IT IS SO ORDERED.

Dated: August 11, 2025

John E. Hoffman, Jr.
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

In re:	:	Case No. 22-52488
	:	
Shannon Latalya Nealey,	:	Chapter 7
	:	
Debtor.	:	Judge Hoffman

Shannon Nealey,	:	
	:	
Plaintiff,	:	
	:	
v.	:	Adv. Pro. No. 24-2016
	:	
Ohio Attorney General *et al.*,	:	
	:	
Defendants.	:	

MEMORANDUM OPINION AND ORDER

I. Introduction

Subject to certain exceptions not applicable here, the Bankruptcy Code "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[.]" 11 U.S.C. § 553(a) (emphasis added). That is, the Bankruptcy Code preserves a creditor's right to set off mutual prepetition debts owed between it and a debtor. The amount of such a setoff is recoverable only to the extent the creditor improves its position within the 90 days before the bankruptcy filing. 11 U.S.C. § 553(b). By contrast, the payment of a nonmutual debt may be subject to avoidance as a preferential transfer under § 547(b) of the Bankruptcy Code.

There are two transactions at issue here. One was the setoff of a mutual debt. That setoff did not improve the creditor's position, so the debtor cannot recover it. The second transaction, however, was the payment of a nonmutual debt. That payment meets all the elements of a preference, and none of the preference defenses apply, so it is avoidable as a preferential transfer. But because a debtor may recover a preference only to the extent she can exempt the transferred property, the debtor's recovery here is limited to what remains available for her to exempt under Ohio law.

II. Jurisdiction and Constitutional Authority

A. Jurisdiction

"Bankruptcy courts . . . derive their jurisdiction from the district courts." *Wasserman v. Immormino (In re Granger Garage, Inc.)*, 921 F.2d 74, 77 (6th Cir. 1990) (cleaned up). District courts have original and exclusive jurisdiction over "all cases under [the Bankruptcy Code]." 28 U.S.C. § 1334(a). This is the jurisdiction over the debtor's "bankruptcy case itself." *Kirk v. Hendon (In re Heinsohn)*, 231 B.R. 48, 56 (Bankr. E.D. Tenn. 1999), *aff'd*, 247 B.R. 237 (E.D. Tenn. 2000). The district courts also have original but not exclusive jurisdiction over civil proceedings "arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334(b). A district court may refer its jurisdiction to the bankruptcy judges for the district, 28 U.S.C. § 157(a), and every district court in the country, including the Southern District of Ohio, s*ee* General Order No. 05-02 (S.D. Ohio Oct. 24, 2005), has referred bankruptcy cases and proceedings to the bankruptcy courts.

Under § 157(b)(1) of the Judicial Code, "[b]ankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title." 28 U.S.C. § 157(b)(1). The statute then sets forth a nonexclusive list of core proceedings. *See* 28 U.S.C. § 157(b)(2). A "proceeding[] to determine, avoid, or recover [a] preference[]" is designated as a core proceeding. 28 U.S.C. § 157(b)(2)(F). Thus, the Court has statutory authority to enter a final judgment on the preference claim at issue here.

B. Constitutional Authority

After *Stern v. Marshall*, 564 U.S. 462 (2011), a bankruptcy court may no longer rely solely on § 157(b)(2)'s distinction between core and noncore proceedings in determining the limits of its final adjudicative authority. In *Stern*, the Supreme Court "held that Article III prohibits Congress from vesting a bankruptcy court with the authority to finally adjudicate certain claims." *Exec. Benefits Ins. Agency v. Arkison*, 573 U.S. 25, 30 (2014) (citing *Stern*). Those claims—known as *Stern* claims—even if designated as core by statute, may not be finally adjudicated by bankruptcy courts if doing so would involve an exercise of judicial power that the Constitution reserves for Article III courts. *See Stern*, 564 U.S. at 503; *Arkison*, 573 U.S. at 30–31 (noting that a claim statutorily designated as a core proceeding in 28 U.S.C. § 157(b)(2) but that cannot constitutionally be adjudicated by the bankruptcy court is known as a *Stern* claim).

