempt the tax overpayment supersedes the government's right to offset. With regard to the first challenge, the Fourth Circuit began by finding that § 541's expansive definition of what constitutes estate property compelled the conclusion that the Copleys' interest in the tax overpayment and resulting potential refund constituted property of their bankruptcy estate. However, the court next found that § 542(b) preserves a defense of setoff, which might be asserted by a creditor against a claim of property of the estate where such a right of offset exists under § 553.

As for the second challenge raised by the IRS, the court saw the real potential conflict arising between § 522(c) and Internal Revenue Code (26 U.S.C.) § 6402(a). Section 6402(a) allows the IRS to offset "any overpayment" against a taxpayer's pre-existing tax liabilities. Under the court's analysis, § 553(a) serves to resolve this apparent conflict. The court found that § 553, by its plain and unambiguous language, provides that no provision of title 11 "affect[s]" the rights of the IRS to offset a mutual, pre-petition debt with the Copleys, subject to several exceptions not relevant to the appeal. By virtue of § 553(a), § 6402(a) supersedes § 522(c).

The progression of the debate between the right of offset and exemption rights is interesting. The "majority" had also considered the plain language of § 553, but decided the issue the other way. For example, *United States v. Jones (In re Jones)*[3] affirmed the bankruptcy court's decision that exemption rights supersede offset. In *In re Jones*, the government offset the 1995 federal income tax refund of the debtor against her 1990 and 1991 federal income tax debts.

Other courts have reached the same conclusion, but for different reasons. The applicability of § 553 has sometimes been interpreted as permissive, implying an equitable or policy consideration not reflected in the plain language of the statute. For example, in *Alexander v. Comm'n, IRS (In re Alexander)*,[4] the court found that a creditor's right of setoff under § 553(a) must yield to the debtor's right to exempt and protect assets under § 522(c).[5] Similarly, the court in *In re Wilde*[6] found that a creditor could not

1 Ms. Pavlova's work in preparing this article was done in her personal capacity. The opinions expressed herein are the author's own and do not reflect the view of Sands Anderson PC.
2 2020 U.S. App. LEXIS 15155 (4th Cir. May 12, 2020).
3 230 B.R. 875, 878 (M.D. Ala. 1999).
4 225 B.R. 145 (Bankr. W.D. Ky. 1998).
5 *Id.* at 149.
6 85 B.R. 147, 149 (Bankr. D.N.M. 1988).

exercise its right of setoff under § 553 against a debtor's funds that were exempt under § 522.

Other courts found that while §§ 522(c) and 553(a) are instructive, state law should also be considered. For example, in *In re Cole*,[7] the court was faced with the question of how to apply a consumer debtor's unapplied pre-petition utility deposit, which was claimed as exempt. The debtor owed Edison $17,000 pre-petition and the debtor exempted her $175.98 deposit, which was paid when the debtor opened the Edison account. The court considered Maryland's exemption laws and decided that a creditor cannot exercise a right of setoff under § 553 against a debtor's property that was exempt under Maryland state law.

Even in Virginia, where the Copleys filed their bankruptcy case, courts have found that "[t]he general rule in Virginia is that a creditor may not exercise a right of setoff against exempt property,"[8] but "[o]verall, the majority rule appears to be that exempt property is not subject to setoff."[9] That view allows for §§ 553 and 522 to coexist and give each other effect, because a setoff would be allowed to the extent not exempted.[10] However, the recent trend has been to allow the creditor to exercise its setoff rights against exempt property. In *In re Bourne*,[11] the court held that § 553 can only be given meaning if exemptions remain subject to setoff:

> [B]y giving primary effect to the exemption rights of a debtor, the offset right of a creditor is often completely nullified[.] It is just as logical to give effect to both provisions [§§ 522 and 553] by holding that a debtor may claim an exemption which is valid as to all creditors except one having a right of offset.[12]

United States v. Luongo,[13] affirmed by the Fifth Circuit, also relied on the clear and unambiguous language of § 553(a),[14] and this trend continued through the early 2000s. In *United States v. White*,[15] the court classified the tax refund that the debtors wanted to recover from the IRS as "an obligation owed to them, rather than funds belonging to them."[16] In *Hurt v. United States Dep't of Hous. & Urban Dev't (In re Hurt)*,[17] the court — at the time at odds with the Eastern District of Virginia in *Copley* — held that the U.S. Department of Housing and Urban Development (HUD) can set off the debtors' tax refund against a deficiency owed to HUD by virtue of a loan to purchase a manufactured home.

