

SEP 24 2007

ORDERED PUBLISHED

HAROLD S. MARENUS, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

6	In re:)	BAP No.	WW-06-1279-DRS
7	WADE COOK FINANCIAL)	Bk. No.	02-25434-TTG
8	CORPORATION; THE STOCK MARKET)	Adv. No.	06-01133-TTG
9	INSTITUTE OF LEARNING, INC.;)		
10	INFORMATION QUEST, INC.;)		
	LIGHTHOUSE BOOKS, INC., fka)		
	LIGHTHOUSE PUBLISHING GROUP,)		
	INC.,)		
)		
	Debtors.)		
)		
	UNITED STATES OF AMERICA,)		
)		
	Appellant,)		
)		
	v.)	O P I N I O N	
)		
	DIANA K. CAREY, Chapter 11)		
	Trustee,)		
)		
	Appellee.)		
)		

Argued by Telephone Conference
and Submitted on March 23, 2007

Filed - September 24, 2007

Appeal from the United States Bankruptcy Court
for the Western District of Washington

Hon. Thomas T. Glover, Bankruptcy Judge, Presiding.

Before: DUNN, RADCLIFFE¹ and SMITH, Bankruptcy Judges.

¹ Hon. Albert E. Radcliffe, Bankruptcy Judge for the
District of Oregon, sitting by designation.

1 DUNN, Bankruptcy Judge:

2
3 The appellant, the United States, on behalf of its agency,
4 the Internal Revenue Service ("IRS"), appeals several orders
5 entered by the bankruptcy court in connection with a summary
6 judgment motion by the appellee, Diana K. Carey, the chapter 11
7 trustee (the "trustee").²

8 This appeal arises out of a dispute between the IRS and the
9 trustee as to whether the IRS may assert its right to set off
10 certain prepetition tax liabilities of the debtors, Wade Cook
11 Financial Corporation ("WCFC") and Stock Market Institute of
12 Learning, Inc. ("SMIL"), against an approximate \$2 million refund
13 due to WCFC, based on the carryback of net operating losses
14 incurred in the 2002 tax year to the 1997 and 1998 tax years.

15 For the reasons set forth below, we REVERSE the bankruptcy
16 court's grant of summary judgment for the trustee and REMAND for
17 further proceedings on the issue of mutuality pursuant to § 553
18 and the issue of recoupment and AFFIRM the bankruptcy court's
19 denial of summary judgment for the IRS.

20
21 **I. FACTS**

22 WCFC was a holding company with several subsidiaries. One

23
24 ² Unless otherwise indicated, all chapter, section and rule
25 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and
26 to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as
27 enacted and promulgated prior to October 17, 2005, the effective
28 date of most of the provisions of the Bankruptcy Abuse Prevention
and Consumer Protection Act of 2005, Pub. L. 109-8, April 20,
2005, 119 Stat. 23 ("BAPCPA"), as the debtors' case was filed in
advance of the BAPCPA effective date.

1 of its subsidiaries, SMIL, provided seminars, teaching various
2 financial techniques and investment strategies, and produced and
3 sold related books, tapes, and other products. Both WCFC and
4 SMIL conducted business at the same physical location in Seattle,
5 Washington.³

6 On December 19, 2002, an involuntary chapter 7 bankruptcy
7 petition was filed against each of WCFC and SMIL (collectively,
8 "the debtors").⁴ On December 20, 2002, upon an ex parte motion
9 of one of the petitioning creditors, the bankruptcy court entered
10 an order consolidating the two cases for the purposes of joint
11 administration.⁵

12 On January 17, 2003, the bankruptcy court entered an order
13 converting the case from chapter 7 to chapter 11. Less than a
14 week later, the trustee was appointed.

15 On February 1, 2003, the trustee filed a corporate tax
16 return, reflecting losses totaling \$8,289,519, on behalf of WCFC
17 for the 2002 tax year, which ended on December 31, 2002. Four
18 days later, the trustee filed an application for a tax refund
19 arising from the carryback and deduction of the net operating
20 loss incurred by WCFC in the 2002 tax year from its 1997 and 1998
21
22

23
24 ³ The trustee later terminated the operations of both WCFC
25 and SMIL.

26 ⁴ WCFC was assigned case no. 02-25434, and SMIL was assigned
27 case no. 02-25433.

28 ⁵ As a result, the WCFC bankruptcy case became the lead
case.

1 income (the "refund").⁶

2 On April 7, 2003, the trustee filed a motion to
3 substantively consolidate SMIL, WCFC, Information Quest, Inc.
4 ("IQ"), and Lighthouse Books, Inc. ("LB"), two non-debtor
5 subsidiaries of WCFC ("Substantive Consolidation Motion"). After
6 a hearing on the matter, the bankruptcy court entered an order on
7 April 28, 2003, substantively consolidating WCFC, SMIL, IQ and
8 LB, effective nunc pro tunc to December 19, 2002 ("Substantive
9 Consolidation Order").

10 Approximately two years after the trustee applied for the
11 refund, the trustee and the IRS entered negotiations regarding
12 the trustee's claim for the refund and any resulting tax
13 consequences for WCFC and SMIL. They agreed that WCFC was
14 overassessed in the amount of \$1,994,232 for the 1997 tax year,
15 but was subject to an additional assessment of \$142,944 in income
16 tax for its 1998 tax year, resulting in a net overassessment of
17 \$1,851,288. The trustee and the IRS also agreed that SMIL was
18 subject to an additional assessment of \$992,481 in income tax for
19 its 1997 tax year. They executed a separate agreement each for
20 WCFC and SMIL, memorializing these determinations ("WCFC Offer to
21 Waive" and "SMIL Offer to Waive," respectively). SMIL also was
22 liable to the IRS for prepetition employment-related taxes from
23 as far back as the 1995 tax year.⁷

24
25 ⁶ According to the trustee, applying the 2002 net operating
26 loss carryback with respect to the 1997 and 1998 taxes paid
27 resulted in an overpayment of \$2,817,861.

28 ⁷ On October 20, 2005, the IRS filed an amended proof of
(continued...)

1 On September 12, 2005, the trustee made a written request to
2 the IRS to tender the refund. On January 10, 2006, the IRS
3 responded that it was entitled to retain the refund and apply the
4 same against the prepetition taxes owed by both WCFC and SMIL.

5 On February 24, 2006, the trustee filed a complaint against
6 the IRS, demanding turnover of the refund. The IRS filed its
7 answer, asserting that it "may freeze the Overpayment and setoff
8 the Overpayment against the prepetition debts owed by the
9 consolidated debtors to the IRS."

10 The trustee later filed a motion for summary judgment,
11 contending that the IRS must turn over the refund because it
12 failed to establish a right of setoff pursuant to § 553(a)
13 ("Summary Judgment Motion").⁸

14 The IRS filed its response and cross-motion for summary
15 judgment ("Cross-Motion"). As in its answer to the complaint,
16

17
18 ⁷(...continued)
19 claim, asserting that SMIL owed approximately \$1.6 million in
20 prepetition employment-related taxes from 1995 through 2002 and
21 related interest and penalties. The trustee conceded, in her
22 response brief, that SMIL indeed owed over \$1 million in
prepetition employment-related taxes, though, in her complaint,
she objected to a part of the IRS's claim which asserted that
\$926,972 of the total amount was secured by a right of setoff.

23 ⁸ 11 U.S.C. § 553(a) provides, in relevant part:

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

1 the IRS argued that mutuality existed, in part, because of the
2 substantive consolidation of the bankruptcy cases, which
3 indicated that SMIL was the alter ego of WCFC. The IRS also
4 advanced in the Cross-Motion, for the first time, recoupment as
5 an affirmative defense in support of its right to effectuate
6 setoff.

7 On June 2, 2006, the bankruptcy court held a hearing on the
8 Summary Judgment Motion and the Cross-Motion (collectively, the
9 "Summary Judgment Motions"). At the hearing, the bankruptcy
10 court made its findings orally on the record, determining that
11 the IRS could not establish a right of setoff because it failed
12 to meet the requirements set out under § 553(a).

