# PART II: ELEMENTS OF A FEDERAL NONTAX DEBT

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# A.DEFINITIONS OF DEBT, DEBTOR, AND DELINQUENCY

## I. INTRODUCTION

Before collecting a debt, it is essential to determine: (1) Is there a debt?, (2) Is it owed by a debtor?, and (3) Is it delinquent? These determinations inform what collection actions, if any, can (or must) be taken. This chapter addresses the meanings of the terms "debt," "debtor," and "delinquency" in the context of nontax debt collection by federal agencies. Unless otherwise specified, these terms are defined for the purposes of federal nontax debt collection under the Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749 (1982) (DCA) and the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321 (1996) (DCIA). Other laws may have different definitions of these terms.

## II. WHAT IS A DEBT?

### A. DEFINITION

To collect a debt, an agency must first determine that a debt exists. *See* 31 U.S.C. §§ 3701(b), 3711(a). A debt is "any amount of funds or property that has been determined by an appropriate official of the Federal Government to be owed to the United States[1] by a person, organization, or entity other than another Federal agency." 31 U.S.C. § 3701(b)(1); *accord* 31 CFR § 900.2. The terms "debt" and "claim" are often used interchangeably in federal debt collection statutes and regulations, and there is generally no meaningful distinction between these terms. 31 U.S.C. § 3701(b) (defining "the term 'claim' or 'debt'"); 31 CFR § 900.2(a) ("[f]or the purposes of the standards in this chapter, the terms 'claim' and 'debt' are synonymous and interchangeable."); *see also* 49 Fed. Reg. 8889, 8889 (Mar. 9, 1984) (former Federal Claims Collection Standards) (there is no meaningful distinction between the terms "debt" and "claim" because the DCA uses them interchangeably). The term "debt" generally includes both current receivables and delinquent debts. *See* 31 U.S.C. § 3701.

### B. TYPES OF FEDERAL DEBTS

Federal debts may arise for a variety of reasons. The categories of federal nontax debt specifically listed in 31 U.S.C § 3701(b)(1) are not exclusive. 31 U.S.C. § 3701(b)(1); 31 CFR § 900.2(a). The categories do, however, provide examples of the ways a federal debt may come into existence. *Id.*

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[1] The definition of "debt" generally means an amount owed to the United States by a person other than a federal agency. For certain purposes, however, this term includes amounts owed to state governments by a person other than a federal agency. For example, states may enter into reciprocal agreements with the Federal Government to use administrative offset to collect their state debts. *See* 31 U.S.C. § 3716(h) (governing the reciprocal offset program). The collection of debts owed to states is outside the scope of this treatise.

### *(1) Direct and Guaranteed Loans*

Debts may arise from "funds owed on account of loans made, insured, or guaranteed by the Government, including any deficiency or any difference between the price obtained by the Government in the sale of a property and the amount owed to the Government on a mortgage on the property." 31 U.S.C. § 3701(b)(1)(A). Loans are governed by contractual arrangements between the lender, the borrower and, if applicable, the guarantor (or other third party). Agencies must therefore understand the terms of the loan (and any applicable guarantees or repurchase rights/obligations) that apply to the debt being collected.

a) Direct Loans

Direct loans are loans made by the Government directly to a borrower. *See* OMB Circ. A-129,[2] Sec. II, § 2.B. Direct loans give rise to federal debts as soon as the funds are disbursed to the borrower. *See* 31 U.S.C. § 3701(b)(1)(A). Direct loans become delinquent if a payment has not been made by the date specified in the agreement or instrument (plus any applicable grace period), unless the agency and borrower agree to an alternative payment arrangement. OMB Circ. A-129, Sec. V.A.1.

b) Insured and Guaranteed Loans

A loan insured or guaranteed[3] by the Government originates between the borrower and a private sector lender. *See* OMB Circ. A-129, Sec. V.A.2. "Loans guaranteed or insured

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[2] Office of Management and Budget, Circular A-129 (revised), Policies for Federal Credit Programs and Non-Tax Receivables (Jan. 2013) [hereinafter OMB Circular A-129].

[3] Several federal statutes allow the United States to "guarantee" a borrower's performance of a loan, either by paying a loss claim to the lender upon the borrowers default, by agreeing to repurchase the loan upon the borrower's default, or by indemnifying the lender for its loss upon the borrower's default. OMB Circular A-129, Sec. V.A.2. Agencies should pay special attention to the relevant statutes, regulations, and debt documents. The terms "guarantee" and "insured" are not always used with precision, and the rights of the relevant parties will depend on the nature of the transaction, rather than whether it is called a "guaranteed loan," a "surety contract," or an "insured loan." As one court stated,

> The use of the word "insurance" in the statute is not determinative in light of the realities existing between the relevant parties. . . . Insurance is a contract where one undertakes to indemnify another against loss, damage or liability caused by an unknown or contingent event. Since the insured pays the insurer for the promise of indemnity, the insurer benefits to the extent that a contingency never occurs. Where a contingency does occur, the insurer can still be made whole, by virtue of subrogation, to the extent that the insured would be able to recover damages from a third party. . . . A surety, on the other hand, promises to assume the responsibility for the payment of a debt incurred by another should he or she fail to repay the creditor. The arrangement is made to induce the creditor to deal with the borrower where there might otherwise be a reluctance to do so. Under this arrangement, the nature, size, and source of the possible loss to the creditor is known from the start. In addition, there is no payment from the creditor to the surety or guarantor for this "insured" payment. Rather, a kind of tripartite relationship is formed.

*United States v. Tilleraas*, 709 F.2d 1088, 1091-1092 (6th Cir. 1983).

by the Federal Government are in default when the borrower breaches the loan agreement with the private sector lender." *Id.* "A default *to the Federal Government* occurs when the [Government] repurchases the loan, pays a loss claim or pays reinsurance on the loan." *See id.* (emphasis added). That is, the Government is owed a debt at the time the Government repurchases the loan, pays a loss claim or pays reinsurance on the loan. 31 U.S.C. § 3701(b)(1)(A); *Guillermety v. Sec'y of Educ.*, 241 F. Supp. 2d 727, 746 (E.D. Mich. 2002) (for purposes of 31 U.S.C. § 3701, a claim does not include a guaranteed loan, until the government pays a claim on the guarantee); OMB Circ. A-129, Sec. V.A.2; *see also United States v. Tilleraas*, 709 F.2d 1088, 1091 (6th Cir. 1983) (for statute of limitations purposes, the government's cause of action accrued when the government paid the private sector lender); *United States v. Frisk*, 675 F.2d 1079, 1083 (9th Cir. 1982) (same); *United States v. Baker*, 681 F. Supp. 750, 751 (M.D. Ala. 1987) ("the government's action could not have accrued until [the date on which the bank assigned the loan to SBA]"); *but see United States v. Excellair, Inc.*, 637 F. Supp. 1377, 1395 (D. Colo. 1986) ("[t]he sole sensible interpretation [of 31 U.S.C. § 3701] is that a loan guaranteed by the government is a 'claim of the United States' even when, at the time of transfer, the guarantee had not yet been honored").

c) Effect of State Anti-Deficiency Law

As stated above, federal debts include "any deficiency or any difference between the price obtained by the Government in the sale of a property and the amount owed to the Government on a mortgage on the property." 31 U.S.C. § 3701(b)(1)(A). Agencies should be aware of state laws governing collection of deficiencies, which may affect whether the deficiency is a valid and legally enforceable debt.

Generally, a federal agency cannot be denied the benefits of federal law due to an election it makes under state procedural law. *See* U.S. Const. Art. VI, cl. 2; *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (state laws cannot "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress"). In other words, if Congress has legislated how and when a deficiency may be recovered, federal law applies in place of state law. *Carter v. Derwinski*, 987 F.2d 611, 615 (9th Cir. Idaho 1993) ("Federal law is mandatory, and neither the State of Idaho through legislation, nor the VA through its litigation choices, can waive its applicability").

When federal law does not expressly address an agency's right to collect deficiency, the agency must look to the analysis set forth in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 726-27 (1979). In *Kimbell*, the Supreme Court identified three factors relevant to determining whether state law applies to liens arising from federal programs: (1) whether the federal program at issue requires uniform federal rules; (2) whether adopting state substantive law would frustrate federal program objectives; and (3) the extent that a uniform federal rule would disrupt normal commercial relationships. *Id.* The Supreme Court also noted that "[a]dopting state law as an appropriate federal rule does not preclude federal courts from excepting local laws that prejudice federal interests." *Id.* at 736 n.37; *see also United States v. Jackobson*, 319 F.3d 323, 323-24 (8th Cir. 2002) (agency was required to adopt state procedural rules, but not state substantive rules, and a debtor's right to protection from deficiency judgments is a substantive rule); *Carter v. Derwinski*, 987 F.2d 611, 615-17 (9th Cir. 1993) ("[s]tate laws which affect lenders' ability to recapture additional amounts from [debtors] after foreclosure . . . do not affect the [agency's] independent right to seek recovery"); *Chicago Title Insurance Co. v. Sherred Village Assoc.*, 708 F.2d 804 (1st Cir. 1983) (following *Kimbell*, in the absence of federal statute setting priorities and no need for a uniform federal rule, state law granting mechanic's lien priority over a later-assigned federal mortgage should apply); *U.S. v. Victory Highway Village, Inc.*, 662 F.2d 488, 497 (8th Cir. 1981) ("because of 'an overriding federal interest in protecting the funds of the United States and in securing federal investments,' federal interest predominates over state interest"); *Resolution Trust Company v. Johnson*, 844 F. Supp. 535, 537 (D. Minn. 1992) (rejecting state statutory redemption requirement because federal law controls when federal government is foreclosing on a lien).

*(2) Expenditures of Nonappropriated Funds*

Debts may also arise from "expenditures of nonappropriated funds, including actual and administrative costs related to shoplifting, theft detection, and theft prevention." 31 U.S.C. § 3701(b)(1)(B). A 2001 amendment to 31 U.S.C § 3701 added "including actual and administrative costs related to shoplifting, theft detection, and theft prevention" in the context of a series of enactments related to military commissaries. Pub. L. No. 107-107, Div. A, Title III, Subtitle C, §335, 115 Stat. 360 (Dec. 28, 2001). The Army and Air Force Exchange Service (AAFES) has a policy of charging every apprehended shoplifter for the cost of any stolen property plus a flat administrative fee associated with the cost of shoplifting. *See* Whiteman Air Force Base, *AAFES Implements Civil Recovery Program for Shoplifters* (Aug. 3, 2007), http://www.whiteman.af.mil/news/story.asp?id=123063314. The program aims to deter shoplifters by adding an extra fee above the cost of the stolen items and to reimburse the Government for the general costs incurred due to shoplifting. *Id.; see also United States v. Santosdedios*, 240 F. Supp. 2d 414, 422 (D. Md. 2002) (AAFES's civil recovery program "was instituted to recoup non-appropriated funds" and that charging the debtor $200 for shoplifting lipstick after prosecuting her criminally did not constitute double jeopardy). Similarly, the Coast Guard has implemented the Nonappropriated Fund Instrumentalities Civil Recovery Program for the same purposes. *See* U.S. Dept. of Homeland Security & U.S. Coast Guard, *Nonappropriated Fund Instrumentalities Manual*, COMDTINST M7010.5C (April. 2015), *available https://www.uscg.mil/directives/cim/7000-7999/CIM_7010_5C.pdf*.

*(3) Overpayments*

Debts may also arise as a result of "over-payments, including payments disallowed by audits performed by the Inspector General of the agency administering the program." 31 U.S.C. § 3701(b)(1)(C). Overpayments are payments issued to the wrong person or in an incorrect amount, whether caused by agency error, or mistake or fraud by the payee. *See* Improper Payments Elimination and Recovery Act of 2010 (IPERA), P.L. 111-204, § (2)(f) (defining "improper payments" as "any payment that should not have been made or that was made in an incorrect amount . . .");[4] Exec. Order No. 13520 (2009) (instructing agencies to "reduce improper payments by intensifying efforts to eliminate payment error, waste, fraud, and abuse in the major programs administered by the Federal Government"). Regardless of the cause of the overpayment, agencies must affirmatively and aggressively attempt to collect these debts. *See, e.g., United States v. Burchard*, 125 U.S. 176, 181 (1888) (affirming the right to collect an overpayment made by disbursing officers to a retired officer of the Navy); *Old Republic v. Fed. Crop Ins. Corp.*, 947 F.2d 269, 272 (7th Cir. 1991) (agencies have authority under contract, statute, and common law to recoup overpayments that result from agency error); *Lawrence v. United States*, 69 Fed. Cl. 550, 552 (Fed. Cl. 2006) (the Government was entitled to collect after it erroneously overpaid an employee's Living Quarters Allowance by $53,762.07); *Bank One v. United States*, 62 Fed. Cl. 474, 475 (Fed. Cl. 2003) ($97,345.66 in mistaken government payments to a bank was eligible for collection as a federal debt). Even if the agency does not become aware of the overpayment for many years, the agency generally must attempt to collect the debt when it discovers the overpayment. *See Brumley v. United States,* 55 Fed. Cl. 431, 432-33 (Fed. Cl. 2003) (collection of overpayments made under the Federal Employees Compensation Act was permissible regardless of the fact that the Government became aware of the overpayments in 1983 but did not move to collect until 1991).