Most recently, and following the *Copley* decision, the Fourth Circuit reversed the district court, which had affirmed the bankruptcy court's decision that a tax refund was estate property and that the debtors' right to claim an exemption took precedence over the government's offset rights.[18] In *In re Wood*, the debtors defaulted on their federally guaranteed home mortgage, and HUD sent them a notice of intent to collect through the Treasury Offset Program. The debtors filed for chapter 7 protection and claimed an exemption in the expected tax refund. After the bankruptcy and without seeking a modification of the automatic stay, the U.S. Treasury offset the overpayment against the deficiency owed to HUD. The court again looked to the statute's plain language and decided that the government's right of setoff overruled the debtor's right to exempt the tax refund under § 522(c).

As these cases demonstrate, the government's persistence is finally bearing fruit. While the cases discussed herein are limited to the government — with the resulting involvement of 26 U.S.C. § 6402 — such issues are not necessarily constrained just to the IRS as a creditor. Other creditors might also have set-off rights against debtors who claim an exemption in the property at issue. Time will tell whether a creditor's rights under § 553 will continue to supersede the rights of a debtor under § 522. abi

7 104 B.R. 736, 740 (Bankr. D. Md. 1989).

8 *In re Ward*, 210 B.R. 531, 536 (Bankr. E.D. Va. 1997) (citing *Commonwealth of Va. v. Haley (In re Haley)*, 41 B.R. 44, 46 (Bankr. W.D. Va. 1984) (finding that setoff was appropriate when debt arose from debtor's embezzlement and disallowed debtors' claimed homestead exemption before allowing setoff); *In re Terry*, 7 B.R. 880, 883 (Bankr. E.D. Va. 1980) (at issue was employer's attempt to set off against debtor's wages, which debtor had claimed exempt, and court held that employer was entitled to setoff against wages for debt owed by debtor to employer, subject to applicable exemptions); *Atl. Life Ins. Co. v. Ring*, 167 Va. 121, 126, 187 S.E. 449, 451 (1936) (court affirmed decision of lower court because disability payments owed to defendant by complainant were exempt from claims of creditors and, under applicable statute, defendant's indebtedness to complainant could not be set off against defendant's disability payments); *see also Hodgson v. Lakewood Broad. Serv. Inc.*, 330 F. Supp. 670, 673-74 (D. Colo. 1971) (minimum wages due to debtor under Fair Labor Standards Act immune from setoff against his employer); *Commerce Union Bank v. Haffner (In re Haffner)*, 12 B.R. 371, 373 (Bankr. M.D. Tenn. 1981) (bank not entitled to set off amounts in debtors' accounts that they properly exempted); *Fin. Acceptance Co. v. Breaux*, 160 Colo. 510, 419 P.2d 955, 958 (Colo. 1966) (employer not entitled to setoff against employee's exempt wages); *Williams v. Dep't of Public Welfare*, 43 N.J. Super. 473, 129 A.2d 56, 59-60 (Law Div. N.J. 1957) (municipality not entitled to set off its claim against former employee arising out of embezzlement against employee's worker's compensation award)).

9 *United States v. Jones (In re Jones)*, 230 B.R. 875, 879 (M.D. Ala. 1999) (citing *Alexander*, 225 B.R. at 149; *In re Swickard*, 133 B.R. 902, 904 (Bankr. S.D. Ohio 1991)).

10 *In re Jones*, 230 B.R. 875, 879 (M.D. Ala. 1999).

11 262 B.R. 745 (Bankr. E.D. Tenn. 2001).

12 *Id.* at 756.

13 255 B.R. 424, 426-27 (N.D. Tex. 2000).

14 *See also In re Martinez*, 258 B.R. 364, 366 (Bankr. W.D. Tex. 2000) ("The clear and unambiguous language of section 553(a) states that Title 11 does not affect a creditor's right of setoff.").

15 365 B.R. 457, 463 (M.D. Pa. 2007).

16 *Id.* at 463.

17 579 B.R. 765 (Bankr. W.D. Va. 2017).

18 *Wood v. U.S. HUD (In re Wood)*, No. 20-1161, 2021 U.S. App. LEXIS 10029 (4th Cir. April 7, 2021).