13 The bankruptcy court based its determination on two
14 findings. First, the bankruptcy court found that the IRS's
15 obligation to remit the refund arose postpetition, not
16 prepetition. Second, the bankruptcy court found that no
17 mutuality existed as to the claims and debts and as to the
18 parties. Specifically, the bankruptcy court determined that
19 substantive consolidation did not create mutuality because the
20 purpose of the substantive consolidation was merely to merge the
21 assets of the two bankruptcy estates for the purposes of
22 distributions among creditors with claims against either debtor,
23 not to characterize the debtors as one legal entity. Thus, the
24 bankruptcy court concluded that no mutuality existed as to the
25 parties because WCFC and SMIL were not the same legal entity
26 prepetition, and no mutuality existed as to the claims and debts
27 among WCFC, SMIL, and the IRS, because the IRS owed the refund to
28

1 WCFC, not SMIL.⁹ The bankruptcy court did not rule specifically
2 on the issue of recoupment.¹⁰

3 On June 12, 2006, the bankruptcy court entered an order,
4 granting summary judgment in favor of the trustee and denying the
5 Cross-Motion ("Summary Judgment Order").¹¹ The Summary Judgment
6 Order fully adjudicated the entire adversary proceeding and
7 constituted a final and appealable order.

8 Soon thereafter, the IRS filed a motion to alter or amend
9 the Summary Judgment Order ("Motion to Alter"), arguing that
10 there were new facts necessitating a reconsideration of the
11 bankruptcy court's findings as to the issue of mutuality.
12 Specifically, the IRS pointed out several facts regarding the
13 business operations of WCFC and SMIL, arguably demonstrating that
14 the debtors were alter egos prior to the petition date. In

15
16 ⁹ Though it is unclear from the transcript of the June 2,
17 2006 hearing, it appears that the bankruptcy court may have made
18 an additional determination as to mutuality between the parties -
19 that the obligation to remit the refund arose postpetition and
20 was made in behalf of the bankruptcy estate, a different entity
21 from WCFC and SMIL, prepetition.

22 ¹⁰ At the June 2, 2006 hearing, counsel for the trustee
23 stated, on the record, that the trustee opposed consideration of
24 recoupment. In response, the bankruptcy court simply stated,
25 "All right. With respect to these matters [i.e., mutuality],
26 first of all, I've got all the motions in front of me this
27 morning, even though some were noted, just because of the time
28 rules, for later dates." Tr. of June 2, 2006 Hr'g at 15:20-23.
It is thus unclear whether the bankruptcy court was making any
determination as to the issue of recoupment.

¹¹ The trustee, in her Summary Judgment Motion, contended
that the IRS violated the automatic stay and requested damages,
sanctions, and attorneys' fees and costs against the IRS. The
bankruptcy court denied her request.

1 support of the Motion to Alter, the IRS submitted numerous
2 documents, forming thirteen exhibits labeled Exhibits A through
3 M. On June 19, 2006, the trustee filed a motion to strike
4 Exhibits B through M ("Motion to Strike Exhibits"), arguing that
5 the IRS was improperly offering evidence it should have offered
6 in conjunction with its Cross-Motion.

7 On July 21, 2006, the bankruptcy court held a hearing on the
8 Motion to Alter and the Motion to Strike Exhibits. Following the
9 hearing, the bankruptcy court entered separate orders granting
10 the Motion to Strike Exhibits ("Motion to Strike Order") and
11 denying the Motion to Alter ("Motion to Alter Order").

12 The IRS timely appealed the Summary Judgment Order, the
13 Motion to Alter Order, and the Motion to Strike Order.

14 15 **II. JURISDICTION**

16 The bankruptcy court had jurisdiction pursuant to 28 U.S.C.
17 §§ 1334 and 157(b)(2). We have jurisdiction over this appeal
18 pursuant to 28 U.S.C. § 158.

19 20 **III. ISSUE**

21 Whether the bankruptcy court erred in granting the Summary
22 Judgment Motion and denying the Cross-Motion based on its finding
23 that the IRS failed to establish its right of setoff under
24 § 553(a).

25 26 **IV. STANDARDS FOR REVIEW**

27 We review summary judgment orders de novo. Tobin v. San
28 Souci Ltd. P'ship (In re Tobin), 258 B.R. 199, 202 (9th Cir. BAP

1 2001). Viewing the evidence in the light most favorable to the
2 non-moving party, we must determine “whether there are any
3 genuine issues of material fact and whether the trial court
4 correctly applied relevant substantive law.” Id.

5 When reviewing an order granting summary judgment, we may
6 neither weigh the evidence nor determine the truth of the matter,
7 but only determine whether there is a genuine issue for trial.
8 Abdul-Jabbar v. Gen. Motors Corp., 85 F.3d 407, 410 (9th Cir.
9 1996). We may affirm an order granting summary judgment on any
10 ground supported by the record. Simo v. Union of Needletrades,
11 Indus. & Textile Employees, 322 F.3d 602, 610 (9th Cir. 2003).

12 Summary judgment may be appropriate when a mixed question of
13 law and fact involves undisputed underlying facts. Citicorp Real
14 Estate, Inc. v. Smith, 155 F.3d 1097, 1103 (9th Cir. 1998).

15 “[W]here the underlying facts are undisputed, a [bankruptcy]
16 court is free, on a motion for summary judgment, to determine
17 whether the established facts satisfy the statutory standard.”
18 Miller v. Schuman (In re Schuman), 81 B.R. 583, 586 n.1 (9th Cir.
19 BAP 1987). Summary judgment is improper, however, if material
20 factual issues exist for trial. Simo, 322 F.3d at 610.

21 A bankruptcy court has discretion in disallowing a setoff.
22 Camelback Hospital, Inc. v. Buckenmaier (In re Buckenmaier), 127
23 B.R. 233, 236 (9th Cir. BAP 1991). We review the bankruptcy
24 court’s disallowance of a setoff for an abuse of discretion. Id.
25 A bankruptcy court abuses its discretion if it bases its ruling
26 on an erroneous view of the law. United States v. Offord
27 Finance, Inc. (In re Medina), 205 B.R. 216, 220 (9th Cir. BAP
28 1996). Absent such abuse, we will not set aside the

1 disallowance. Buckenmaier, 127 B.R. at 236.

2 We review the bankruptcy court's denial of a motion for
3 reconsideration for an abuse of discretion. First Ave. West
4 Bldg., LLC v. James (In re OneCast Media, Inc.), 439 F.3d 558,
5 561 (9th Cir. 2006). A bankruptcy court "abuses its discretion
6 in denying a motion to reconsider if the underlying decision
7 'involved a clear error of law.'" Id. (quoting McDowell v.
8 Calderon, 197 F.3d 1253, 1255 (9th Cir. 1999) (en banc)).

9 We review a bankruptcy court's grant of a motion to strike
10 for abuse of discretion. Golden Gate Hotel Ass'n v. City &
11 County of San Francisco, 18 F.3d 1482, 1485 (9th Cir. 1994). A
12 bankruptcy court abuses its discretion when its judicial actions
13 are "'arbitrary, fanciful or unreasonable' or 'where no
14 reasonable man [or woman] would take the view adopted by the
15 trial court.'" Id. (quoting Delno v. Market St. Ry. Co., 124
16 F.2d 965, 967 (9th Cir. 1942)).

17 18 **V. DISCUSSION**

19 A. The Bankruptcy Court's Ruling on the Summary Judgment 20 Motions

21 In granting summary judgment to the trustee, the bankruptcy
22 court concluded that no genuine issues of material fact existed
23 with respect to mutuality, even though the IRS raised the
24 question as to whether substantive consolidation was indicative
25 that WCFC and SMIL operated as a single functional entity. The
26 bankruptcy court also concluded that the IRS's obligation to
27 remit the refund was a purely postpetition obligation.

28 On appeal, the IRS argues that the bankruptcy court erred in

1 granting the Summary Judgment Motion and denying the Cross-
2 Motion. The IRS contends that the bankruptcy court made
3 incorrect rulings as to the issues of mutuality and the timing of
4 the IRS's obligation to remit the refund (i.e., whether such
5 obligation arose with respect to prepetition or postpetition tax
6 liabilities and credits). The IRS asserts that, contrary to the
7 bankruptcy court's ruling, it is entitled to setoff the refund
8 against the prepetition tax liabilities of WCFC and SMIL.