*(4) Unpaid Share of Non-Federal Partner in Program Involving Federal Payment and Matching/Cost-sharing Payment by Non-Federal Partner*

Federal debt can also result from "the unpaid share of any non-federal partner in a program involving a federal payment and a matching, or cost-sharing, payment by the non-federal partner." 31 U.S.C. § 3701(b)(1)(E). Agencies must collect debts from non-federal partners, such as states, who do not meet their contractual obligations arising from a payment-sharing agreement with the Federal Government. *See Gallegos v. Lyng*, 891 F.2d 788, 789 (10th Cir. 1989) (a state participant in a food stamp cost-sharing program owed a federal debt when an unacceptable number of food stamps were lost in the mail, because the state had accepted liability for lost stamps as part of its participation in the program).

*(5) Fines and Penalties*

Federal debts also arise from "any fines or penalties assessed by an agency." 31 U.S.C. § 3701(b)(1)(F). In this context, "penalty" refers to the debt itself, and not to the "penalty" charged pursuant to 31 U.S.C. § 3717 for failure to pay a debt on time. However, interest, administrative costs, and penalties assessed on delinquent debts are also "debts" for the purpose of 31 U.S.C. § 3701(b).

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[4] The definition of "improper payments" in IPERA includes underpayments. For the purpose of debt collection, however, "erroneous payments" and "overpayments" are the salient categories of "improper payments."

*(6) Other Debts*

Finally, the categories of debts listed by 31 U.S.C. § 3701(b)(1) are not meant to be an exhaustive listing of the ways in which debts can be owed to the United States. 31 U.S.C. § 3701(b)(1)(G) (debts include "other amounts of money or property owed to the Government"). Thus, "any amount of funds or property that has been determined by an appropriate official of the Federal Government to be owed to the United States," other than a debt owed by a federal agency, is a debt for the purposes of chapter 37 of title 31 of the United States Code. 31 U.S.C. § 3701(b).

## C. SPECIAL CLASSES OF DEBT

a) Internal Revenue Code, Social Security Act, and Tariff Laws

The applicability of some debt collection tools is limited for certain classes of debts. 31 U.S.C. § 3701(d). Specifically, sections 3711(e) (consumer credit reporting), 3716 (administrative offset); 3717 (interest, costs, and penalties), 3718 (private collection contractors); and 3719 (reporting on debt collection activities) of title 31 of the United States Code do not apply to debts under the Internal Revenue Code, the Social Security Act (with various exceptions), or the tariff laws of the United States. 31 U.S.C § 3701(d); *see also* 31 CFR § 900.3. While these classes of debt are exempt from certain debt collection schemes, they may be subject to collection under other law.

b) Fraud, Antitrust, False Claims, or Misrepresentation

Upon identification of a claim that, in whole or in part, involves fraud, antitrust violations, false claims, or misrepresentation, agencies should promptly notify the Department of Justice (DOJ) for appropriate action. 31 CFR § 900.3(a).[5] Only DOJ has the authority to compromise or suspend or terminate debt collection action on such claims. *Id.*; *see also* 31 U.S.C. § 3711(b)(1). At its discretion, DOJ may return the claim to the appropriate agency for further handling in accordance with the Federal Claims Collection Standards (FCCS). 31 CFR § 900.3(a).

## D. ESTABLISHING DEBTS

*(1) Agency Regulations Defining Debt*

Agencies are required to issue debt collection regulations. 31 U.S.C. §§ 3711(d), 3716(b). Agencies are also required aggressively to collect debts. *Id*. § 3711; 31 CFR § 901.1. As such, agencies must ensure that their regulations support collection of all debts that may arise. *See* 31 U.S.C. §§ 3711(d), 3716(b). In other words, if defining the term "debt" in their regulations, agencies should either adopt the statutory definition codified in 31 U.S.C.

[5] Agencies with independent litigating authority do not need to notify DOJ of these debts.

§ 3701(b) or should ensure that their definition does not unintentionally narrow their ability to collect amounts owed.

*(2) Agency Determination*

An appropriate agency official must establish the existence of a debt. 31 U.S.C. § 3701(b)(1). An "appropriate official" is generally a person with a level of expertise necessary for understanding the debt. Agency employees who establish debts generally have relevant training and manage debts owed to the agency as a main job function. The level of expertise required varies depending on the size and type of debt with which they work. Thus, who constitutes an appropriate official to establish a debt is context-dependent.

*(3) General Procedures for Establishing Debt*

Agency procedures for establishing debts vary, just as the types of debts owed to different agencies vary. Generally, agencies do not have to go to court to establish a debt; a federal nontax debt exists because an agency determines that it exists. *E.g.*, *United States v. Beulke*, 892 F. Supp. 2d 1176, 1187 (D.S.D. 2012) (court order was not required for Government to refer the debtor to the Treasury Offset Program); *Ingram v. Cuomo*, 51 F. Supp. 2d 667, 672 (M.D.N.C. 1999) (a debt established by HUD was past-due and legally enforceable even though it had not been reduced to judgment in a court); *Hurst v. Dep't of Educ.*, 695 F. Supp. 1137, 1139 (D. Kan. 1988), *aff'd*, 901 F.2d 836 (10th Cir. 1990) ("In its most basic sense, 'legally enforceable' means that a party could go to court and obtain a judgment on the debt"); *Bell v. New Jersey*, 461 U.S. 773, 775 (1983) (the Secretary of Education did not need a court order to collect funds that had been misapplied by certain states); *Di Silvestro v. United States*, 405 F.2d 150, 155 (2d Cir. 1968) (Veterans Affairs could establish and collect a debt without any court determination because it used acceptable internal procedures). Agencies must establish debts even if those debts could not be established in court because they are barred by a statute of limitations for pursuing judicial remedies. *See, e.g.*, *United States v. Moriarty*, 8 F.3d 329, 334 (6th Cir. 1993) ("[A]lthough the United States may be precluded by the applicable statute of limitations from bringing an action for money damages, it continues to have a 'right to payment' against the debtor in this case and thus may enforce that right in other ways"). The debtor has the right to contest the agency's determination that a debt exists. *See, e.g.*, 31 U.S.C. §§ 3711(e)(2) (consumer reporting agency), 3716(a)(3) (administrative offset), 3720D(b)(5) (administrative wage garnishment); *see also* 5 U.S.C. § 702 (describing a person's right to judicial review of agency actions).

*(4) Establishing Estimated Debts*

If the exact amount of a claim is unknown, but an agency can make a reasonable estimate of the claim, the agency should begin collection activity based on its estimate. *See Ratanasen v. California, Dep't of Health Servs.*, 11 F.3d 1467, 1468 (9th Cir. 1993) (in an appeal of a bankruptcy case, holding that "the use of sampling and extrapolation as part of audits" is an appropriate way to establish a debt, "provided the aggrieved party has an opportunity to rebut such evidence"); *Michigan Dep't of Education v. U.S. Dep't of Education*, 875 F.2d 1196, 1205 (6th Cir. 1989) (an "audit of the thousands of cases comprising the universe of cases would be impossible" and that the United States could therefore determine the overpayment through statistical sampling); *Illinois Physicians Union v. Miller,* 675 F.2d 151, 156 (7th Cir. 1982) ("sampling and extrapolation is proper provided there is an opportunity to rebut the initial determination of overpayment"); *Mile High Therapy Centers, Inc. v. Bowen*, 735 F. Supp. 984, 986 (D. Colo. 1988) (creditor could collect the funds it overpaid, determined by conducting an audit of the claims it paid using a statistical sampling method, and then extrapolating the sample to the total claims). As explained in a Comptroller General opinion:[6]

> [T]he government may set off the estimated amounts of its claims, and may do so even in the absence of final resolution of the underlying dispute. The use of this method of collection is not conditioned on whether the claim arose out of contract or otherwise.

*Matter of Chandler Trailer Convoy, Inc.*, B-193432, B-211194, 1984 U.S. Comp. Gen. LEXIS 1737 (U.S. Comp. Gen. 1984); *see also Alan I. Saltman,* B-259532, 1995 WL 905738, at *4 (Comp. Gen. Mar. 6, 1995) (estimates based on valid presumptions and made by appropriate administrative officials are enough to justify offsets); *Metro Machine Corp.*, B-187178, 1976 U.S. Comp. Gen. LEXIS 1966 (Comp. Gen. Oct. 7, 1976) (the government may "set off the estimated amount of claims due the United States by withholding amounts due under Government contract"); *Frank Briscoe Co., Inc.*, B-161283, 1976 U.S. Comp. Gen. LEXIS 2818 (Comp. Gen. Mar. 16, 1976) (rejecting the argument that it was premature to declare the company a debtor and holding that the agency could initiate collection action for estimated debts that arose out of a contract); *Wright*, B-176791, 1972 U.S. Comp. Gen. LEXIS 1884 (Comp. Gen. Sept. 8, 1972) ("where the amount due the Government had not been finalized . . ., the unilateral deduction of the amount estimated by the Government to be due" is appropriate); *but see Artech Corp.*, 56 Comp. Gen. 963 (1977) (random sampling for purposes of projecting the full amount of an overpayment was not sufficiently certain to warrant offset) (citing 4 CFR § 102.3(a) (former version of the Federal Claims Collection Standards); *Nw. Airlines, Inc.*, B-210600, 1984 WL 46650, at *3 (1984) (interpreting 4 CFR § 102.3 (1984)), held that a claim against one airline based only on the experience of other airlines is too uncertain for offset purposes). The Government's right to commence collection on estimated debts is needed to "protect its rights as a creditor." *Wright*, 1972 U.S. Comp. Gen. LEXIS 1884.

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[6] Opinions of the Comptroller General are not binding on federal agencies in the debt collection context. General Accounting Office Act of 1996, Pub. L. 104-316, § 115(g), 110 Stat. 3826, 3835; Todd David Peterson, Deputy Assistant Attorney General, *Administrative Settlement of Disputes Concerning Determinations of Mineral Royalties Due the Government,* Office of Legal Counsel, 1998 OLC Lexis, 32, 14-15 (1998) (GAO opinions provide useful guidance but are not binding on federal agencies); *see generally Bowsher v. Synar*, 478 U.S. 714 (1986).

*(5) Establishing Tort Debts*

Just as with any other debt, agencies may establish a tort debt without going to court. *Red River Farms v. United States*, 2009 WL 2983195 (D. Ariz. 2009) (the U.S. Coast Guard's National Pollution Fund Center was authorized to establish a debt related to oil spill cleanup costs and offset was proper when the plaintiffs did not pay the debt). In some circumstances, tort damages evaluations may require considerable legal or technical expertise. The agency should ensure that agency officials who establish tort debts are knowledgeable about the factors that will affect the debt determination.

*(6) Establishing Contract Debts*

Debts owed to the United States may arise when an agency contracts with a person for a good or service. Before commencing collection activity, agencies should determine how their debt collection authority interacts with the Contract Disputes Act of 1978 (CDA). Pub. L. 95-563, 92 Stat. 2383) (now codified at 41 U.S.C. §§ 7101-09). The CDA sets forth procedures for handling claims related to government contracts, whether the claims are against the government or against the contractor. *Id.; Cecile Indus., Inc. v. Cheney*, 995 F.2d 1052, 1055 (Fed. Cir. 1993) (the "CDA clearly and comprehensively defines the procedures for all contractual disputes between the United States and private contractors"). The administration of a contract is under the jurisdiction of the relevant contracting agency and, just as with other debts, the agency does not need to seek a judicial determination of the amount of money owed to it. *See Wright*, B-176791, 1972 WL 6336 (Comp. Gen. Sept. 8, 1972).

The collection of debts arising under a contract through the offset of payments owed under the contract by the United States are generally governed by the CDA, rather than the DCA. *See Avco Corp. v. United States*, 10 Cl. Ct. 665, 666 (1986) (no "debt" as contemplated by the DCA existed when an agency withheld payment under the contract because it was dissatisfied with a contractor's performance); *Cecile Indus., Inc. v. Cheney*, 995 F.2d 1052, 1055 (Fed. Cir. 1993) (offset of claims from a single contract is not governed by DCA); *Allied Signal, Inc. v. United States*, 941 F.2d 1194, 1198 (Fed. Cir. 1991) (no "debt" existed under the DCA when the agency wanted to reduce payments under the contract because the agency was reducing a contract price in accordance with the CDA); *Spectrum Leasing Corp. v. United States*, 764 F.2d 891, 894 (D.C. Cir. 1985) ("[t]he right to these payments is created in the first instance by the contract, not by the [DCA]" and that "[t]he DCA, even if it applied, confers no such right in the absence of the contract itself"). As one court explained, "the CDA clearly and comprehensively defines the procedures for all contractual disputes between the United States and private contractors" and, as such, the court was "reluctant to construe the DCA to inject 'a new procedural matrix into every contract.'" *Cecile Indus., Inc. v. Cheney*, 995 F.2d 1052, 1055 (Fed. Cir. 1993). Thus, a "debt" does not exist for DCA purposes until the contract price is fixed.