9 The IRS advances three main arguments. First, the IRS need
10 not follow the requirements of § 553 to effectuate a setoff
11 because § 106 and 26 U.S.C. § 6402 allow the IRS to override
12 these requirements to enforce its setoff.¹² Second, the IRS
13 establishes its right of setoff under § 553 because it meets all
14 of the statutory requirements. Third, the IRS is entitled to
15 setoff pursuant to the doctrine of recoupment. We address each
16 of these arguments in turn.

17
18 1. Section 553(a) controls in determining whether the IRS
19 may assert its right of setoff.

20 As a preliminary matter, we must decide the question as to
21 which rule of law prevails in determining the setoff rights of
22 the IRS. The IRS argues that § 106 and the provisions of IRC
23 § 6402 enable it to override the requirements set out under § 553
24 and to effectuate setoff of the refund against the prepetition
25

26 ¹² The IRS cites to various sections of the Internal Revenue
27 Code, 26 U.S.C. § 1 et al. Hereafter, we refer to the Internal
28 Revenue Code as "IRC," to distinguish it from the Bankruptcy
Code.

1 tax liabilities of both WCFC and SMIL.¹³

2
3 ¹³ 26 U.S.C. § 6402(a) provides:

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

11 Section 106 provides, in relevant part:

12 (a) Notwithstanding an assertion of sovereign immunity,
13 sovereign immunity is abrogated as to a governmental
14 unit to the extent set forth in this section with
15 respect to the following:

16 (1) Sections 105, 106 . . . [and] 553 . . . of this
17 title.

18 (2) The court may hear and determine any issue arising
19 with respect to the application of such sections
20 to governmental units.

21 (3) The court may issue against a government unit an
22 order, process, or judgment under such sections or
23 the Federal Rules of Bankruptcy Procedure,
24 including an order or judgment awarding a money
25 recovery, but not including an award of punitive
26 damages. Such order or judgment for costs or fees
27 under this title or the Federal Rules of
28 Bankruptcy Procedure against any governmental unit
shall be consistent with the provisions and
limitations of section 2412(d)(2)(A) of title 28.

(4) The enforcement of any such order, process, or
judgment against any governmental unit shall be
consistent with appropriate nonbankruptcy law
applicable to such governmental unit and, in the
case of a money judgment against the United
States, shall be paid as if it is a judgment
rendered by a district court of the United States.

. . .

(continued...)

1 The IRS asserts that a court may allow the setoff of a debt
2 that crosses the petition date as long as the requisites of
3 common law setoff are met.¹⁴ The IRS does not need to meet the
4

5 ¹³(...continued)

6 (c) Notwithstanding any assertion of sovereign immunity by
7 a governmental unit, there shall be offset against a
8 claim or interest of a governmental unit any claim
9 against such governmental unit that is property of the
10 estate.

11 ¹⁴ The IRS cites to United States v. Gordon Sel-Way, Inc.
12 (In re Gordon Sel-Way, Inc.), 239 B.R. 741 (E.D. Mich. 1999),
13 aff'd, 270 F.3d 280 (6th Cir. 2001), in support of this
14 proposition. In Gordon Sel-Way, the debtor, which filed for
15 chapter 11 relief in 1988, failed to pay federal employment-
16 related taxes from 1987 through 1990. This failure to pay
17 resulted in an unsecured claim for the IRS. The debtor grouped
18 the IRS's unsecured claim with the claims of other unsecured
19 creditors in its confirmed plan, which provided for a 20%
20 distribution to unsecured creditors. All of the creditors in the
21 class, except the IRS, received a distribution. Later, the
22 debtor discovered that it had a claim for a refund, based on
23 overpayments which it made postpetition for unemployment taxes
24 for the 1987 and 1989 tax years. Relying on In re Seal, 192 B.R.
25 442 (Bankr. W.D. Mich. 1996), which allowed for the setoff of
26 postpetition debts in a case involving analogous facts, the
27 district court determined that, although the IRS's unsecured
28 claim arose at least in part prepetition, it became a
postpetition debt when the debtor grouped the claim with the
claims of other unsecured creditors in the plan, and that
classification survived plan confirmation. Gordon Sel-Way, 239
B.R. at 751. The district court further interpreted § 553 to
address only prepetition debts; it did not abrogate the right of
a party to offset mutual postpetition debts. Id. at 750-51
("Section 553 merely addresses prepetition debts and is silent as
to offset for mutual postpetition debts. Nothing about the
Bankruptcy Code abrogates the common law right to setoff; thus,
bankruptcy courts have recognized the right to setoff for
postpetition debts."). The court found that the debts were
mutual. Based on its determination as to the mutuality of the
(continued...)

1 requirement of mutuality specified in the common law, however, if
2 an applicable statute defines the level of mutuality required.
3 The IRS contends that IRC § 6402 is such a statute, supplanting
4 the mutuality standard under the common law and substituting an
5 alternate standard. According to the IRS, IRC § 6402 limits
6 mutuality to who made the overpayment, not when the debts and
7 claims arose. In other words, the determinative factor for
8 mutuality under IRC § 6402 is not whether the debts and claims
9 arose prepetition, but whether the same parties are involved.¹⁵
10 Under the IRC § 6402 definition of mutuality, the IRS may set off
11 its debt (i.e., its obligation to remit the refund) against the
12 prepetition tax liabilities of WCFC because, even though the net
13 operating loss was recognized postpetition, WCFC, the prepetition
14 debtor, made the overpayment.

15 The IRS provides no authority to support this proposition.
16 Although the IRS has a right of setoff under IRC § 6402, the fact
17 that the IRS holds this right does not mean that IRC § 6402
18 supplants § 553 in determining whether this right is recognized
19 and preserved in bankruptcy. Contrary to the IRS's assertion,
20 IRC § 6402 merely grants a right of setoff to the IRS. See Aetna
21 Cas. & Sur. Co. v. LTV Steel Co. (In re Chateaugay Corp.), 94
22

23 ¹⁴ (...continued)
24 debts and its reading of § 553, the district court concluded that
25 the IRS could set off its claim against the refund.

26 ¹⁵ Section 553 conditions mutuality on whether the
27 countervailing debts are "'in the same right and between the same
28 parties, standing in the same capacity.'" Newbery Corp. v.
Fireman's Fund Ins. Co., 95 F.3d 1392, 1399 (9th Cir. 1996)
(quoting 4 COLLIER ON BANKRUPTCY ¶ 553.04[2] (15th ed. 1995)).

1 F.3d 772, 781 (2d Cir. 1996) (“We are convinced that, just as 26
2 U.S.C. § 6402(d) . . . gives federal agencies other than the IRS
3 a right of setoff against tax overpayments, so [IRC] § 6402(a)
4 grants that right to the IRS itself.”); Campbell v. United States
5 (In re Davis), 889 F.2d 658, 661 (5th Cir. 1989) (stating that
6 the IRS’s right of setoff is derived from IRC § 6402, which
7 provides that, generally, a party has a right to a tax refund of
8 the amount exceeding any outstanding tax liabilities); Stewart v.
9 Army & Air Force Exch. Serv. (In re Stewart), 253 B.R. 51, 53
10 (Bankr. E.D. Ark. 2000) (stating that the IRS’s right to setoff
11 exists pursuant to IRC § 6402(a)); Jones v. United States (In re
12 Jones), 212 B.R. 680, 682 n.12 (Bankr. M.D. Ala. 1997) (stating
13 that IRC § 6402 creates the right of setoff, and § 553 preserves
14 this right).¹⁶

15 Section 553 is the primary statute that governs whether a
16 right of setoff is recognized and preserved in bankruptcy.
17 AmerisourceBergen Corp. v. Dialysist West, Inc., 465 F.3d 946,
18 956 n.12 (9th Cir. 2006) (stating that § 553 governs the
19 equitable right of setoff in bankruptcy, but does not create a
20 right of setoff); Newbery, 95 F.3d at 1398 (stating that § 553
21 governs setoff in bankruptcy cases and that § 553 is not an
22 independent source of setoff law, but a legislative attempt to
23 preserve nonbankruptcy setoff rights) (citing United States v.
24 Arkison (In re Cascade Roads, Inc.), 34 F.3d 756, 763 (9th Cir.
25 1994)); Biggs v. Stovin (In re Luz Int’l, Ltd.), 219 B.R. 837,

26
27 ¹⁶ In In re Chateaugay, the appellate court points out and
28 cites to a number of courts that do not consider IRC § 6402 as a
codification of the common law rule of setoff. 94 F.3d at 781.