The term "debt," as used in the DCA, "contemplates an existing liability by the contractor, rather than a denial of further liability by the Government within an on-going contract." *Allied Signal, Inc. v. United States*, 941 F.2d 1194, 1198 (Fed. Cir. 1991). As one court explained:

> to the extent that the DCA applies to the collection of interest, it applies only to "outstanding" debts. In order for a debt to be outstanding for the purposes of the DCA, there must first exist some amount due. In this case, the individual contracts determine when an amount becomes due. Until such amounts become due under the contracts, no "outstanding debts" exist for the purposes of the DCA.

*Precision Pine & Timber, Inc. v. United States*, 75 Fed. Cl. 80, 88 (Fed. Cl. 2006). Thus, once an agency determines that an amount is due, it must establish a debt and collect that debt. *See* 31 U.S.C. §§ 3701, 3711.

## III. WHO IS A DEBTOR?

### A. DEFINITION

Under federal debt collection laws, a debtor is any legal entity other than a federal agency,[7] including individuals, corporations, partnerships, guarantors of loans, and state and municipal governments. *See* 31 U.S.C. § 3701(b)(1). Once a person owes a debt, the person is considered to be a debtor within the meaning of federal debt collection laws. 31 U.S.C. § 3701.

### B. CERTAIN TYPES OF DEBTORS

*(1) States, Localities, and Domestic and Foreign Sovereigns*

State and local governments can be "debtors" for federal debt collection purposes. 31 U.S.C. § 3701; 31 CFR § 285.2.[8] Similarly, a literal reading of 31 U.S.C. § 3701 would include foreign and domestic sovereigns within the meaning of "debtor." 31 U.S.C. § 3701. Collection from foreign sovereigns is generally governed by international law, federal statute and federal policies. Because this collection activity can have important foreign policy implications, agencies will need to understand the legal and practical limits on their

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[7] The term "executive, judicial, or legislative agency" is defined by 31 U.S.C. § 3701(a)(4) as "a department, agency, court, court administrative office, or instrumentality in the executive, judicial, or legislative branch of Government, including government corporations." Resolution of interagency claims is governed by Executive Order No. 12,146. Exec. Order No. 12146 (1979) (to resolve interagency legal disputes, "each agency is encouraged to submit the dispute to the Attorney General."); *see also* 31 CFR § 900.3(c) (the FCCS do not apply to interagency claims).

[8] The DCIA changed the definition of "person" for the purposes of sections 3716 and 3717 of title 31. *Id.* Prior to the DCIA, the term "person" excluded "an agency of the United States Government, of a State government, or of a unit of general local government." 31 U.S.C.S. § 3701. The DCIA's definition of person excludes only "an agency of the United States Government." *Id.*

collection activities. Whether the sovereign will be immune from suit, for example, will depend on a variety of factors, including whether the sovereign consented (either explicitly or implicitly) to be sued, whether the United States has waived its own sovereign immunity in similar cases, the impact the suit would have on foreign relations, and whether the sovereign is acting in its capacity as a sovereign or in a commercial capacity. In cases involving private litigants and foreign sovereigns, courts have noted the importance of the State Department's policy regarding immunity.[9] While agencies may pursue collection of debts owed by foreign and domestic sovereigns under common law, agencies should consult their legal counsel to determine whether collection action is appropriate under current law.

*(2) Representatives of Debtors' Trusts and Estates*

A representative of a person or an estate may become liable to the United States if the representative fails to pay the United States before paying the claims of other creditors. 31 U.S.C. § 3713(b). For a discussion of the statute providing priority for federal claims, see Chapter B, below.

## C. JOINT AND SEVERAL LIABILITY

Two or more debtors can be held individually liable for the same federal nontax debt. "[A]n assertion of joint and several liability is an assertion that *each* defendant is liable for the entire amount, although the plaintiff only recovers the entire amount once." *Golden v. Golden*, 382 F.3d 348, 355 n.5 (3d Cir. 2004) (emphasis in original), *superseded on other grounds by Marshall v. Marshall*, 547 U.S. 293 (2006); *accord SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 843 (3d Cir. 2006). Joint and several liability is defined by Black's Law Dictionary as follows:

> Liability that may be apportioned either among two or more parties or to only one or a few select members of the group, at the adversary's discretion. • Thus, each liable party is individually responsible for the entire obligation, but a paying party may have a right of contribution and indemnity from nonpaying parties.

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[9] *See, e.g., Nat'l City Bank v. Republic of China*, 348 U.S. 356, 360 (1955) ("touching the evolution of legal doctrines regarding a foreign sovereign's immunity is the restrictive policy that our State Department has taken toward the claim of such immunity" and noting that "the State Department has pronounced broadly against recognizing sovereign immunity for the commercial operations of a foreign government"); *The Schooner Exch. v. McFaddon*, 11 U.S. 116 (1812) (finding implied consent to suit); *New York and Cuba Mail S.S. Co. v. Republic of Korea*, 132 F. Supp. 684, 686-87 (1955) (the claim of immunity by a foreign sovereign "presents a political rather than judicial question" and that "Courts may not so exercise their jurisdiction, by the seizure and detention of property by a friendly sovereign, as to embarrass the executive arm of the government in conducting foreign relations" (internal quotations and citations omitted)); *The Roseric*, 254 F. 154, 158 (1918) (in cases involving foreign sovereigns, courts have sometimes accorded the sovereign with immunity, not because they lacked the judicial power over the sovereign, but because the exercise of that power "was waived out of a due regard for the dignity and independence of a sister sovereignty"); *Et Ve Balik Kurumu v. B.N.S. Int'l Sales Corp.*, 204 N.Y.S.2d 971, 975-7 (N.Y. Sup. Ct. 1960) ("an agency wholly or partly owned or controlled by a foreign government is not entitled to the immunity of the government" and "the privileged position of a sovereign is one of policy, and as such it should not be applied in matters wholly of a commercial nature").

BLACK'S LAW DICTIONARY 933 (9th ed. 2009). When two or more debtors are liable for the same debt, the Government can simultaneously pursue collection against all the debtors. *SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 843 (3d Cir. 2006); *United States v. Gregg*, 226 F.3d 253, 260 (3d Cir. 2000); 31 CFR § 902.4(a); *see also Resolution Mgmt. Consultants v. Hickey*, 2011 U.S. Dist. LEXIS 70928, 18-19 (D.N.J. June 29, 2011) (in case between private litigants, the fact that two persons are jointly and severally liable does not require the creditor to sue both parties in the same action); *World Entm't, Inc. v. Brown*, 2011 U.S. Dist. LEXIS 55182 (E.D. Pa. May 20, 2011) (in a case between private litigants, "[l]iability is joint and several when the plaintiff may recover from one or more of the parties to such liability separately, or all of them together." (internal citations and quotations omitted)).

A compromise with one debtor does not release an agency's claim against any co-debtor. 31 CFR § 902.4(b). Likewise, if the Government enters into a compromise agreement with one debtor, the compromise shall not be considered determinant of the amount that will be required of co-debtors. *Id.* Agencies should not attempt to allocate the burden between co-debtors, but rather pursue collection activity against all the debtors. *Id.*; *Jean Harris*, 58 Comp. Gen. 778, 782 (1979) (the Government is not required to collect a proportionate share of the claim against joint and severally liable debtors, but may collect in the manner best calculated to liquidate indebtedness as quickly as possible, even if this means collecting the entire amount from one debtor). However, if the Government chooses to pursue collection action against only one debtor, the Government does not release its claim against the other debtor(s). *See* 31 CFR § 902.4(b).

## IV. WHAT IS DELINQUENCY?

### A. GENERAL DEFINITION

A debt becomes "delinquent" when the debt "has not been paid by the date specified in [an] agency's initial written demand for payment or applicable agreement or instrument." 31 CFR § 900.2(b). Delinquency is defined broadly in the FCCS because the FCCS apply to a wide range of agencies and programs. *FCCS*, 65 Fed. Reg. 70390, 70391 (Nov. 22, 2000); OMB Circ. A-129, Sec. V. "Delinquency," however, may be defined differently for different purposes. For example, in the context of barring delinquent debtors from obtaining federal loans, loan insurance, or guarantees under 31 U.S.C. § 3720B, "delinquency" is defined as 90 days late. 31 CFR § 285.13(d)(1).

### B. CONSEQUENCES OF DELINQUENCY

Agencies must distinguish between receivables (or current debts) and delinquent debts. Most of the debt collection procedures described in this *Treatise* are appropriate only when a debt is delinquent. *See, e.g.*, *Precision Pine & Timber, Inc. v. United States*, 75 Fed. Cl. 80, 97-98 (Fed. Cl. 2006) (for the purposes of interest collection under the Debt Collection Act, "debt" means "delinquent debt"); *Guillermety v. Secretary of Education*, 241 F. Supp. 2d 727, 731 (6th Cir. 2002) (an outstanding claim under 31 U.S.C. § 3716 only accrues when the Government has a "right to collect" the money owed). While the debt is current, the United States has no additional right to collect the money owed, and the use of adverse debt collection tools is generally inappropriate. Once the debt becomes delinquent, however, agencies should make use of such tools, including administrative and tax refund offset, administrative wage garnishment, credit bureau reporting, and referral to private collection contractors. Agencies generally must also start accruing interest, penalties, and costs from the date of delinquency. 31 U.S.C. § 3717; 31 CFR § 900.9. Moreover, federal agencies are generally prohibited from providing financial assistance to delinquent debtors. 31 U.S.C. § 3720B; 31 CFR § 285.13.

## C. DELINQUENCY BY DEBT TYPE

### *(1) Administrative Debt*

Administrative debt generally becomes delinquent if and when the debtor does not pay the debt by the date specified in the agency's initial written demand for payment. 31 CFR § 900.2; *see* OMB Circ. A-129, Sec. V.A.3. Typically, an agency will demand payment within 30 days of the date the agency mails a notice to the debtor that money is owed. 31 CFR § 901.2. The debt is due as of the date of the agency's notice. However, agencies provide a 30-day grace period for debtors to make payment, prior to assessing interest, costs, and penalties, or using other adverse debt collection tools. *See* 31 CFR §§ 901.2, 901.9(g). However, if payment is not received within 30 days, the debt is delinquent as of the date that the original notice was mailed. 31 CFR § 901.2. For example, if an agency mails a letter on January 1 to a debtor informing him of a debt and demanding payment by February 1, the debtor must pay the debt by February 1. If the debtor fails to pay the debt by February 1, the date of delinquency is January 1, and interest, costs, and penalties will accrue from January 1.

Like other types of administrative debt, overpayments are generally not delinquent until after an agency makes demand for payment, even if this demand is made a long time after the overpayment was made. *See Brumley v. United States,* 55 Fed. Cl. 431, 432-33 (Fed. Cl. 2003) (collection of overpayments was permissible regardless of the fact that the Government became aware of the overpayments in 1983 but did not move to collect until 1991).

*(2) Direct Loans*

A direct loan becomes delinquent "if a payment has not been made by the date specified in the agreement or instrument (including a post-delinquency payment agreement), unless other satisfactory payment arrangements have been made." Circular A-129, App. A, Pt. V, § 5; *accord* 31 CFR § 900.2(b). The loan agreement may include a grace period and, if payment is received during the grace period, the agency will not assess interest, costs, or penalties, or use any adverse debt collection tools. 31 CFR § 900.2(b). However, if the debtor does not submit payment by the end of the grace period, the date of delinquency will be the date on which the original payment was due. *Id.* An agency that intends to collect payments in regular installments generally should include an acceleration clause in the contract, under which the entire remaining balance of the loan becomes due if an installment payment is missed. 31 CFR § 901.8. Agencies may reach alternative payment agreements with the debtor instead of declaring the loan delinquent and beginning adverse collection procedures. OMB Circ. A-129, Sec. V.

*(3) Guaranteed Loans*

A loan insured or guaranteed by the Government becomes delinquent federal debt when the Government "repurchases the loan, pays a loss claim or pays reinsurance on the loan" after the borrower breaches the loan agreement with the private sector lender. *See* 31 U.S.C. § 3701(b)(1)(A); *Guillermety*, 241 F. Supp. 2d at 746; OMB Circ. A-129, Sec. V.A.2. The date of the delinquency, however, is the original due date to the private lender for the missed payment, unless the debtor has reached a new payment agreement with the third-party lender or the Government. 31 CFR § 900.2(b); OMB Circ. A-129, Sec. V.

*(4) Repayment Agreements*

A repayment agreement becomes delinquent if a payment has not been made by the date specified in the agreement. Generally, repayment agreements should include an acceleration clause whereby one missed payment will result in the entire amount of debt becoming immediately due.

## D. AVOIDING OR CURING DELINQUENCY

Debtors may be able to avoid or cure a delinquency. Prior to using most debt collection tools, agencies are required to consider a debtor's request for a reasonable repayment agreement. *E.g.*, 31 U.S.C. § 3711(e)(1)(D)(i) (credit bureau reporting); 31 U.S.C. § 3716(a)(4) (administrative offset); 31 U.S.C. § 3720D(b)(4) (administrative wage garnishment). Also, in the context of loan debts, the loan agreement or applicable statute may provide additional opportunities to cure or avoid delinquency.

# B. FEDERAL PRIORITY STATUTE

## I. FEDERAL DEBTS HAVE PRIORITY OVER OTHER DEBTS

Claims of the United States have priority over claims owed to other creditors, and, when a person is insolvent, federal claims must be satisfied first. 31 U.S.C. § 3713. This statutory right has roots in the common law and should be interpreted broadly in favor of the United States.[10] As the Supreme Court explained:

> The right of priority of payment of debts due to the government is a prerogative of the crown well known to the common law. It is founded not so much upon any personal advantage to the sovereign, as upon motives of public policy, in order to secure an adequate revenue to sustain the public burthens and discharge the public debts. . . . and as that policy has mainly a reference to the public good, there is no reason for giving to them a strict and narrow interpretation.[11]

To protect its right to priority, federal agencies should promptly notify the debtor (or debtor's representative) of its claim, if appropriate.

## II. SCOPE OF PRIORITY

### A. FEDERAL DEBTS

Debts for purposes of 31 U.S.C. § 3713 include all debts, whether current or delinquent, matured or unmatured, liquidated or unliquidated, and federal tax or federal nontax.[12]

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[10] *United States v. State Bank of NC*, 31 U.S. 29, 35 (1832); *United States v. Coppola*, 1994 U.S. Dist. LEXIS 16848, *25 (E.D.N.Y. 1994).

[11] *State Bank of NC*, 31 U.S. at 35 (interpreting a precursor to 31 U.S.C. § 3713).

[12] *Id.* at 38 (interpreting precursor to 31 U.S.C. § 3713 and finding that priority must be accorded to debts whether matured or unmatured); *Viles v. Comm'r of Internal Revenue*, 233 F.2d 376, 379-80 (6th Cir. 1956) (interpreting precursor to 31 U.S.C. § 3713 and finding that priority must be accorded even if the tax debt had not been formally assessed and liquidated); *United States v. Snyder*, 207 F. Supp. 189, 191 (E.D. Pa. 1962) (United States could recover overpayments of annuity made to decedent).

## B. APPLICABILITY OF STATE LAW

Federal law pre-empts inconsistent state law.[13] Consequently, state statutes of limitation do not apply to the United States, and state law cannot invalidate a claim of the United States.[14] A delay by the United States, therefore, in enforcing its rights to collect a debt will not necessarily extinguish its rights to collect the debt.[15]

## C. EXCEPTIONS TO PRIORITY

There are some exceptions to the rule that federal claims are to be given priority over other creditor's claims. This priority, for example, does not apply to claims subject to a bankruptcy proceeding filed under title 11 of the United States Code. 31 U.S.C. § 3713(a)(2).

While 31 U.S.C. § 3713 does not explicitly provide for any other exceptions to the priority of federal claims, most courts have found that the United States' priority attaches only to the net proceeds of the estate. In the context of the estate of a deceased debtor, for example, courts have found that the United States has priority over the debts of the decedent but not debts of the estate. *United States v. MacIntyre*, 2012 U.S. Dist. LEXIS 87597 (S.D. Tex. 2012).

Most courts have recognized that administrative expenses of an estate[16] have superpriority over claims of the United States.[17] Administrative expenses are the necessary and reasonable costs of administering an estate, including accounting, appraisers' and attorneys' fees, court costs, and other costs associated with maintaining property of an estate.[18] Courts have generally also given

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[13] *United States v. Fisher*, 6 U.S. 358, 396-397 (1805) (rejecting the claim that granting priority to the United States will "interfere with the right of the state sovereignties respecting the dignity of debts"); *United States v. Cole*, 733 F.2d 651, 655 (9th Cir. 1984) (state statute could not supersede federal government's priority); *but see United States Dep't of Treasury v. Fabe*, 508 U.S. 491, 508 (1993) (priority of the United States affected by state statute enacted "for the purpose of regulating the business of insurance" due to the anti-exemption provisions of the McCarran-Ferguson Act).

[14] *United States v. Summerlin*, 310 U.S. 414, 416 (1940) (state statute requiring the United States to file its probate claim within eight months "cannot deprive the United States to enforce its claim"); *see also United States v. Vibradamp Corp.*, 257 F. Supp. 931, 940 (S.D. Cal. 1966); *Snyder*, 207 F. Supp. at 190-91.

[15] *Id*.

[16] Expenses that may gain superpriority over claims of the United States have generally arisen in the context of a debtor that is an estate. However, 31 U.S.C. § 3713 applies to all debtors, not just estate debtors. *See* 31 U.S.C. § 3713.

[17] *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960) (interpreting a precursor to 31 U.S.C. § 3713 and finding that administrative expenses, such as reasonable legal fees, have priority over the claims of the United States); *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925) (interpreting a precursor to 31 U.S.C. § 3713 and holding that administrative expenses were entitled to priority over federal debts); *United States v. Idaho Falls Assocs.*, 81 F. Supp. 2d 1033, 1043 (D. Idaho 1999) ("[i]t has long been settled that administration expenses of a receivership take precedence over claims asserted by the Government pursuant to 31 U.S.C. § 3713"); *Estate of Capato v. United States*, 1992 U.S. Dist. LEXIS 18217 (D. Or. 1992) (defining "administrative expenses" by reference to Internal Revenue Service regulations and applicable state law); *but see Estate of Friedman v. Cadle Co.*, 2009 U.S. Dist. LEXIS 130505 (D. Conn. Sept. 8, 2009) (the Internal Revenue Service had priority over administrative expenses because it had a federal tax lien and, therefore, 31 U.S.C. § 3713 did not govern).

[18] *See id.*

priority to reasonable funeral and burial expenses.[19] Generally, if funeral expenses are to be given priority, they must be reasonable in amount.[20] Because the statute does not explicitly provide for the prior payment of administrative and funeral expenses, agencies should consider whether to cede priority to such expenses.[21]

Furthermore, the federal priority statute may not give priority to the United States over creditors with a perfected security interest in the debtor's property.[22] Courts have also recognized exceptions to the federal priority statute when another specific federal statute governs.[23]

## III. PERSONAL LIABILITY OF REPRESENTATIVE

When a debtor has insufficient assets to pay all of its debts, the debtor's representative can be held personally liable to the United States if he or she pays the general creditors of an estate without first satisfying the Government's claims.[24] In this context, the representative includes persons who have control over the debtor's assets, not necessarily just the personal representative.[25] It is this personal liability provision that gives the federal priority statute "teeth."[26]

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[19] Courts generally have distinguished between "funeral and burial expenses" and "administrative expenses," but have—without analysis— nevertheless accorded them both priority over claims of the United States. *See United States v. Marshall*, 771 F.3d 854, 877 (5th Cir. 2014); *MacIntyre*, 2012 U.S. Dist. LEXIS 87597, *15-16; *United States v. Weisburn*, 48 F. Supp. 393, 397 (E.D. Pa. 1943). The theory for according funeral expenses priority appears to be that they were not obligations of the decedent when the decedent was alive.

[20] *Marshall*, 771 F.3d at 877 (estate representative was personally liable for funeral expenses above the maximum amount allowed under state law); *MacIntyre*, 2012 U.S. Dist. LEXIS 87597, *15-16 (same).

[21] *See* Internal Revenue Manual, Part 5.17.13.4 (07-09-2012), *available at* http://www.irs.gov/irm/part5/irm_05-017-013.html.

[22] *United States v. Estate of Romani*, 523 U.S. 517, 534 (1998) ("nothing in the text or the long history of interpreting the federal priority statute justifies the conclusion that it authorizes the equivalent of a secret lien as a substitute for the expressly authorized tax lien that Congress [in the Tax Lien Act of 1966] has said 'shall not be valid' in a case of this kind"); *Cole*, 733 F.2d at 654-655 (United States did not dispute prior payment to choate lienholders); *but see Straus ex rel. Tasemkin, Inc. v. United States*, 196 F.3d 862, 865 (7th Cir. Ill. 1999) (recognizing the priority of the United States despite state's choate tax lien).

[23] *See Estate of Romani*, 523 U.S. at 530-31 ("[o]n several prior occasions the Court had . . . concluded that a specific policy embodied in a later federal statute should control our construction of the priority statute, even though it had not been expressly amended").

[24] 31 U.S.C. § 3713(b). *United States v. Crocker*, 313 F.2d 946, 948 (9th Cir. 1963) (receiver who distributed the debtor's assets was liable to the United States under a precursor to 31 U.S.C. § 3713); *United States v. Sperry*, 2013 U.S. Dist. LEXIS 58530, *22-23 (S.D. Ind. 2013) (estate representative was liable for federal claim because he wrongfully distributed estate assets to himself and a commercial creditor prior to paying the federal claim); *United States v. Blakeman*, 750 F. Supp. 216 (N.D. Tex. 1990) (an executor who paid the state inheritance tax before paying the federal estate tax was personally liable for the outstanding federal tax).

[25] *King*, 379 U.S. at 337; *United States v. Tyler*, 528 Fed. Appx. 193, 201 (3d Cir. 2013).

[26] *United States v. Moore*, 423 U.S. 77, 81 (1975).

Courts generally hold the representative liable only if the representative:

> (1) pays a non-federal debt (2) before paying a claim of the United States (3) at a time when the [person] was insolvent, (4) if he had knowledge or notice of the claim.[27]

While the statute does not explicitly require that the representative have "knowledge" as a prerequisite to imposing personal liability, courts have interpreted the statute to include such a requirement, due to the highly penal nature of imposing personal liability.[28] Either actual or constructive knowledge will generally satisfy this knowledge requirement.[29] A representative will not, however, be immune from personal liability if the representative pays non-federal claims before federal claims due to a belief (whether or not in good faith) that the federal claims are not valid.[30]

Moreover, a representative will only be held personally liable if the debtor is insolvent. 31 U.S.C. § 3713. A representative who makes a distribution to non-priority creditors before paying the United States generally will not be held liable if the debtor was not insolvent at the time of distribution to non-priority creditors, but later became insolvent as the result of other events, such as a decline in the market value of an estate asset.[31]

## IV. TRANSFER LIABILITY OF DISTRIBUTEES

In some cases, the Government may be able to recover from persons to whom the assets have been distributed.[32]

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[27] *United States v. Renda*, 709 F.3d 472, 480-81 (5th Cir. 2013); *see also MacIntyre*, 2012 U.S. Dist. LEXIS 87597, *9; *United States v. Russell*, 2003 U.S. Dist. LEXIS 24246, *17 (E.D. Mich. 2003).
[28] *Crocker*, 313 F.2d at 948; *United States v. Boots*, 675 F. Supp. 550, 552 (E.D. Mo. 1987).
[29] *See Marshall*, 771 F.3d at 875; *United States v. Volta*, 1988 U.S. App. LEXIS 22247, *4 (9th Cir. 1988); *MacIntyre*, 2012 U.S. Dist. LEXIS 87597, *11; *United States v. Idaho Falls Assocs.*, 81 F. Supp. 2d 1033, 1042 (D. Idaho 1999).
[30] *Marshall*, 771 F.3d at 875; *Renda*, 709 F.3d at 485; *MacIntyre*, 2012 U.S. Dist. LEXIS 87597, *11-12.
[31] *Schwartz v. Commissioner*, 560 F.2d 311, 319 (8th Cir. 1977); *United States v. Lutz*, 295 F.2d 736, 742 (5th Cir. 1961); *but see United States v. Johnson, 2013 U.S. Dist. LEXIS 106671 (D. Utah 2013)*, *45 (D. Utah 2012) (the individuals who distributed the estates assets accepted the risk that the taxes would not be paid).
[32] *See United States v. Purdome*, 240 F. Supp. 221, 223 (W.D. Mo. 1963) (finding a transferee of decedent's estate, who also happened to be the estate representative, liable to the Government in the amount of the transferred assets, under a trust fund theory); *Snyder*, 207 F. Supp. at 191 (the United States may recover a decedent's debt from the distributees of decedent's estate); *United States v. Anderson*, 66 F. Supp. 870, 871 (D. Minn. 1946) (finding the existence of a constructive trust in the amount of the Government's claim that had been distributed to decedents' sole heir).

# C. DECEASED DEBTORS

[forthcoming]

# D. DEBTORS IN BANKRUPTCY

## I. BANKRUPTCY OVERVIEW

### A. INTRODUCTION

The commencement of a bankruptcy proceeding under title 11 of the United States Code (the Bankruptcy Code) can have a substantial effect on a creditor's ability to collect against a debtor. Nevertheless, an agency owed a debt by a debtor that has filed for bankruptcy protection still has an obligation to affirmatively pursue collection of the debt, subject to the restrictions imposed by the Bankruptcy Code, unless it has authority to terminate or suspend debt collection action. 31 U.S.C. § 3711(a); 31 CFR § 901.1.

This section will describe some basic bankruptcy concepts and will address some of the factors that agencies should consider when a debtor files for bankruptcy protection, including the automatic stay which goes into effect immediately upon filing and which a creditor must observe or risk sanctions. Bankruptcy is a complex area of the law, and agencies should consult with their counsel as appropriate. This section of the *Treatise* is provided to alert agencies to common bankruptcy issues, and is not be relied on as a thorough explanation of bankruptcy law. Agencies should conduct their own legal research or consult with the Department of Justice (DOJ) prior to taking actions on debts affected by bankruptcy.