1 843 (9th Cir. BAP 1998); In re Medina, 205 B.R. at 220-21;
2 Beaucage v. United States (In re Beaucage), 334 B.R. 353, 356
3 (Bankr. D. Mass. 2005) (where the IRS recognized that its right
4 of setoff under IRC § 6402 is subject to the mutuality
5 requirement of § 553(a)); In re Jones, 212 B.R. at 682 n.12.

6 Though IRC § 6402 creates a right of setoff for the IRS, it
7 does not except the IRS from meeting the requirements of § 553.

8 There is nothing in the Bankruptcy Code that grants the IRS
9 a special status above and beyond other creditors whose rights of
10 setoff are subject to the requirements of § 553. See Chateaugay,
11 94 F.3d at 781 (finding that, although a federal treasury statute
12 granted priority to IRS setoffs over other government agencies'
13 setoffs, it does not circumvent the requirements of § 553, which
14 requires a creditor, in order to have its right to setoff
15 preserved in bankruptcy, to show that the setoff involves a
16 prepetition mutual debt).¹⁷ Cf. United States v. Whiting Pools,

17
18 ¹⁷ In its reply brief, the IRS maintains that Chateaugay
19 supports its assertion that IRC § 6402 supplants § 553, allowing
20 the IRS to set off postpetition debts against prepetition claims.
21 Specifically, the IRS quotes to this language in Chateaugay to
22 support this proposition: "[I]f LTV Steel's excise tax
23 liabilities were pre-petition claims, the IRS's claim would take
24 precedence over the claims of the DOL, and hence over Aetna's
25 claims. But it cannot serve to defeat Aetna's pre-petition
26 claims if LTV Steel's tax liabilities arose post-petition." 94
27 F.3d at 781.

28 In Chateaugay, the debtor was entitled to receive a refund
for overpayment on certain taxes. The debtor was liable for
postpetition excise taxes to the IRS, but was also liable to the
Department of Labor ("DOL") and its subrogee, Aetna, for black
lung disability benefits payments they made prepetition. The IRS
argued that it could exercise its right to setoff its claim

(continued...)

1 Inc., 462 U.S. 198, 209 (1983) (Although the IRS had a right to
2 levy on the debtor-in-possession's property pursuant to IRC
3 § 6331, the statute did not transfer ownership of the property to
4 the IRS; thus, the IRS, though a governmental unit, was still
5 subject to § 542(a) to the same extent as any other secured
6 creditor, obligating it to turn over the property, as "[n]othing
7 in the Bankruptcy Code or its legislative history indicates that
8 Congress intended a special exception for the tax collector in
9 the form of an exclusion from the estate of property seized to
10 satisfy a tax lien."); United States v. Fuller (In re Fuller),
11 134 B.R. 945, 948 (9th Cir. BAP 1992) (finding that the IRS is
12 not entitled to be excepted from the automatic stay violation
13 provisions of § 362, in a case where the IRS tried to attach a
14 prepetition tax lien, pursuant to IRC § 6321, against funds
15 inherited by the debtor 120 days after the petition date) (citing
16 Whiting Pools, 462 U.S. at 209).

17 Even in conjunction with other statutes, IRC § 6402 does not

18
19 ¹⁷(...continued)
20 against the refund before the DOL and Aetna could do so.
21 The IRS misreads Chateaugay. In Chateaugay, the appellate
22 court only acknowledged that a treasury regulation generally
23 entitled the IRS to priority to offset its claim against any
24 overpayment before any other government agency, so long as the
25 tax liabilities on which its claim was based arose prepetition.
26 However, the appellate court went on to state that this
27 regulation would not allow the IRS to execute its right of setoff
28 before that of the DOL and Aetna, as the IRS's claim was based on
postpetition tax liabilities. Thus, Chateaugay does not stand
for the proposition the IRS advances.

The IRS refers us to portions of the record in Chateaugay,
which the trustee provided to us as "Supplemental Authorities."
We find that these additional materials are not relevant and do
not impact our reading of Chateaugay.

1 override § 553. The IRS asserts that IRC §§ 6402(a) and 6411(b)
2 together mandate that no right to refund exists until the IRS
3 credits the overpayment against the taxpayer's unpaid tax
4 liabilities. The IRS implies that these two statutes grant it
5 the right to effectuate setoff against the debtors. Again, there
6 is nothing in the Bankruptcy Code that grants the IRS special
7 status, excusing it from meeting the requirements of § 553.

8 Nor does § 106 allow the IRS to circumvent the requirements
9 of § 553, as the IRS contends.

10 According to the IRS, under § 106(a)(4), read in conjunction
11 with IRC § 7422 and 28 U.S.C. § 1346(a)(1), the IRS may apply an
12 overpayment to another tax liability owed by a taxpayer pursuant
13 to IRC § 6402 before remitting a refund to the taxpayer.¹⁸ The
14 IRS misconstrues and misapplies these statutes. Section

15
16 ¹⁸ 26 U.S.C. § 7422(a) provides:

17 No suit or proceeding shall be maintained in any
18 court for the recovery of any internal revenue tax
19 alleged to have been erroneously or illegally assessed
20 or collected, or of any penalty claimed to have been
21 collected without authority, or of any sum alleged to
22 have been excessive or in any manner wrongfully
23 collected, until a claim for refund or credit has been
24 duly filed with the Secretary, according to the
25 provisions of law in that regard, and the regulations
26 of the Secretary established in pursuance thereof.

27 28 U.S.C. § 1346(a)(1) provides that a district court shall
28 have original jurisdiction, concurrent with a federal tax court,
of any civil action against the United States for the recovery of
any internal revenue tax alleged to have been erroneously or
illegally assessed or collected, or any penalty claimed to have
been collected without authority or any sum alleged to have been
excessive or in any manner wrongfully collected under the federal
tax laws.

1 106(a)(4) provides that a governmental unit waives sovereign
2 immunity as to the enforcement of any orders, processes or
3 judgments rendered against it, so long as such enforcement is
4 consistent with nonbankruptcy law applicable to that particular
5 governmental unit. Brown v. United States (In re Brown), 211
6 B.R. 1020, 1023-24 (Bankr. S.D. Ga. 1997). IRC § 7422, in
7 conjunction with 28 U.S.C. § 1346(a), conditions a federal
8 court's authority to hear a refund suit upon the filing of a
9 claim for refund by the taxpayer. United States v. Dalm, 494
10 U.S. 596, 601-02 (1990); Miller v. United States, 784 F.2d 728,
11 729 (6th Cir. 1986); Perkins v. United States (In re Perkins),
12 216 B.R. 220, 225-26 (Bankr. S.D. Ohio 1997). These statutes do
13 not generally authorize the IRS to set off a refund against any
14 prepetition tax liabilities of a bankrupt taxpayer before
15 remitting the refund for the benefit of the estate.

16 The IRS also asserts that § 106(c) authorizes the offset of
17 any claim, regardless of whether the claim is prepetition or
18 postpetition, so long as that claim is property of the estate.
19 Under this interpretation of § 106(c), the trustee's claim for
20 the refund, which constitutes property of the estate under § 541,
21 must be offset against the IRS's claim for payment of prepetition
22 tax liabilities.

23 The IRS again misinterprets a statute in an attempt to end
24 run the requirements of § 553. Section 106(c) merely allows the
25 bankruptcy estate to set off any claim it has against the
26 government against any claim that a governmental unit may have
27 against the bankruptcy estate, notwithstanding any assertion of
28 sovereign immunity by the governmental unit. Franklin Sav. Corp.

1 v. United States (In re Franklin Sav. Corp.), 385 F.3d 1279,
2 1285, 1289-90 (10th Cir. 2004) (stating that “[s]ection 106 is
3 simply a waiver of sovereign immunity; it does not create a claim
4 for relief, nor does it provide a separate basis for subject
5 matter jurisdiction” and that “[t]he legislative history of
6 § 106, as evidenced by both the Senate and House Committee
7 reports, confirms that Congress intended § 106 to provide a
8 limited waiver of sovereign immunity to enable a debtor to
9 recover damages only to the same extent that the debtor’s claims
10 would be cognizable outside of bankruptcy”); Chateaugay, 94 F.3d
11 at 779 n.10 (finding that, contrary to the appellant’s assertion,
12 § 106(c) does not grant a right to setoff, but purports to
13 recognize a partial waiver of sovereign immunity by empowering a
14 debtor to assert a setoff right against a governmental agency
15 when it has filed proofs of claim in the bankruptcy case); 2
16 COLLIER ON BANKRUPTCY ¶¶ 106.01, 106.02[4], 106.07 (15th ed. rev.
17 2006). See also Ossen v. Dep’t of Soc. Serv. (In re Charter Oak
18 Assocs.), 361 F.3d 760, 769 (2nd Cir. 2004) (stating that, under
19 § 106(c), a state’s sovereign immunity does not protect it
20 against any counterclaim the bankruptcy estate may assert against
21 a state to the extent that it would reduce or defeat any claim
22 asserted by the state); In re Microage Corp., 288 B.R. 842, 852-
23 53 (Bankr. D. Ariz. 2003) (stating that, under § 106(c), the
24 state has no sovereign immunity against any counterclaims
25 asserted by the bankruptcy estate to offset any claims asserted
26 against it by the state). As such, § 106 does not, as the IRS
27 claims, expand any setoff rights the IRS may have against the
28 bankruptcy estate.

1 Regardless of whether the IRS has a right to setoff under
2 IRC § 6402 and/or other nonbankruptcy statutes, its ability to
3 assert its right of setoff in bankruptcy is subject to the
4 requirements of § 553. The IRS must demonstrate that it has an
5 enforceable right to setoff that should be preserved in the
6 bankruptcy case pursuant to § 553. Newbery, 95 F.3d at 1399
7 (stating that the party asserting the right of setoff has the
8 burden of proving it has an enforceable right) (citing Fed. Nat.
9 Mortgage Ass'n v. County of Orange (In re County of Orange), 183
10 B.R. 609, 615 (Bankr. C.D. Cal. 1995)); Luz Int'l, 219 B.R. at
11 843 (stating that, to enforce a setoff right, the creditor must
12 show that it has a right of setoff under nonbankruptcy law and
13 that this right should be preserved in bankruptcy under § 553).

14
15 2. Issues of material fact exist making summary judgment
16 improper.

17 Having determined which statute controls the ability of a
18 creditor to assert setoff rights in a bankruptcy case, we now
19 turn to § 553 to decide whether the bankruptcy court erred in
20 concluding that the IRS could not assert its right of setoff
21 against the debtors on the grounds that the IRS's obligation to
22 remit the refund arose postpetition and that the countervailing
23 claims lacked mutuality.

24 Section 553 sets forth three conditions that must be met in
25 order for a right of setoff to be recognized and preserved in
26 bankruptcy: "(1) the debtor owes the creditor a prepetition debt;
27 (2) the creditor owes the debtor a prepetition debt; and (3) the
28 debts are mutual." Luz Int'l, 219 B.R. at 843-44; see also 5

1 COLLIER ON BANKRUPTCY ¶ 553.01[1] (15th ed. rev. 2006).

2 In essence, a creditor must establish two elements before a
3 setoff may be asserted: timing and mutuality. Buckenmaier, 127
4 B.R. at 238.

5 With regard to the timing element, "each debt or claim
6 sought to be offset must have arisen prior to the filing of the
7 bankruptcy petition." Newbery, 95 F.3d at 1398 (emphasis added);
8 Buckenmaier, 127 B.R. at 238.

9 With respect to the mutuality element, the debts and claims
10 must be "'in the same right and between the same parties,
11 standing in the same capacity.'" Newbery, 95 F.3d at 1398-99
12 (quoting 4 COLLIER ON BANKRUPTCY ¶ 553.01[4] (15th ed. 1995);
13 Parkway Plaza Investors v. Bacigalupi (In re Bacigalupi, Inc.),
14 60 B.R. 442, 446 (9th Cir. BAP 1986). The mutuality requirement
15 is strictly construed. Newbery, 95 F.3d at 1399; Bacigalupi, 60
16 B.R. at 446; see also Hopkins v. D.L. Evans Bank (In re Fox Bean
17 Co.), 287 B.R. 270, 286 (Bankr. D. Idaho 2002) ("Section 553(a)
18 recognizes a creditor's right of offset provided mutual debts
19 exist. In other words, the Code does not allow an offset absent
20 mutuality.") (emphasis in original).

21
22 a. The IRS's obligation to remit the refund may be a
23 prepetition debt.

24 The bankruptcy court misapplied the law in determining that
25 the IRS's obligation to remit the refund was wholly postpetition
26 in nature. The bankruptcy court found that WCFC did not possess
27 a right to claim a refund until December 31, 2002, approximately
28 eleven days after the filing of the involuntary bankruptcy

1 petition, as it was only after filing the federal tax return for
2 the year ended December 31, 2002, that the trustee ascertained
3 that it could carry back WCFC's net operating loss and apply it
4 to WCFC's 1997 and 1998 taxable income. The bankruptcy court
5 concluded that the IRS's obligation to remit the refund did not
6 arise until postpetition. Accordingly, mutuality was lacking.

7 The trustee asks us to uphold the bankruptcy court's
8 determination. She asserts that the IRS's tax refund obligation
9 did not arise until the end of the taxable year, postpetition,
10 and cites to a number of cases in support. See, e.g., In re
11 Franklin Sav. Corp., 177 B.R. 356 (Bankr. D. Kan. 1995); In re
12 Thorvund-Statland, 158 B.R. 837 (Bankr. D. Idaho 1993); Rozel
13 Indus., Inc. v. Internal Revenue Service (In re Rozel Indus.,
14 Inc.), 120 B.R. 944 (Bankr. N.D. Ill. 1990). According to the
15 trustee, the "rationale [for this holding] is that [the IRS]
16 cannot owe a taxpayer a refund until the taxpayer actually
17 overpays the taxes." Under this reasoning, WCFC did not have a
18 valid and enforceable right against the IRS for a refund
19 prepetition because it could not have known until the end of the
20 2002 tax year, December 31, 2002, the exact amount of losses it
21 would suffer and could carry back and apply to prior years'
22 taxable income.¹⁹ Thus, the trustee argues, the IRS cannot
23 establish that its obligation to remit the refund arose

24
25 ¹⁹ Net operating losses "are simply an accounting method for
26 figuring [the taxpayer's] entitlement to the refund under the
27 present tax code. Pre-election, the right to carry back the [net
28 operating losses] represented simply the right to a tax refund .
. . ." United States v. Sims (In re Feiler), 218 F.3d 948, 956
(9th Cir. 2000).

1 prepetition.

2 The Bankruptcy Code defines a "debt" as a "liability on a
3 claim." 11 U.S.C. § 101(12); In re Luz Int'l, 219 B.R. at 844;
4 Braniff Airways, Inc. v. Exxon Co., 814 F.2d 1030, 1035 (5th Cir.
5 1987); United States v. Gerth, 991 F.2d 1428, 1433 (8th Cir.
6 1993). A "claim" is a "right to payment, whether or not such
7 right is reduced to judgment, liquidated, unliquidated, fixed,
8 contingent, matured, unmatured, disputed, undisputed, legal,
9 equitable, secured or unsecured" 11 U.S.C. § 101(5).
10 "'Debt' should be read as being coextensive with the term
11 'claim.'" Gerth, 991 F.2d at 1433; see also Buckenmaier, 127
12 B.R. at 238 (stating that the meanings of claim and debt are
13 coextensive) (quoting Pennsylvania Dep't of Pub. Welfare v.
14 Davenport, 495 U.S. 552, 558 (1990)).