### B. THE BANKRUPTCY PROCESS

Bankruptcy is the process through which a debtor can obtain relief from some or all of its[33] indebtedness. This relief can come in the form of a court-approved repayment plan and/or a full or partial discharge (or forgiveness) of indebtedness. In exchange for this relief, the debtor may be required to surrender some or all of its assets and/or comply with the terms of the court-approved payment plan. The proceeds generated from the sale of the debtor's assets or the payments made pursuant to the repayment plan will be distributed to the debtor's creditors in accordance with the Bankruptcy Code.

A bankruptcy proceeding begins upon the filing of the bankruptcy petition, usually by the debtor (considered a "voluntary" proceeding) or, rarely, by the debtor's creditors (considered an "involuntary" proceeding). 11 U.S.C. §§ 301, 303. Along with the bankruptcy petition, the debtor is required to file schedules, which provide information about the debtor's financial status, including the debtor's assets and liabilities. *Id.* § 521. Immediately upon the filing, an automatic stay takes effect and generally lasts the entire duration of the bankruptcy case. *Id.* § 362(a), (c). The stay operates much like an injunction, protecting the debtor and the debtor's

[33] A debtor can be a natural person or an entity. However, for simplicity, this Chapter generally uses the pronoun "it" to when referring to a debtor. Also, the terms "debtor," "debtor in possession," and "trustee" each have different meanings, and cannot always be used interchangeably. Nevertheless, because this *Treatise* does not attempt to give a full treatment of bankruptcy law, this Chapter generally uses the term "debtor" to refer to the debtor in bankruptcy, the debtor in possession, or the trustee managing the debtor's estate.

estate from creditors from nearly all types of collection action. *Id.* § 362(a). The purpose of the stay is to prevent a race to the courthouse by a single creditor and allow, instead, an equitable distribution of assets. The automatic stay also halts collection action to allow the debtor to come up with a repayment plan. The filing of the bankruptcy petition also triggers the creation of the bankruptcy estate. *Id.* § 541(a). Except for certain enumerated exemptions, the estate consists of all of the debtor's interests in property at the time of filing, both legal and equitable, including real property and personal property (e.g., cars, cash, government-issued licenses and permits, business goodwill, etc.). *See id.*

## C. TYPES OF BANKRUPTCY

The Bankruptcy Code, which governs the rights of debtors, creditors and other interested parties, is divided into several chapters. Chapters 1, 3, and 5 are general provisions of the Bankruptcy Code that govern all bankruptcy proceedings, while the remaining chapters govern specific types of bankruptcy proceedings. Bankruptcy cases typically fall into one of two categories: liquidation (where creditors are paid the proceeds that result from a sale of a debtor's nonexempt property) or reorganization (where the debtor restructures its liabilities and forms a plan to repay creditors, in whole or in part, over time).[34]

### *(1) Liquidation (Chapter 7)*

Chapter 7, available to individuals, partnerships, and corporations, provides for liquidation of a debtor's nonexempt assets as of the petition date as the means of satisfying creditors' claims. *Id.* § 109(b). The debtor's future income is not considered as a means of satisfying creditors' claims. *See id.* § 726. A trustee is appointed from a panel administered by the United States Trustee[35] to control and liquidate the debtor's nonexempt property and to distribute the proceeds of any liquidation to the creditors. *Id.* § 701-704. Regardless of whether a debtor's nonexempt property generates sufficient proceeds to satisfy all claims, individual debtors will receive a discharge at the conclusion of the case. *Id.* § 727. Non-individual debtors will cease to exist. *See id.* § 726.

### *(2) Reorganization (Chapters 11, 12 and 13)*

#### a) Chapter 11

Chapter 11 cases can be used by individual debtors, but they are far more commonly used by business debtors. *See id.* § 109(d) (describing what types of persons can be chapter 11 debtors). Chapter 11 allows a debtor to restructure its indebtedness. A chapter 11 filing

[34] Chapters 9 and 15 are not discussed in this *Treatise*. A chapter 9 bankruptcy, which allows financially-distressed municipalities to negotiate with creditors to adjust its debts, is the exclusive remedy available to municipalities under the Bankruptcy Code. *Id*. § 109(c). A chapter 15 bankruptcy, also known as an ancillary or cross-border proceeding, facilitates coordination among courts and estate representatives in different countries in order to enhance efficiency and avoid inconsistent outcomes. *Id.* §§ 1525-1532.

[35] In Alabama and North Carolina, the duties of the United States Trustee are performed by Bankruptcy Administrators.

provides the debtor with significant flexibility to repay some or all of its debts, allowing for repayment out of future income or through the sale of assets. During a chapter 11 case, the debtor generally stays in control of its estate, assuming a fiduciary role as a "debtor in possession." *See id.* §§ 1101, 1107.

In chapter 11 cases, the debtor typically negotiates with its significant creditors and stakeholders regarding the reorganization of its debts through a plan of reorganization. *See id.* § 1126. If a negotiated resolution fails, however, a plan of reorganization may still be confirmed by the court if it meets the statutory requirements. *Id*. § 1129. Generally, for business debtors, confirmation of a plan discharges all pre-confirmation debts not paid in the plan. *Id.* § 1141(d)(1). For individuals, debts are generally discharged after all payments required by the plan have been paid. *Id.* § 1141(d)(5).

b) Chapter 12

Chapter 12 cases are available exclusively to family farmers and family fishermen, which may include individuals, corporations, and partnerships. *Id.* § 109(f), 101(18)-(19B). A trustee is appointed in each chapter 12 case, but the trustee generally does not control the debtor's farm or fishing operation. *See id.* § 1202-1203. Chapter 12 allows the farmer or fisherman to restructure its debts, while retaining both ownership and use of its business. *Id.* § 1203. To be eligible for a chapter 12 filing, the farmer or fisherman must have debt within limits prescribed by the Bankruptcy Code and which are periodically revisited, as well as regular annual income out of which payments towards the reorganization plan may be made. *Id.* § 109(f). Once a debtor completes the payments required under the plan and certain other requirements, the debtor receives a discharge. *Id.* § 1228.

c) Chapter 13

Chapter 13 cases can be used by individual debtors with regular income that can be contributed to a plan to adjust his or her debts, and have debt within limits prescribed by the Bankruptcy Code which are periodically revisited. *Id.* § 109(e). A standing chapter 13 trustee (sometimes more than one) is appointed in each district to serve as the representative of the chapter 13 estates, but does not seize control of the debtor's assets. *Id.* § 1302-1303. Instead, the debtor makes payments into his or her plan which is administered by the trustee who then makes distribution payments to the creditors. Once a debtor completes the payments required under the plan and certain other requirements, he or she receives a discharge. *Id.* § 1328.

## II. SOVEREIGN IMMUNITY

The United States is immune from suit except when it consents to be sued. *E.g., Fed. Deposit Ins. Corp. v. Meyer*, 510 U.S. 471, 475 (1994); *United States v. Sherwood*, 312 U.S. 584, 586-87 (1941). The terms of the Government's consent to suit define a court's jurisdiction over a case. *Id*. The Bankruptcy Code provides a limited waiver of sovereign immunity. 11 U.S.C. § 106.

Section 106 of the Bankruptcy Code is a forum waiver, which means that the waiver applies to the forum for raising claims and does not waive sovereign immunity for causes of action for which the United States would have been immune in a non-bankruptcy context. *Id.* § 106(a)(5) (nothing in section 106 "shall create any substantive claim for relief or cause of action not otherwise existing under this title, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law").

By filing a proof of claim,[36] for example, the Government waives sovereign immunity "with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose." *Id.* § 106(b). In other words, debtors may assert compulsory counterclaims up to or exceeding the value of the government's claim. *See id.* Waiver of sovereign immunity by one federal agency could theoretically subject other federal agencies to the jurisdiction of the bankruptcy court. Agencies, therefore, should coordinate with each other when appropriate.

Section 106(c) of the Bankruptcy Code also permits a debtor to setoff (sometimes referred to as "offset") the agency's claim against the debtor by the debtor's claim against the agency. *Id.* § 106(c). In other words, section 106(c) of the Bankruptcy Code allows the debtor to assert permissive counterclaims up to the value of the agency's claim. *See id.*

## III. PROOF OF CLAIM

### A. CLAIM

A claim is a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured" and includes the "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." *Id.* § 101(5).

### B. CONTENTS OF A PROOF OF CLAIM

A proof of claim[37] is "a written statement setting forth a creditor's claim" against the debtor. Fed. R. Bankr. P. 3001(a); *see also* 11 U.S.C. §§ 501-02. Determining whether to file a proof of claim depends on a variety of factors. For example, the agency must weigh the minimal expense of filing a proof of claim and monitoring the bankruptcy case with the likelihood of collection. *See* 31 CFR § 903.3. Filing a proof of claim for a $5,000 debt may be worthwhile if the debtor has substantial assets. *See id.* Claims are not filed in no-asset cases.[38] In addition and as

[36] For more information on proof of claims, see section III (Proof of Claim), below.
[37] *See* Proof of Claim Form (Form B-10), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_Official_2010/B_010_0410.pdf.
[38] When a creditor received notice of the bankruptcy filing, the notice will indicate whether the bankruptcy is considered an asset or no-asset case.

discussed above, by filing a proof of claim, agencies may be waiving sovereign immunity and subjecting themselves to the jurisdiction of the bankruptcy court. 11 U.S.C. § 106(b).

A proof of claim and must "conform substantially" to Form B-10. Fed. R. Bankr. P. 3001(a), 9009. The proof of claim should include the creditor's name, the debtor's name, the case number, the amount of the claim, the basis for the claim, and whether some or all of the claim has priority or is secured. Form B-10. Creditors should state the entire amount of the debt as of the petition date, including accrued interest, penalties, and costs. 11 U.S.C. § 502. A creditor may file a proof of claim, even if the exact amount of the claim is not known. *Id.* §§ 101(5), 502(c). The deadline for agencies to file their proofs of claim is generally 180 days after the petition date. Fed. R. Bankr. P. 3002(c)(1). Copies of any evidentiary documents relevant to the agency's claim should be filed with the proof of claim. *Id*. 3001(c)-(d). If the claim is for a mortgage debt, information about the mortgage must be filed. A proof of claim should never be signed by anyone who does not have personal knowledge of the facts. Agencies should exercise caution before disclosing this supporting documentation, however, if there is an indication that such disclosure would harm the United States or the interests of another party.

To avoid the inadvertent waiver of any creditor rights when filing a proof of claim, agencies should include language, such as:

> This claim reflects the known liability of the debtor to this agency of the United States. The United States reserves the right to amend this claim to assert subsequently discovered liabilities. This agency holds subject to setoff against this claim a debt owed to the debtor of _____________ (amount). The identification of any sums held subject to setoff is without prejudice to any other right under 11 U.S.C. § 553 to set off against this claim debts owed by this or any other federal agency.

*See* U.S. Dep't of Justice, *United States Attorneys' Manual*, Title IV, Civil Resource Manual, Pt. 62 (1998) [hereinafter USAM CRM-62]. This language can help ensure that the government does not forgo its right of setoff. Failure to include this language, however, will not necessarily constitute a waiver of the right of setoff.

## C. PROOF OF CLAIM GENERALLY REQUIRED TO RECEIVE DISTRIBUTION

Federal agencies generally must file a proof of claim to participate in a distribution of the debtor's estate, even if the debtor has properly listed the agency's claim in its schedules. *E.g.*, 11 U.S.C. §§ 501, 502, 726(a). Filing a proof of claim is not required in a no-asset chapter 7 case, in which there will be no distribution to the creditors. Likewise, it is not necessary to file a proof of claim in a chapter 11 case, if the debtor has correctly listed the agency's claim in its schedules and no interested party has objected to the scheduled amount. *See id.* § 1111(a).[39]

[39] However, failure to file a proof of claim may preclude the creditor from voting on a proposed plan of reorganization. *See In re Woodward*, 2013 Bankr. LEXIS 4553 (Bankr. D. Neb. Oct. 31, 2013). Generally, federal agencies do not vote on plans with the exception of the Secretary of the Treasury or through DOJ. *See* 11 U.S.C. § 1126(a).

However, it is generally advisable to file claims in asset cases. Agencies owed secured debts also do not need to file a claim to participate in a distribution but, to the extent their debt is undersecured, or may be undersecured, filing a proof of claim is necessary for the full amount of their claim to be recognized. 11 U.S.C. § 506(d)(2). Even when filing a proof of claim is not strictly necessary to receive a distribution, filing a proof of claim can better protect an agency's interests.

## D. GOVERNMENT PROCEDURES FOR FILING A PROOF OF CLAIM

Agencies should file their own proofs of claim. The proof of claim should be signed by someone with personal knowledge of the debt and the amount due. There are some circumstances, however, when the proof of claim may be filed by the DOJ, rather than the agency. For example, where the debt has already been referred to DOJ for collection purposes, the agency should coordinate with DOJ prior to filing a proof of claim. Similarly, an agency should consult with DOJ prior to filing a proof of claim if the agency believes that coordination with other agencies is needed to protect the interests of the United States. Claims referred to DOJ should be accompanied by a Claims Collection Litigation Report. 31 CFR § 904.2; *see also* USAM CRM-62.