15 "[D]ependency on a postpetition event does not prevent a
16 debt from arising prepetition." Gerth, 991 F.2d at 1433. The
17 character of a claim does not transform from prepetition to
18 postpetition because that claim is contingent, unliquidated or
19 unmatured when the debtor files its petition. Braniff, 814 F.2d
20 at 1036 (citing Stair v. Hamilton Bank of Morristown (In re
21 Morristown Lincoln-Mercury, Inc.), 42 B.R. 413, 417-18 (Bankr.
22 E.D. Tenn. 1984)). A debt can be owing prepetition even though
23 that debt did not come into existence until postpetition events
24 occurred. Gerth, 991 F.2d at 1434; In re Gibson, 308 B.R. 763,
25 766-68 (Bankr. N.D. Tex. 2002); Rozel, 120 B.R. at 949
26 ("Generally, a claim or debt must be found to be absolutely owing
27 at the time of the filing of the petition to be considered a pre-
28 petition item. This does not necessarily require that the amount

1 of such item be specifically known or that it be currently due,
2 only that some definite liability has accrued."); Eggemeyer v.
3 Internal Revenue Service (In re Eggemeyer), 75 B.R. 20, 21
4 (Bankr. S.D. Ill. 1987) ("The right to setoff exists provided
5 that the debt is 'absolutely owing at the time of the filing of
6 the petition even though [it is] not due or liquidated.'")
7 (quoting Lawrence v. Commissioner (In re Lawrence), 19 B.R. 627,
8 629 (Bankr. E.D. Ark. 1981)). Further, there is nothing in the
9 definitions of "debt" or "claim" or in the provisions of § 553
10 requiring that an amount due must be computed before the
11 bankruptcy petition date. Braniff, 814 F.2d at 1036.

12 It is true, as the trustee points out, that a number of
13 courts have held that a tax refund arises at the end of the tax
14 year to which it relates. See Rozel, 120 B.R. at 950-51
15 ("[T]here are several decisions which hold that a tax refund for
16 purposes of § 553 arises at the end of the taxable year to which
17 it relates, and not when that right of refund is claimed by the
18 taxpayer/debtor."); In re Glenn, 207 B.R. 418, 420 (E.D. Penn.
19 1997) ("[T]he vast majority of courts . . . have held that a
20 taxpayer's interest in a tax refund arises at the end of the
21 taxable year"); United States v. Johnson (In re Johnson),
22 136 B.R. 306, 309 (Bankr. M.D. Ga. 1991) ("Courts generally have
23 held that the substantive right to a tax refund arises at the end
24 of the tax year to which the refund relates.").

25 But the trustee unduly emphasizes the necessity to calculate
26 and determine the extent of the refund prior to the filing of the
27 bankruptcy petition to determine whether the IRS's debt to WCFC
28 was prepetition or postpetition. The fact that the extent of the

1 refund is indeterminate at the time of the filing of the petition
2 does not affect the right of the taxpayer to claim a refund. See
3 Braniff, 814 F.2d at 1036; Rozel, 120 B.R. at 949-50.

4 WCFC's claim for a loss-carryback refund, though
5 unliquidated at the time the involuntary bankruptcy petition was
6 filed against WCFC, is still based largely on prepetition events.
7 Even if the claim to the refund is unliquidated, unmatured or
8 contingent, the taxpayer still holds an enforceable claim, which
9 the IRS is obligated to satisfy. See Luz Int'l, 219 B.R. at 844
10 (determining that a claim as a right to payment "encompass[es]
11 virtually any type of obligation reducible to some monetary
12 equivalence"); Braniff, 814 F.2d at 1036 (finding that "[t]he
13 debt owed the debtor does not have to be calculated prior to the
14 filing of the bankruptcy petition in order for setoff to be
15 available to a creditor"); Gerth, 991 F.2d at 1433 ("For setoff
16 purposes, a debt arises when all transactions necessary for
17 liability occur, regardless of whether the claim was contingent,
18 unliquidated, or unmatured when the petition was filed."); see
19 also Buckenmaier, 127 B.R. at 238 (stating that "under the broad
20 definition of the term 'claim,' contribution and indemnification
21 claims arise at the time when the acts giving rise to the alleged
22 liability were performed, and not when the claims technically
23 accrue under state law.").

24 Here, WCFC's refund claim relates back to the 1997 and 1998
25 tax years, even though the carryback losses occurred in 2002.
26 Although WCFC could not calculate the complete extent of the loss
27 carryback claim until after the 2002 tax year ended, eleven days
28 postpetition, a substantial portion of WCFC's losses probably

1 took place and were reasonably ascertainable before the end of
2 the 2002 tax year.

3 Under the approach set forth in Segal v. Rochelle, 382 U.S.
4 375 (1966), the IRS's debt could be characterized as a
5 prepetition debt because the refund was generated by a loss
6 carryback, which was based on losses incurred primarily
7 prepetition, but determined postpetition. See Segal, 382 U.S. at
8 379-80 (holding that a loss carryback tax refund, based on
9 prepetition losses but received postpetition, constitutes
10 property of the estate under the former Bankruptcy Act because it
11 is "sufficiently rooted in the pre-bankruptcy past," and such "an
12 interest is not outside its reach because it is novel or
13 contingent or because enjoyment must be postponed."). Though
14 Segal was decided under the prior Bankruptcy Act, it remains good
15 law under the Bankruptcy Code applicable to the instant case.
16 United States v. Sims (In re Feiler), 218 F.3d 948, 955 (9th Cir.
17 2000); Chappel v. Proctor (In re Chappel), 189 B.R. 489, 493 (9th
18 Cir. BAP 1995).

19 Further, Segal suggests that if the refund for a tax year is
20 increased because of losses incurred postpetition, the court
21 should consider a proration of the refund between the prepetition
22 and postpetition portions of the tax year at issue. Barowsky v.
23 Serelson (In re Barowsky), 946 F.2d 1516, 1517 (10th Cir. 1991)
24 (citing Segal, 382 U.S. at 380 n.5)). Under this principle, the
25 bankruptcy court could characterize most of the refund claim as
26 prepetition. See, e.g., Sticka v. Lambert (In re Lambert), 283
27 B.R. 16, 21 (9th Cir. BAP 2002) (affirming the bankruptcy court's
28 order prorating a portion of a tax refund as property of the

1 estate only to the extent attributable to the prepetition part of
2 the tax year); Barowsky, 946 F.2d at 1517-19 (affirming the
3 bankruptcy court's proration of the debtors' income tax refund
4 between the prepetition and postpetition portions of the tax
5 year); In re Dussing, 205 B.R. 332, 333 (Bankr. M.D. Fla. 1996)
6 (ordering turnover of a prorated amount of an income tax refund
7 received postpetition as a portion of the tax year preceded the
8 filing of the bankruptcy case); In re Orndoff, 100 B.R. 516, 517-
9 18 (Bankr. E.D. Cal. 1989) (citing Segal and finding that the
10 bulk of an income tax refund due to the debtor constituted
11 property of the estate, based on a proration as to that portion
12 of the income tax refund attributable to prepetition
13 withholdings). The bankruptcy court did not consider the Segal
14 principles in ruling that WCFC's refund claim was a postpetition
15 claim.

16 WCFC's refund claim was unliquidated prepetition, but it
17 existed nonetheless.²⁰ The bankruptcy court based its ruling on
18 an erroneous view of the applicable law. It erred in granting
19 summary judgment to the trustee on the ground that the IRS failed
20 to establish its right of setoff by finding that the IRS's debt
21 arose postpetition.

22
23 ²⁰ The trustee advances an argument similar to the argument
24 advanced by the debtor in Braniff. There, the debtor argued that
25 the debt arose postpetition because it did not arise until the
26 amount of an unused prepayment could be calculated, which was
27 done postpetition. Braniff, 814 F.2d at 1035. The appellate
28 court decided, however, that based on the above principles, the
debt did not have to be calculated before the petition date in
order for setoff to be available to the creditor. Id. at 1035-
36.

1 b. Material issues of fact exist as to mutuality.

2 Based on the WCFC Offer to Waive, there is no question that
3 the IRS is able to setoff the refund against the prepetition tax
4 liabilities of WCFC.²¹ The question before the bankruptcy court
5 and now before us is whether the IRS may assert a setoff of the
6 refund arising from losses incurred by WCFC against the
7 prepetition tax liabilities of SMIL.

8 As the bankruptcy court recognized, mutuality is the
9 critical issue in determining whether the IRS could assert and
10 effectuate its right of setoff against WCFC and SMIL. The IRS
11 contends that mutuality exists, in part, because of the
12 substantive consolidation of the bankruptcy cases, which
13 evidences that SMIL is the alter ego of WCFC.

14 Contrary to the IRS's assertion, substantive consolidation
15 alone does not establish that SMIL was and is the alter ego of
16 WCFC. Substantive consolidation is a mechanism whereby the
17 assets and liabilities of two or more related entities are pooled
18 to create a single fund from which creditors of the combined
19 estate may receive distributions. In re Bonham, 229 F.3d 750,
20 764 (9th Cir. 2000). Essentially, substantive consolidation
21 ignores the corporate form in order to combine the assets and
22 liabilities of entities whose businesses and/or finances are so
23 intertwined that it makes no sense to disentangle them.

24
25
26 ²¹ Contrary to the Summary Judgment Order, which stated that
27 the IRS had no right of setoff against any prepetition tax
28 liability owed by WCFC, in the WCFC Offer to Waive, the trustee
explicitly agreed to an offset of WCFC's 1998 income tax
liability against the refund.

1 Accordingly, the substantive consolidation of WCFC and SMIL
2 does not establish per se that SMIL was the alter ego of WCFC or
3 vice versa. The bankruptcy court nonetheless erred in granting
4 summary judgment in favor of the trustee, as the trustee herself
5 presented factual evidence in declarations filed with the
6 bankruptcy court in support of her Substantive Consolidation
7 Motion, suggesting that SMIL may have been the alter ego of WCFC.
8 The bankruptcy court granted the Substantive Consolidation
9 Motion, and the IRS referenced the Substantive Consolidation
10 Order several times in the Cross-Motion.

11 The Substantive Consolidation Motion and its supporting
12 declarations were included in Exhibit C to the Declaration of
13 Paul Ham (the "Ham Declaration") in support of the Motion to
14 Alter. In the Motion to Strike Exhibits, the trustee moved to
15 strike Exhibits B through M to the Ham Declaration, including
16 Exhibit C. The bankruptcy court granted the Motion to Strike
17 Exhibits without determining the admissibility of any of the
18 subject exhibits. In fact, the bankruptcy court did not make any
19 findings or rulings with respect to the exhibits either at the
20 hearing on the Motion to Strike Exhibits or in the Motion to
21 Strike Order, other than stating in the order that "good cause
22 has been shown." Based on this record, it is not possible to
23 determine the basis for the bankruptcy court's ruling, and we
24 conclude that the bankruptcy court abused its discretion in
25 granting the Motion to Strike Exhibits. Accordingly, we reverse
26 the Motion to Strike Order, and we have considered the
27 Substantive Consolidation Motion and its supporting declarations
28 included as part of the record in this appeal. See Golden Gate

1 Hotel Ass'n, 18 F.3d at 1485. See also S.O.S., Inc. v. Payday,
2 Inc., 886 F.2d 1081, 1085 (9th Cir. 1989); Sidney-Vinsein v.
3 A.H. Robins Co., 697 F.2d 880, 885 (9th Cir. 1983).

4 In Washington, though courts ordinarily recognize a parent
5 corporation as a legal entity distinct and separate from its
6 subsidiary, courts may disregard the distinction between a parent
7 corporation and its subsidiary when necessary to do justice in
8 particular cases. Kueckelhan v. Fed. Old Line Ins. Co., 418 P.2d
9 443, 456 (Wash. 1966) (quoting Superior Portland Cement, Inc. v.
10 Pacific Coast Cement Co., 205 P.2d 597, 620 (Wash. 1949)).

11 Courts may disregard the corporate form (i.e., pierce the
12 corporate veil) and hold a parent corporation liable for the
13 actions of its subsidiary under either the doctrine of corporate
14 disregard or the theory of alter ego.²² Compare Meisel, 645 P.2d
15

16 ²² Under the doctrine of corporate disregard (i.e., piercing
17 the corporate veil), the parent corporation may be liable for the
18 activities of its subsidiary where its subsidiary "has been
19 intentionally used to violate or evade a duty owed to another."
20 Meisel v. M&N Modern Hydraulic Press Co., 645 P.2d 689, 692
21 (Wash. 1982) (quoting Morgan v. Burks, 611 P.2d 751, 755 (Wash.
22 1980)). When the separateness of corporations is disregarded,
23 they are considered alter egos. Harris, Washington's Doctrine of
24 Corporate Disregard, 56 Wash. L. Rev. 253 n.2 (1981).

25 Two elements must be proved before a court may disregard the
26 separateness of the corporate entities: (1) the corporate form
27 must be intentionally used to violate or evade a duty; and (2)
28 disregard is necessary to prevent unjustified loss to the injured
party. Meisel, 645 P.2d at 692 (quoting Morgan, 611 P.2d at
756). With respect to the first element, the court must find an
abuse of the corporate form, such as fraud, misrepresentation or
some other kind of manipulation of the corporation for the
benefit of the stockholder and to the detriment of the creditor.
Id. (quoting Truckweld Equip. Co. v. Olson, 618 P.2d 1017, 1021

(continued...)

1 at 692 (stating that the doctrine of corporate disregard applies
2 when the corporation has been found "to have been intentionally
3 used to violate or evade a duty owed to another"), with
4 Kueckelhan, 418 P.2d at 456 (stating that courts will disregard
5 the corporate form to defeat fraud or injustice on third parties
6 "if one corporation so dominates and controls another as to make
7 that other merely an adjunct to it'") (quoting Superior Portland
8 Cement, Inc., 205 P.2d at 620).

9 Merely that a corporation is the owner of the stock of
10 another and that the two are intimately related in carrying on
11 their business for the purpose of mutual benefit is not enough to
12 characterize a corporation as the alter ego of the other
13 corporation. H.E. Briggs & Co. v. Harper Clay Products Co., 272
14 P. 962, 963 (Wash. 1928) (quoting First National Bank v. Walton,
15 262 P. 984, 986 (Wash. 1928)). Rather, there must be such a
16 commingling of the affairs of two corporations as to work an
17 injustice on third parties if their separate status is
18 recognized, in order for the court to hold the two corporations
19 are, in effect, one legal entity. H.E. Briggs & Co., 272 P. at
20 963. "[T]heir property rights [must be] so commingled and their
21 affairs so intimately related in management as to render it

22 _____
23 ²²(...continued)
24 (Wash. Ct. App. 1980)). With respect to the second element, the
25 wrongful activities of the corporation "must actually harm the
26 party seeking relief so that disregard is necessary." Id. at
27 693. In other words, the corporation's intentional misconduct
28 must be the cause of the harm. Id.

The IRS does not assert the doctrine of corporate disregard
in its attempt to prove WCFC and SMIL should be treated as one
and the same.

1 apparent that they are, in fact and in intent, one, and, so
2 related, to have them regarded otherwise would work a fraud upon
3 third persons.'" Id. (quoting First National Bank, 262 P. at
4 986).

5 In the declarations filed in support of the Substantive
6 Consolidation Motion, the trustee presented facts indicating that
7 SMIL may have been the alter ego of WCFC. According to the
8 trustee, the business operations of SMIL and WCFC were mixed, and
9 there were few arm's length transactions between them. For
10 example, in 2001, all of the employees working at the same office
11 building in Seattle, Washington were employed by SMIL, regardless
12 of whether their services benefitted WCFC or SMIL. Further, all
13 of the overhead expenses for the office building in Seattle were
14 incurred and paid by SMIL; there was no allocation of these
15 expenses among the subsidiaries and parent corporation using the
16 building.

17 The trustee also pointed out that the business and financial
18 records of WCFC and SMIL were substantially commingled. SMIL
19 routinely paid the obligations of WCFC and its other
20 subsidiaries. WCFC and its subsidiaries used any available cash
21 to fund the subsidiaries' operations; as a result, WCFC owed SMIL
22 approximately \$13 million. WCFC's payable to SMIL was comprised
23 of funds borrowed for WCFC's various investments. In addition,
24 SMIL paid for a 1998 Chevy Suburban, though the vehicle title
25 lists WCFC as the legal owner. Also, SMIL owes a debt of \$3
26 million to Sun Life Assurance Company of Canada; to secure the
27 debt, Sun Life has a first trust deed on the Seattle office
28 building from which WCFC and its subsidiaries were operated, and

1 a guaranty from WCFC.