# IV. AUTOMATIC STAY

## A. INTRODUCTION

With few exceptions, the automatic stay, which bars nearly all actions against a debtor, takes effect immediately upon the commencement of the bankruptcy case. 11 U.S.C. § 362(a).[40] The automatic stay functions to provide the debtor with the breathing room necessary to organize its affairs in a manner that maintains the status quo as to the relationship between the debtor, creditors, and other parties-in-interest.

Collection actions taken in violation of the stay are void or voidable, even if the violation was unintentional, and an agency that takes such actions may be subject to sanctions.[41] As such, agencies should carefully consider what actions to collect their debt are appropriate during the pendency of the stay, as any collection activity that takes place after they stay is instituted could be considered a violation of the stay. 11 U.S.C. § 362(a). The automatic stay applies to the collection of both dischargeable and non-dischargeable debts. *See id*. Administrative collection procedures such as offset, sending demand letters, and administrative wage garnishment, must

[40] The Bankruptcy Code provides for an exception to the automatic application of the stay when a debtor is a serial filer, such as when a debtor files a second repeat filing within a one-year period. *See id.* § 362(c)(3).
[41] *See id.* § 362; *Majestic Star Casino, LLC v. Barden Dev., Inc. (In re Majestic Star Casino, LLC)*, 716 F.3d 736, 750 (3d Cir. 2013); *Schwartz v. United States (In re Schwartz),* 954 F.2d 569, 574-75 (9th Cir. 1992); *Ellis v. Consolidated Diesel Elec. Corp.,* 894 F.2d 371, 372-73 (10th Cir. 1990); *In re Smith*, 876 F.2d 524, 525-26 (6th Cir. 1989); *In re 48th St. Steakhouse*, 835 F2d 427, 431 (2d Cir. 1987); *Borg-Warner Acceptance Corp. v. Hall*, 685 F.2d 1306, 1308 (11th Cir. 1982).

cease upon a debtor's filing for bankruptcy. *See id.* For willful violations of the automatic stay, agencies may be liable for actual damages, including costs and attorneys' fees.[42]

## B. AUTOMATIC STAY APPLIES REGARDLESS OF CREDITOR NOTICE

A debtor has a duty to file schedules with the court that list the debtor's assets and liabilities. *Id.* § 521(a)(1). The Bankruptcy Code requires that all creditors and certain other parties receive notice of the bankruptcy proceedings. Fed. R. Bankr. P. 2002. Additionally, debtors who are or may be liable to the agency must notify both the agency and DOJ upon the filing of a bankruptcy petition. *Id.* 2002(j). Nevertheless, the stay applies regardless of whether the agency has actual or constructive notice of the bankruptcy. *E.g., In re Calder*, 907 F.2d 953, 956 (10th Cir. 1990); *In re Smith*, 876 F.2d at 526.

## C. THE AUTOMATIC STAY AS IT APPLIES TO SPECIFIC COLLECTION ACTIONS

### *(1) Demand Letters and Collection Calls*

While the automatic stay does not bar non-coercive, non-harassing communication between the debtor and creditor, it generally does bar creditors from requesting payment from the debtor. *See* 11 U.S.C. § 362(a)(6). Prior to contacting a debtor, agencies should consider whether the communication might violate (or might be perceived as violating) the automatic stay, erring on the side of caution by assuming that any communication may be deemed to be a violation of the stay. Moreover, if a debtor is represented by counsel, an agency should determine whether future communications should be directed to the debtor's counsel, rather than to the debtor.

### *(2) Garnishment Orders*

Unless a creditor has obtained relief from the stay, it should not issue any garnishment orders after the petition date, as doing so could constitute a violation of the automatic stay. *Id.* § 362(a)(6). Moreover, because the Bankruptcy Code generally prohibits "any act to create, perfect, or enforce any lien against property of the estate," an agency should suspend its efforts to collect under a garnishment order, even if it had perfected its interest prior to the petition date. *Id.* § 362(a)(4). The agency, however, should consider whether it may be entitled to relief from the stay.

### *(3) Furnishing Information to Credit Bureaus*

Agencies are generally required to submit information about delinquent debts to credit bureaus. 31 U.S.C. § 3711(e); OMB Circ. A-129, Sec. IV.B.4. Agencies are also

[42] *Id.* § 362(k); *see also id*. § 105. The Bankruptcy Code does not provide for a waiver of sovereign immunity for punitive damages. *See id*. § 106. While the Bankruptcy Code allows for actual damages for only "willful" violations of the automatic stay, all violations are problematic and some courts apply a very low bar for determining what constitutes a "willful" violation.

encouraged to submit information about current debts to credit bureaus as well. OMB Circ. A-129, Sec. IV.B.4; *see also* 31 U.S.C. § 3711 (e)(5). Once a debtor files for bankruptcy, however, an agency must determine whether continued reporting is appropriate. By reporting only accurate information and handling similarly-situated debtors similarly (and not using the report as a method of coercing payment), agencies are unlikely to run afoul of the automatic stay when reporting debts to credit bureaus.[43]

*(4) Accrual of Interest, Penalties, and Administrative Costs*

Postpetition interest, penalties, and costs generally cannot be charged against the bankruptcy estate.[44] While the postpetition assessment of interest, penalties, and costs, may violate the stay, the mere accrual of these charges generally is permissible.[45] To the extent the accrual of such charges is a mere bookkeeping entry, rather than an action against the debtor, accrual of these charges will not violate the bankruptcy stay. *See id.* As such, for accounting purposes, agencies should generally continue to accrue applicable charges. Doing so will protect the agency in the event that the debtor's bankruptcy case is dismissed or if its debt is not discharged. It also allows the agency to pursue co-debtors who did not file for bankruptcy protection for the entire amount of the debt, including interest, penalties, and costs. *See id.*

*(5) Setoff*

While setoff rights are preserved in bankruptcy, creditors generally cannot exercise those setoff rights without first obtaining relief from the stay (or waiting until the conclusion of the bankruptcy case).[46] Accordingly, creditors generally may "freeze" or temporarily withhold funds without violating the automatic stay, provided that the creditor then timely seeks relief from the stay. *See Strumpf*, 516 U.S. at 18-19. In these circumstances, an agency should request the United States Attorney in the District where the case was filed to seek relief from the stay.

While the automatic stay may delay a creditor's right of setoff, it generally will not delay the creditor's right of recoupment. Unlike setoff, recoupment is only available where the mutual debts arise out of the same transaction or occurrence. This distinction between setoff and

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[43] *See, e.g., Mortimer v. Bank of America*, No. 12-01959, 2013 U.S. Dist. LEXIS 51877, *25 (N.D. Cal. April 10, 2013); *Mortimer v. JP Morgan Chase Bank, N.A.*, No. 12-1936, 2012 U.S. Dist. LEXIS 108576, *9 (N.D. Cal. Aug. 2, 2012); *In re Burkey*, No. 09-12371, 2012 Bankr. LEXIS 5516, *13-14 (Bankr. N.D.N.Y. Nov. 28, 2012); *Singley v. Am. Gen. Fin. (In re Singley)*, 233 B.R. 170, 173 (Bankr. S.D. Ga. 1999); *but see In re Sommersdorf*, 139 B.R. 700, 701-02 (Bankr. S.D. Ohio 1992).

[44] *See generally* 11 U.S.C. § 726. However, the bankruptcy estate can be charged postpetition interest (and possibly costs and penalties) when the estate is solvent and on debts which are oversecured. *See id.* §§ 506(b), 726(a)(5).

[45] *See id.* § 362(a); *compare id.* § 101(5) (defining claim) *with id.* 101(12) (defining debt); *see also Bruning v. United States*, 376 U.S. 358, 360 (1964); *Salazar v. Comm'r*, 338 Fed. Appx. 75, 78 (2d Cir. 2009); *United States v. Monahan (In re Monahan)*, 497 B.R. 642, 649 (B.A.P. 1st Cir. 2013); *Jung Bea Han v. Ge Capital Small Bus. Fin. Corp.(In re Jung Bea Han)*, 333 B.R. 881, 890 (Bankr. N.D. Fla. 2005); *In re Moore*, 307 B.R. 394, 396 n.3 (Bankr. S.D.N.Y. 2004); *Kerney v. Capital One Fin. Corp. (In re Sims)*, 278 B.R. 457, 470-72 (Bankr. E.D. Tenn. 2002).

[46] 11 U.S.C. §§ 362(a)(7), 553; *Citizens Bank v. Strumpf*, 516 U.S. 16, 18-19 (1995).

recoupment is important for the purposes of determining whether the proposed action will violate the automatic stay. In general, "a debtor may not assume the favorable aspects of a contract (postpetition payments) and reject the unfavorable aspects of the same contract (the obligation to repay prepetition overpayments by means of recoupment)." *Kosadnar v. Metropolitan Life Ins. Co. (In re Kosadnar)*, 157 F.3d 1011, 1016 (5th Cir. 1998) (citation and quotation omitted); *see also In re B&L Oil Co.*, 782 F.2d 155, 159 (10th Cir. 1986).

## D. EFFECT OF STAY ON PARTIES WHO HAVE NOT FILED FOR BANKRUPTCY PROTECTION

### *(1) Effect of Stay on Co-Debtors*

In chapter 12 and 13 cases, but not in chapter or 7 or 11 cases, the automatic stay prohibits collection actions against certain individuals who are liable with the debtor in bankruptcy on a debt, but have not filed for bankruptcy protection themselves. Specifically, the co-debtor stay protects individuals who are liable on a consumer debt[47] with the debtor in bankruptcy, when that debtor has filed for bankruptcy protection under chapter 12 or 13. *See* 11 U.S.C. §§ 1201 and 1301. If a creditor wants to collect against such an individual, the creditor must request relief from the co-debtor stay prior to initiating collection action.

The co-debtor stay, however, offers only temporary relief. The co-debtor's liability for the debt cannot be discharged, unless the co-debtor files for bankruptcy itself. Once the bankruptcy case is closed, dismissed, or converted to a chapter 7, the co-debtor stay is lifted, and the creditor may pursue collection against the co-debtor, even if the debtor that filed for bankruptcy protection received a general discharge.

### *(2) Effect of Stay on Spouses*

Because spouses are not automatically liable for each other's debts, there may be circumstances where one spouse may choose to file for bankruptcy while the other spouse does not. To the extent the spouses are liable together on certain debts, the spouse that did not file for bankruptcy may be entitled to the protection of the co-debtor stay, discussed above.

In addition, agencies should exercise caution prior to collecting from a debtor if that debtor's spouse has filed for bankruptcy. In community property states, for example, some courts have found that some or all of the property of the spouse who did not file for bankruptcy is included in the bankruptcy estate, and that collection against property of the estate would violate the automatic stay, even if the collection related to a debt owed only by the spouse who did not file for bankruptcy.[48]

[47] The term "consumer debt" is defined as a "debt incurred by an individual primarily for a personal, family, or household purpose." 11 U.S.C. § 101(8).
[48] *See, e.g.*, *In re Thongta*, 401 B.R. 363, 367-68 (Bankr. E.D. Wis. 2009); *In re Passmore,* 156 B.R. 595, 599 (Bankr. E.D. Wis. 1993).

## E. THE AUTOMATIC STAY: EXCEPTIONS, RELIEF, AND TERMINATION

*(1) Action Excepted from the Stay*

The Bankruptcy Code excepts certain actions from the limits imposed by the automatic stay. 11 U.S.C. § 362(b). Exceptions from the stay include, among others, audits and demands for tax returns and collection of domestic support obligations from property that is not property of the estate. *Id*. Government agencies generally are permitted to pursue administrative or judicial action against debtors pursuant to statutes or agency regulations, so long as there is a public policy purpose separate from recovering the debt owed. *Id*. § 362(b)(4). Prior to commencing or continuing such an action, the agency should consult its own counsel or consult with DOJ. The automatic stay does not apply to criminal enforcement.

*(2) Relief from the Stay to Take Action Against the Debtor*

A creditor may seek relief from the stay to affect a setoff, exercise its rights to collateral, or take certain other actions. *Id*. §§ 105, 362(d). To obtain relief from the stay, the creditor must show cause for relief, as well as a colorable claim against property of the estate. *Id.* § 362(d). Courts are also empowered to grant retroactive relief from the stay. *See id.* Generally, creditors will obtain relief from the stay only when they have a secured claim or when they have setoff rights under 11 U.S.C. § 553.

*(3) Termination of the Stay*

The stay will usually terminate when the case is closed, dismissed, or when a discharge is granted or denied. *Id*. § 362(c)(2). The court may also modify or terminate the stay upon the request of a party in interest upon a showing of cause. *Id.* § 362(d)-(g).

# V. DISCRIMINATION

Creditors are generally barred from refusing service to the debtor when the refusal serves as a means of inducing the debtor to pay his debts. *Id*. § 525. Federal agencies should consult legal counsel prior to denying a person any right, benefit, or payment as a result of a bankruptcy filing.

# VI. AVOIDANCE ACTIONS

## A. INTRODUCTION

Any entity in possession of property of the estate is generally required to turn over that property to the trustee. *Id*. § 542(a). Debtors, for example, are generally required to turn over nonexempt property to the trustee. *See id*. The trustee has the power to recover property of the estate not in its possession, including the power to avoid, or set aside, certain transactions or transfers of property. *See, e.g., id.* §§ 544-549. A trustee can avoid certain actions taken during the bankruptcy proceeding and can also avoid certain actions taken prior to the bankruptcy filing. For example, the trustee can generally avoid actions taken in violation of the automatic stay,[49] preferential transfers taken place prior to the initiation of the bankruptcy proceeding,[50] fraudulent transfers,[51] or certain other transactions.[52]

## B. AVOIDING GARNISHMENTS

The trustee may attempt to recover amounts garnished from wages, bank accounts, or other property. Whether the trustee can "avoid" the garnishment depends on a variety of factors, including when the garnishment order was issued and when the garnishments were taken in relation to the petition date, and the underlying non-bankruptcy law permitting the garnishment.

### *(1) Postpetition Garnishments*

If a creditor garnished any amounts in violation of the automatic stay, the trustee generally would be able to avoid those collections. *Id.* §§ 362, 549. In fact, the creditor generally would have an affirmative duty to return these garnished funds, once notified of the bankruptcy. *See, e.g., Sternberg v. Johnston*, 595 F.3d 937, 945 (9th Cir. 2009); *Johnson v. Smith (In re Johnson)*, 501 F.3d 1163, 1172 (10th Cir. 2007); *Sucre v. MIC Leasing Corp. (In re Sucre)*, 226 B.R. 340, 348 (Bankr. S.D.N.Y. 1998). Agencies should consult with their counsel and/or with DOJ prior to returning amounts collected pursuant to a garnishment order.

### *(2) Prepetition Garnishments*

If a garnishment order was issued during the ninety days preceding bankruptcy, then the trustee will generally be able to recover any amounts pursuant to that order. *See* 11 U.S.C. § 547. Whether a trustee must return garnishments paid during the preference period will depend on the specific facts and the non-bankruptcy law under which the garnishment order was issued.

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[49] *Id.* § 549.

[50] During the ninety days preceding bankruptcy (or, in the case of insiders, one year), transactions that put the creditor in a better position vis-à-vis other creditors may be avoidable. *See id.* § 547. Specifically, the trustee may avoid any transfer of property of the debtor that enables to creditor to receive more than it would have in a chapter 7 liquidation, if the transfer is made:

- to or for the benefit of a creditor for or on account of an antecedent debt
- while the debtor was insolvent; and
- within ninety days prior to the petition date (or, if the transferee creditor is an insider, within one year prior to the filing).

*Id.*

[51] The fraudulent transfer power protects creditors from transactions which are designed, or have the effect, of unfairly draining the pool of assets available to satisfy creditors' claims. *See id.* § 548. If a transfer is made with actual or constructive fraud, the debtor or trustee will generally be able to avoid such transfers. *See id.* § 548.

[52] *See, e.g., id.* §§ 544(b), 522(f), 553.

One of the determining factors will be when the "transfer" occurred. *See id*. § 547(e)(2). To the extent that the lien was perfected prior to the preference period <u>and</u> where the debtor had already obtained an interest in the property, garnishments taken pursuant to that lien cannot be considered preferential transfers because, at the time the funds were actually garnished, the debtor no longer had a right to such funds.[53]

In general, this means that wages garnished during the preference period can be avoided, even if the garnishment order was issued prior to the preference period, while the garnishment of non-wage assets requires a more detailed analysis of the specific facts and relevant state law. Agencies should consult with their counsel and/or with DOJ prior to returning amounts collected during the preference period.

## <u>C. AVOIDING PREPETITION SETOFFS</u>

In some circumstances, a debtor may be able to avoid a setoff during the preference period. Generally, however, federal agencies will be able to retain amounts collected through offset during the "preference period." A prepetition setoff is generally not avoidable as a preferential transfer under 11 U.S.C. § 547.[54]

Section 553(b) of the Bankruptcy Code limits a creditor's setoff rights if the creditor improved its position relative to other creditors within the ninety days immediately preceding the petition date. To determine whether there has been an improvement in position, courts determine what the creditor's "insufficiency"[55] was at the time of setoff. To the extent that the "insufficiency" decreased from ninety days prior to the petition date to the date of the setoff, an impermissible preference exists, and the trustee can avoid the transaction(s).[56]

# VII. THE RIGHT OF SETOFF

## <u>A. BANKRUPTCY CODE PRESERVES SETOFF RIGHTS</u>

The Bankruptcy Code preserves a creditor's right to setoff. Section 553(a) of the Bankruptcy Code provides:

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[53] *See id*. §§ 547(e)(1)(B), (e)(3); *see also Barnhill v. Johnson*, 503 U.S. 393, 400-02 (1992); *Morehead v. State Farm Mut. Auto. Ins. Co. (In re Morehead)*, 249 F.3d 445, 449 (6th Cir. 2001); *Freedom Group v. Lapham-Hickey Steel Corp. (In re Freedom Group)*, 50 F.3d 408, 412 (7th Cir. 1995); *Battery One-Stop v. Atari Corp. (In re Battery One-Stop)*, 36 F.3d 493, 495-99 (6th Cir. 1994).

[54] *See* 11 U.S.C. §§ 547, 553; *see also In re Dillard Ford, Inc.*, 940 F.2d 1507, 1513 (11th Cir. 1991); *Lee v. Schweiker*, 739 F.2d 870, 876-77 (3d Cir. 1984).

[55] To determine the insufficiency, a court will look at the amount by which the creditor's claim against the debtor exceeded the debtor's claim against the creditor at the time of setoff compared with at ninety days prior to the petition date (or if there was no insufficiency at ninety days prepetition, then the date on which there was an insufficiency).

[56] *See* 11 U.S.C. §§ 547, 553.

> Except as otherwise provided in this section and sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .

*Id.* § 553(a). By preserving the right of setoff, the Bankruptcy Code avoids the "absurdity of making A pay B when B owed A." *Strumpf*, 516 U.S. at 18 (quoting *Studley v. Boylston National Bank*, 229 U.S. 523, 528 (1913)).

Setoff requires mutuality in that the indebtedness must be between the same parties. 11 U.S.C. § 553(a). For bankruptcy purposes, this generally requires that both debts (i.e., the debt owed ***by*** the debtor and the debt owed ***to*** the debtor) fall on the same side of the bankruptcy line (i.e., on the same side of the timeline marked by the filing of the petition). *See id.* That is, with some exceptions, both debts must be prepetition or both debts must be postpetition. *See id.*

Creditors with prepetition setoff rights have a secured claim under section 506(a)(1) of the Bankruptcy Code.[57] Agencies with setoff rights should take appropriate steps to protect their interests.

## B. TYPES OF SETOFF (OFFSET)

### *(1) Offset Of Federal Tax Overpayments*

Federal agencies are authorized to intercept certain federal payments to collect delinquent debt owed to the United States. *See* 31 U.S.C. § 3716; 26 U.S.C. § 6402(d); 31 U.S.C. §§ 3720A. This includes the authority to offset tax overpayments for debts owed to the United States. 26 U.S.C. § 6402(a), (d); 31 U.S.C. § 3720A. This applies only to tax refunds for years before the debtor filed for bankruptcy protection. Offsets for postpetition years are not allowed, unless the debtor owes postpetition debts to the United States. Some courts have noted an apparent conflict between section 553 of the Bankruptcy Code, which preserves a creditor's setoff rights, and section 522 of the Bankruptcy Code, which describes property that may be exempted from property of the estate. 11 U.S.C. §§ 522, 553. Cases addressing this apparent conflict have generally arisen in the context of tax refund offset. The position that most courts have now adopted indicates that no such conflict exists.

#### a) The Majority Position

A tax overpayment is any payment made by a taxpayer that is over and above tax liability.[58] A tax refund, on the other hand, is an amount that the Internal Revenue

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[57] *Id*. § 506(a)(1) ("[a]n allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff").

[58] *See, e.g., United States v. Gould (In re Gould)*, 401 B.R. 415, 426-27 (B.A.P. 9th Cir. 2009); *In re Luongo*, 259 F.3d at 335; *USDA Rural Hous. Serv. v. Riley (In re Riley)*, 485 B.R. 361, 365 (W.D. Ky. 2012); *Beaucage v. United*

Service (IRS) is obligated to pay the taxpayer after the IRS has exercised its statutory right to offset.[59] Therefore, the tax overpayment does not necessarily create a debt due to the taxpayer, since the taxpayer has no right to payment until after the IRS has reduced the tax overpayment by outstanding federal tax debt, federal nontax debt, child support debt, state income tax debt, and unemployment compensation debt. 26 U.S.C. § 6402.

In the bankruptcy context, the United States retains this statutory right to reduce a tax overpayment for these types of debts. *See* 11 U.S.C. § 553. The United States retains this right even when a debtor attempts to exempt tax payments under section 522 of the Bankruptcy Code from property of the estate, because a debtor may only exempt property of the estate. *Id.* § 552(b); *see also id.* § 541. Only the portion of the tax overpayment remaining after IRS deducts the amounts under 26 U.S.C. § 6402 constitutes the tax refund payment, which becomes property of the estate.[60] Thus, a debtor's attempt to exempt its tax refund will not affect the United States' right of statutory offset under 26 U.S.C. § 6402.[61] If an agency anticipates that a debtor in bankruptcy will receiving a tax payment, it should contact the IRS to request that payment be withheld until it is able to request and obtain relief from the stay to conduct the offset.

b) The Minority Position

Some courts have disagreed with the majority position and found that there is a conflict between sections 522 and 553 of the Bankruptcy Code. These courts, nevertheless, have generally found that any attempt by the debtor to exempt the tax refund would not affect the rights of the United States to setoff.[62] Most of these courts recognize that even if

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*States*, 342 B.R. 408, 411 (D. Mass. 2006); *Newberry v. United States (In re Newberry)*, 2013 Bankr. LEXIS 622, *14-15 (Bankr. S.D. Ill. 2013); *In re Scales*, 477 B.R. 679, 684 (Bankr. N.D. Ohio 2012); *In re Abbott*, 2012 Bankr. LEXIS 3009, *5-6 (Bankr. E.D.N.C. 2012); *Gordon v. United States (In re Sissine)*, 432 B.R. 870, 881-82, 887 (Bankr. N.D. Ga. 2010); *Jones v. IRS (In re Jones)*, 359 B.R. 837, 840-41 (Bankr. M.D. Ga. 2006); *In re Baucom*, 339 B.R. 504, 506-07 (Bankr. W.D. Mo. 2006); *In re Pigott*, 330 B.R. 797, 802 (Bankr. S.D. Ala. 2005); *In re Shortt*, 277 B.R. 683, 687-88 (Bankr. N.D. Tex. 2002); *see also Wiegand v. Tahquamenon Area Credit Union (In re Wiegand)*, 199 B.R. 639, 641-642 (W.D. Mich. 1996).

[59] 26 U.S.C. § 6402(a). Section 6402 of the Internal Revenue Code governs when a taxpayers' overpayment may be paid to the taxpayer. It provides in relevant part:

> (a) In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d), (e), and (f), refund any balance to such person.

26 U.S.C. § 6402(a).

[60] *See supra* fn. 58.

[61] *See supra* fn. 58.

[62] *See Junio v. Astoria Fed. Savs.*, 2002 U.S. Dist. LEXIS 25735, *24 (E.D.N.Y. Feb. 25, 2002); *Posey v. U.S. Dep't of the Treasury - IRS*, 156 B.R. 910, 916-917 (W.D.N.Y. 1993); *In re Allen*, 266 B.R. 713, 716 (Bankr. N.D. Iowa 2001); *In re Bourne*, 262 B.R. at 754-758; *In re Kadrmas, No. 00-31338*, 2000 Bankr. LEXIS 1764, at *7-16 (Bankr. W.D. Wis. Sept. 19, 2000).

there is a conflict between sections 522 (exemptions) and 553 (setoff) of the Bankruptcy Code, the rights of the United States to setoff would prevail over a debtor's attempted exemption.[63]

*(2) Other Types of Offset*

For a creditor to have setoff rights under 11 U.S.C. § 553, both the obligation of the creditor to the debtor and the debtor's obligation to the creditor must arise prior to the petition date. While the most common example of when both obligations would arise prepetition in the federal debt collection context is when the debtor has made overpayments of federal tax in the year preceding its bankruptcy filing, there are other circumstances where an obligation of the United States may arise prior to the petition date. For example, certain portions of a federal salary payment may have accrued to the debtor prior to the petition date, and to the extent the debtor owed the United States a federal debt prior to the petition date, the United States would have setoff rights with regard to those portions of the federal salary payment. The same would be true for retirement payments, vendor payments, and tort payments, to the extent the right to those payments arose prior to the petition date. To the extent a creditor agency is aware of a federal payment to which the debtor is entitled, the agency should analyze whether its setoff rights have been preserved by section 553 of the Bankruptcy Code.