2 The facts presented by the trustee in support of the
3 Substantive Consolidation Motion suggest that SMIL may have been
4 the alter ego of WCFC. And based on these facts, the bankruptcy
5 court entered the Substantive Consolidation Order. The
6 substantive consolidation of WCFC and SMIL in bankruptcy, as
7 argued by the IRS, raises a material fact question as to whether
8 WCFC and SMIL functioned as alter egos or one entity prepetition
9 and should be treated as such for setoff purposes. Accordingly,
10 we reverse the bankruptcy court's grant of summary judgment in
11 favor of the trustee.²³

12 On the same basis, we decline to reverse and remand the
13 bankruptcy court's order denying summary judgment to the IRS.
14 The IRS itself has raised issues of material fact that we, as the
15 reviewing court, cannot decide. See Tobin, 258 B.R. at 202. We
16 may neither weigh the evidence included in the record nor

17
18 ²³ At oral argument, the IRS presented a new argument with
19 respect to substantive consolidation. Under Bonham, substantive
20 consolidation combines the assets of the consolidated debtors
21 into one pool of assets against which the creditors of either
22 debtor may satisfy their claims. Thus, according to the IRS,
23 under Bonham, the IRS may set off the tax liabilities of SMIL
24 against the refund of WCFC, as the refund has been merged into
25 this common pool of assets.

26 Generally, although we will not consider matters not
27 specifically and distinctly argued in an appellant's opening
28 brief, United States v. Ullah, 976 F.2d 509, 514 (9th Cir. 1992),
for the sake of completeness, we will address the IRS's new
argument. Whether the pooling of assets through substantive
consolidation allows a creditor to set off the debt of one of the
consolidated debtors against the pool of assets containing assets
of another consolidated debtor is an open question. Bonham
simply does not deal with setoff rights under § 553.

1 determine the truth of this matter, as the IRS has requested.
2 See Abdul-Jabbar, 85 F.3d 407. Fact questions must be considered
3 and weighed by the trier of fact. We affirm the bankruptcy
4 court's denial of the Cross-Motion.

5
6 3. Recoupment.

7 The IRS advances recoupment as an additional ground for
8 establishing and effectuating its right of setoff. Under the
9 doctrine of recoupment, the IRS asserts a setoff right against
10 both WCFC and SMIL as the estate's claim for a refund and the
11 IRS's counterclaim for an offset arise out of the tax
12 consequences that flow through the consolidated corporate tax
13 returns of WCFC and SMIL over multiple tax years. In other
14 words, according to the IRS, "the various years involved in [the]
15 loss carryback make[] transactions from tax year to tax year
16 related transactions." The trustee contests this argument on two
17 grounds: (1) the IRS failed to plead recoupment in its answer;
18 and (2) the IRS cannot assert recoupment because it cannot meet
19 the required conditions.

20 The trustee contends that recoupment qualifies as an
21 affirmative defense and/or counterclaim, which needs to be
22 pleaded in an answer. Thus, she asks us not to consider the
23 issue as the IRS, by failing to assert recoupment in its answer,
24 waived it.

25 "[R]ecoupment 'is the setting up of a demand arising from
26 the same transaction as the plaintiff's claim or cause of action,
27 strictly for the purpose of abatement or reduction of such
28 claim.'" Newbery, 95 F.3d at 1399 (quoting 4 COLLIER ON BANKRUPTCY

1 ¶ 553.03 (15th ed. 1995) (emphasis in original)). Under
2 recoupment, a defendant may meet a plaintiff's claim with a
3 countervailing claim that arose out of the same occurrence or
4 transaction as the plaintiff's claim. Id. "For this reason,
5 recoupment has been analogized to both compulsory counterclaims
6 and affirmative defenses." Id. See also Aetna U.S. Healthcare,
7 Inc. v. Madigan (In re Madigan), 270 B.R. 749, 755 (9th Cir. BAP
8 2001) (stating that recoupment is the common law precursor to the
9 compulsory counterclaim).

10 Rule 13(a) of the Federal Rules of Civil Procedure ("FRCP
11 13(a)") sets forth guidelines for asserting compulsory
12 counterclaims. FRCP 13(a) characterizes a compulsory
13 counterclaim as one that "arises out of the transaction or
14 occurrence that is the subject matter of the opposing party's
15 claim." FRCP 13(a) requires the defendant to assert a
16 counterclaim in its responsive pleading or otherwise lose that
17 counterclaim forever. 10 COLLIER ON BANKRUPTCY ¶ 7013.02 (15th ed.
18 rev. 2006).

19 Rule 7013 incorporates FRCP 13(a), with a few variations.
20 Reiter v. Cooper, 507 U.S. 258, 265 n.2 (1993). Rule 7013
21 differs from FRCP 13(a) in that "'a party sued by a trustee or
22 debtor in possession need not state as a counterclaim any claim
23 that the party has against the debtor, the debtor's property, or
24 the estate, unless the claim arose after the entry of an order
25 for relief.'" In re Merritt Logan, Inc., 109 B.R. 140, 143
26 (Bankr. E.D. Pa. 1990) (quoting Rule 7013). Thus, if a trustee
27 initiates an adversary proceeding against a creditor, who has a
28 prepetition claim against the debtor, that creditor does not need

1 to assert that claim as a counterclaim in its answer to the
2 trustee's complaint. 10 COLLIER ON BANKRUPTCY ¶ 7013.02 (15th ed.
3 rev. 2006).

4 The creditor may choose to assert prepetition claims by
5 filing a proof of claim. Merritt Logan, Inc., 109 B.R. at 143.
6 Unlike FRCP 13(a), which mandates that a defendant plead a
7 compulsory counterclaim or lose it, Rule 7013 recognizes
8 bankruptcy claims procedures as applicable to prepetition claims.
9 Id. at 144.

10 As the trustee points out, she chose to litigate the proofs
11 of claim filed by the IRS by objecting to them in her complaint.
12 Thus, according to the trustee, the IRS had to plead recoupment
13 in its answer.

14 Assuming that the IRS's obligation to remit the refund arose
15 postpetition (and we do not), the trustee would be correct that
16 the IRS was required to plead its recoupment counterclaim in its
17 answer in order to preserve it. However, we already have decided
18 that the bankruptcy court erred in granting summary judgment in
19 the trustee's favor.

20 Based on our review of the record, it appears that the
21 bankruptcy court made no definite determination on the recoupment
22 issue when it denied summary judgment to the IRS. On remand, the
23 IRS can determine whether it wishes to move to amend its answer
24 specifically to assert a recoupment claim. Evidence as to
25 whether the concerned tax liabilities and refund claim arose out
26 of the same transaction for recoupment purposes can be revisited
27 in further proceedings before the bankruptcy court.

1 B. The Bankruptcy Court's Rulings on the IRS's Motion to Alter
2 and the Trustee's Motion to Strike Exhibits

3 At the June 2, 2006 hearing, the bankruptcy court denied the
4 IRS's Motion to Alter and granted the trustee's Motion to Strike
5 Exhibits.

6 With respect to the bankruptcy court's ruling on the IRS's
7 Motion to Alter, the bankruptcy court made no findings as to
8 whether sufficient facts existed on the IRS's allegation that
9 WCFC and SMIL were alter egos to merit reconsideration. We need
10 not make any determination as to whether the bankruptcy court
11 erred in denying the Motion to Alter, however, as we are
12 reversing and remanding the Summary Judgment Order, rendering the
13 IRS's appeal of the Motion to Alter Order moot.

14 With respect to the bankruptcy court's ruling on the
15 trustee's Motion to Strike Exhibits, as discussed supra, we are
16 reversing the Motion to Strike Order as an abuse of discretion.

17
18
19 **VI. CONCLUSION**

20
21 The IRS raised genuine issues of material fact with respect
22 to the issues of mutuality and timing in its attempt to establish
23 and enforce its right of setoff. The bankruptcy court erred in
24 granting summary judgment in favor of the trustee. Thus, we
25 REVERSE the bankruptcy court's grant of summary judgment for the
26 trustee and REMAND for further proceedings on the issues of
27 mutuality and timing pursuant to § 553 and the issue of
28 recoupment. We further REVERSE the bankruptcy court's Motion to

1 Strike Order.

2 The bankruptcy court did not err in denying summary judgment
3 in favor of the IRS, as genuine issues of material fact exist, as
4 raised by the IRS itself. Thus, we AFFIRM the bankruptcy court's
5 denial of summary judgment for the IRS.

6

7

8

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

26

27

28