Therefore, if any agency is aware of a payment to which the United States may have setoff rights, it should contact the paying agency to determine whether that payment should be withheld until the agency owed money is able to request relief from the stay. DOJ generally must file a motion for relief from the stay, and have the court grant the motion, before a setoff is made.

## VIII. DISCHARGE

### A. SCOPE OF DISCHARGE

*(1) Discharge of Personal Liability*

A debtor's goal in bankruptcy is usually to receive a discharge at the end of the bankruptcy proceeding. *See* 11 U.S.C. § 524(a). With some important exceptions, bankruptcy generally discharges the personal liability of the debtor with regard to all of the debtor's debts. In a chapter 7 case, generally all debts owed by the debtor on the petition date (and some debts incurred during the pendency of the bankruptcy proceeding) will be discharged. *Id.* § 727(b). In a chapter 11 case, generally all debts owed at the time of plan confirmation will be discharged. *Id.* § 1141(d)(1). In chapter 12 and 13 cases, generally all debts provided for by the plan are discharged. *Id.* §§ 1228(c); 1328(c).

A discharge, however, does not discharge the debt itself. *Id.* § 524(e). Rather, it eliminates the personal liability of the debtor on the debt. *Id.*; *Johnson v. Home State Bank*, 501 U.S.

[63] *See id.; but see In re Jones*, 230 BR 875, 880-81 (M.D. Ala. 1999).

78, 82-83 (1991). As such, the discharge of the debtor in bankruptcy will not affect the rights of secured creditors with regard to their collateral.[64] Similarly, a discharge will not affect the setoff rights of creditors.[65] However, if an agency discovers that it has collateral or setoff rights after the conclusion of a bankruptcy proceeding, the agency should, as a precautionary measure, consider requesting that the court grant it relief from the discharge injunction prior to exercising those rights.

*(2) Non-Dischargeable Debts*

While a debtor's debts generally will be discharged in bankruptcy, there are some important exceptions for individual debtors. Generally, only debts listed in the debtor's schedules will be discharged. 11 U.S.C. § 523(a)(3). Creditors should be cautious, however, in relying on this exception, because courts may allow debtors to amend their schedules, even after a case has been closed. *See id.* § 350(b).

Other non-dischargeable debts include certain debts for a tax or customs duty, domestic support obligations, certain fines and penalties imposed by a governmental unit, and debts resulting from educational benefit or overpayment. *Id.* §§ 523(a)(1), (5), (7), (8). They also include debts resulting from willful and malicious injury by the debtor to another person. *Id.* § 523(a)(6). Debts obtained as a result of false pretenses, a false representation, or actual fraud, as well as certain consumer debts related to the purchase of luxury items during the preference period, are also generally non-dischargeable. *Id.* §§ 523(a)(2), (4). Criminal fines and restitution are non-dischargeable. *Id.* §§ 523(a)(7), (13); 1328(a)(3). Certain debts to bank regulators of for security fraud are also non-dischargeable. *Id.* §§ 523(a)(11), (12), (19).

*(3) Discharging Otherwise Non-Dischargeable Debts*

While the debts described above are generally non-dischargeable, it is possible for a debtor to overcome this default rule in certain circumstances. In chapter 13 cases, for example, several of the debts described in 11 U.S.C. § 523(a) may be discharged. *Id.* § 1328(a)(2). So, in a chapter 13 case, the debtor may be able to discharge more debt that would have been permissible in a chapter 7 case. *See id.* Student loan debts can be discharged if the debtor can demonstrate that excepting the debt from discharge would cause undue hardship for the debtor or the debtor's dependents. *Id.* § 523(a)(8).

[64] *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992).
[65] *See* 11 U.S.C. § 553; *see also Strumpf*, 516 U.S. at 20; *IRS v. Luongo (In re Luongo)*, 259 F.3d 323, 333 (5th Cir. 2001); *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269, 1276-1278 (9th Cir. 1992); *In re Davidovich*, 901 F.2d 1533, 1539 (10th Cir. 1990); *In re Kadrmas*, 2000 Bankr. LEXIS 1764 (Bankr. W.D. Wis. 2000); *In re Conti*, 50 B.R. 142, 149 (Bankr. E.D. Va. 1985).

*(4) Effect of Discharge on Co-Debtors*

A debtor's discharge discharges the personal liability of the debtor in bankruptcy, but does not discharge the personal liability of co-debtors who are not in bankruptcy. *See id*. 524(e). To the extent that a co-debtor who is not in bankruptcy is married to the debtor in bankruptcy, however, the discharge may protect community property, thereby providing the spouse a "phantom discharge."[66] Agencies, therefore, should exercise caution before continuing to pursue collection against the co-debtor spouse of a debtor in bankruptcy.

## B. TIMING OF DISCHARGE

The timing of the discharge depends on the type of bankruptcy proceeding. *E.g., id.* §§ 727 (a chapter 7 individual debtor can generally obtain a discharge after the debtor has sold all non-exempt assets and distributed the proceeds to creditors),[67] 1141(d) (a chapter 11 debtor can generally obtain a discharge at the time the debtor's reorganization plan is confirmed by the court), 1228(a) (a chapter 12 debtor can generally obtain a discharge after the debtor has successfully completed all payments in accordance with the court-approved repayment plan), 1328 (a chapter 13 debtor can generally obtain a discharge after the debtor has successfully completed all payments in accordance with the court-approved repayment plan).

## C. DENIAL OF DISCHARGE

If the court finds that the debtor abused the bankruptcy process, the debtor may be denied a discharge.[68] There are strict deadlines on the filing of an action to deny a discharge or hold a debt non-dischargeable for fraud. The court may also dismiss a bankruptcy case, effectively denying the debtor a discharge, if the debtor is found to have abused the bankruptcy process. *E.g.*, *id.* §§ 707, 1112, 1208, 1307.

In certain circumstances, the court may revoke a discharge previously granted, if the discharge was obtained by fraud. *E.g.*, *id.* §§727(e), 1144, 1228(d), 1328(e). There are a variety of other circumstances in which a debtor may be denied a discharge.

With some exceptions, a debtor may also be denied a discharge if the debtor was a debtor in a prior bankruptcy proceeding within a certain number of years before the current filing. For

[66] *See id*. § 524(a)(3); *see also Rooz v. Kimmel (In re Kimmel)*, 378 B.R. 630 (9th Circ. BAP 2007); *In re Thongta*, 2009 Bankr. LEXIS 1428, *7-8 (Bankr. E.D. Wis. June 5, 2009); *In re Moore*, 318 B.R. 679, 681-82 (Bankr. W. D. Wis. 2004); *First La. Bus. & Indus. Dev. Corp. v. Dyson (In re Dyson)*, 277 B.R. 84, 90 (Bankr. M.D. La. 2002); *Gonzales v. Costanza*, 151 B.R. 588, 589-90 (Bankr. D. N.M. 1993).

[67] Debts owed by entity debtors in chapter 7 proceedings are not technically discharged because, at the conclusion of the bankruptcy proceeding, such debtors cease to exist.

[68] *See, e.g.*, 11 U.S.C. §§ 727 (listing specific reasons for why the court can deny a discharge in a chapter 7 case), 1129(a)(3) (requiring a chapter 11 plan to be made in good faith), 1141 (confirmation of the plan operates as a discharge), 1225(a)(3) (requiring a chapter 12 plan to be made in good faith), 1228 (a discharge in a chapter 12 case can be granted only after the court approves a plan), 1325(a)(3) (requiring a chapter 13 plan to be made in good faith), 1328 (a discharge in a chapter 13 case can be granted only after the court approves a plan).

example, a chapter 7 debtor will not receive a discharge if the debtor received a discharge under a chapter 11 proceeding within eight years of the current filing date, or under a chapter 12 or 13 proceeding within six years of the current filing date. *Id.* §§ 727(a)(8)-(9). Similarly, a chapter 13 debtor will not receive a discharge if the debtor had received a discharge under a chapter 7, 11, or 12 proceeding within four years of the current filing date, or under a chapter 13 proceeding within two years of the current filing date. *Id.* § 1328(f). Failure to complete a personal financial management course can also result in the denial of a discharge. *E.g., id.* §§ 727(a)(11), 1328(g).

## D. DISCHARGE INJUNCTION

The discharge of a debtor "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived." *Id.* § 524(a)(2). It generally bars creditors from taking collection action against the debtor with regard to any discharged debt.

Continued reporting of a discharged debt probably violates the discharge injunction, because it is inaccurate to report a debt for which the debtor is no longer liable.[69] However, accurately reporting after a discharge that the debtor was delinquent during the pendency of the bankruptcy case would generally not be impermissible.[70]

Offset may be appropriate to collect against a discharged debt if the debt owed by the agency to the debtor predated the date on which the debtor filed for bankruptcy. Agencies should consult with their counsel prior to taking any action to collect a debt which may have been discharged in bankruptcy.

# IX. CONCLUSION

Protecting an agency's rights in the realm of bankruptcy is an important part of the federal debt collection process. This chapter has provided a broad overview of how bankruptcy can affect a federal agency's rights. However, because bankruptcy is a complex area of the law, agencies should consult their bankruptcy counsel or DOJ when appropriate.

While, in some circumstances, an agency may determine that it is appropriate to terminate its debt collection efforts once a debtor files for bankruptcy, there may be other circumstances where the agency should actively protect its rights. Agencies should be aware of whether their

[69] *See id*. § 524; *see also Mortimer v. Bank of America*, 2013 U.S. Dist. LEXIS 51877, *27-33; *Mahoney v Wash. Mut., Inc. (In re Mahoney)*, 368 B.R. 579, 584-86 (Bankr. W.D. Tex. 2007); *Lohmeyer v. Alvin's Jewelers (In re Lohmeyer)*, 365 B.R. 746, 751 (Bankr. N.D. Ohio 2007); *Norman v. Applied Card Sys. (In re Norman)*, Adv. Pro. 01-1133, 2006 Bankr. Lexis 2576, at *4 (Bankr. M.D. Ala. 2006).

[70] *See Mortimer v. Bank of America*, 2013 U.S. Dist. LEXIS 51877, *27-33; *In re Mahoney*, 368 B.R. 579, 584-86; *In re Norman*, 2006 Bankr. Lexis 2576, at *4. If the creditor choses to report the discharged debt in this manner, the creditor should also report that the debt was discharged and that the balance on the account is zero to ensure that it is presenting a complete and accurate picture.

debts are afforded priority over other debts if there is any distribution of assets. Likewise, agencies should also be aware of whether their debts are generally non-dischargeable. Agencies should consider filing proofs of claim, or whether to work with DOJ to request relief from the automatic stay, request "adequate protection" for any secured interests, object to and/or vote on a debtor's proposed plan of reorganization, or object to a debtor's discharge. Agencies should also monitor the case to ensure that they participate in distributions of property or so that they can resume normal collection action if the case is dismissed.

In addition to protecting their rights, agencies must also ensure that they do not unlawfully interfere with the debtor's rights – agencies must not violate the automatic stay and, absent a defense, must return property taken during the preference period. They must also discontinue collection action on discharged debts.

# E. ENTITIES OUT OF BUSINESS

## I. INTRODUCTION

When an entity goes out of business, it must pay its creditors before distributing its assets to its owners. Entities created under state law can "dissolve" through state law dissolution proceedings or under Title 11 of the United States Code (i.e., the Bankruptcy Code). While applicable law differs from state-to-state, this section provides a very broad overview of how these state-created entities can dissolve through state law dissolution proceedings, wind-down their business, and liquidate. Practitioners should be aware of state law when pursuing entities that are out of business.

## II. THE PROCESS

State law generally governs the process for the dissolution of a state-created entity. Generally, the owners of the entity can choose to dissolve the entity, and may do so by filing the appropriate paperwork with the state (e.g., a certificate of dissolution). The principals or owners of the entity are generally required to notify all creditors and claimants of their intent to dissolve the entity so as to permit the creditors an opportunity to notify the entity of any unpaid debts. Thereafter, the entity may proceed to wind up its affairs, collect and sell its assets, pay its liabilities, and distribute any remaining assets (if any) to the owner(s) of the entity.

## III. DETERMINE WHETHER CONTINUED COLLECTION IS WARRANTED

If an agency is owed a debt after the debtor-entity dissolved, the agency should determine whether continued collection is warranted. Agencies should consider the costs of collection, the size of the debt, and whether there are any enforcement principles at issue.

Separate entities are not typically responsible for one another's debts. However, there are several exceptions to this general rule. Agencies should consider whether any of the owners or principals guaranteed the debt and whether the entity is a limited liability entity.

Agencies should also consider whether the principals and owners properly dissolved the entity under applicable law. For example, if the assets of the entity were distributed to any non-federal creditor, the agency should determine whether to pursue the entity's representative for the amount of the distribution. *See supra* Section B. Likewise, agencies should determine whether there are any theories for "piercing the corporate veil" in the event that separate entities behaved as a single entity.[71] In such circumstances, such entities may be liable for one another's debts.

[71] In determining whether to pierce the corporate veil, courts consider several factors, including: the absence of corporate formalities, commingling of assets, siphoning of corporate funds by a dominate stockholder, and the fact the entity is a façade for personal operations of a dominate stockholder.

# F. INTEREST, PENALTIES, AND COSTS

[forthcoming]