Stern made clear, however, that bankruptcy courts have the authority to finally adjudicate any claim that "stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." *Stern*, 564 U.S. at 499. And even if neither of those conditions is met, "Article III is not violated when the parties knowingly and voluntarily consent to adjudication by a bankruptcy judge," meaning "litigants may validly consent to adjudication by bankruptcy courts." *Wellness Int'l Network, Ltd. v. Sharif*, 575 U.S. 665, 669, 674 (2015).

Courts are split on whether preference claims involving creditors who have not filed proofs of claim, which is the case here, are *Stern* claims that bankruptcy courts lack the authority to finally adjudicate. Some say they are. *See, e.g.*, *Redeye II, LLC v. MorrisAnderson & Assocs. Ltd. (In re Swift Air, L.L.C.)*, 624 B.R. 694, 702 (D. Ariz. 2020) ("[P]reference actions are *Stern* claims . . . ."); *Penson Fin. Servs., Inc. v. O'Connell (In re Arbco Cap. Mgmt., LLP)*, 479 B.R. 254, 266 (S.D.N.Y. 2012) (same). Other courts disagree, finding that preference claims stem from the bankruptcy itself. *See, e.g.*, *Reid v. Wolf (In re Wolf)*, 595 B.R. 735, 751 (Bankr. N.D. Ill. 2018) ("There is also no *Stern* issue with the preference claim[.]"), *aff'd*, 644 B.R. 725 (N.D. Ill. 2022), *aff'd*, No. 23-1045, 2023 WL 6564882 (7th Cir. Oct. 10, 2023); *Pantazelos v. Benjamin (In re Pantazelos)*, 543 B.R. 864, 873 (Bankr. N.D. Ill. 2016) ("Since a preference claim 'stems from the bankruptcy itself' bankruptcy courts have authority to hear and determine preference actions . . . ."); *West v. Freedom Med., Inc. (In re Apex Long Term Acute Care—Katy, L.P.)*, 465 B.R. 452, 463 (Bankr. S.D. Tex. 2011) ("The Court concludes that preference actions both stem from the bankruptcy itself and are decided primarily pursuant to *in rem* jurisdiction.").

Here, the Court need not address whether a preference claim asserted against a defendant that has not filed a proof of claim is a *Stern* claim. This is so because all parties in this adversary proceeding have consented to the Court's entry of final judgment. *See* Defendants' Pretrial Statement, Adv. Doc. 7 at 2; Plaintiff's Pretrial Statement, Adv. Doc. 8 at 2. The Court accordingly has the authority to enter final judgment in this adversary proceeding. *See Wellness*, 575 U.S. at 669, 674.[1]

III. Background

Shannon Latalya Nealey, proceeding pro se, filed a Chapter 7 bankruptcy petition on August 26, 2022 ("Petition Date"). *See* Doc. 1.[2] Nearly two years later, on March 21, 2024, she initiated this adversary proceeding against the Ohio Attorney General and the Ohio Department of Job and Family Services (together, the "State"). *See* Adv. Doc. 1 ("Complaint").

By the Complaint, Nealey seeks the "return or refund of intercepted tax refunds" from the State. *Id.* at 1. In particular, on May 27, 2022 and June 21, 2022, the State set off Nealey's 2020 and 2021 Ohio tax refunds against the debts she owed to various State-related entities, including Columbus State Community College. *See* Adv. Doc. 14 ("State's Trial Brief") at 3. The June 21, 2022 setoffs were made within the 90-day preference period, but the May 27, 2022 setoffs were taken exactly 91 days before the Petition Date. For ease of discussion, the Court will refer to this series of transactions as the "Ohio Setoff."

On June 9, 2022—less than 90 days before the Petition Date—the United States Department of Treasury ("Treasury") transferred the money it would have owed Nealey for her

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[1] A preference claim against a defendant that has filed a proof of claim is not a *Stern* claim because the preference claim would necessarily be resolved in the claims allowance process by virtue of § 502(d) of the Bankruptcy Code. Section 502(d) provides, among other things, that the bankruptcy court shall disallow any claim of any entity that is the transferee of a transfer avoidable as a preference. 11 U.S.C. § 502(d); s*ee also Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 747 (7th Cir. 2013) ("The current dispute comes within a bankruptcy judge's authority, notwithstanding *Stern*, because all of the defendants submitted proofs of claim . . . and thus subjected themselves to preference-recovery . . . claims by the Trustee. The Supreme Court held in *Katchen v. Landy*, 382 U.S. 323, 329–36 (1966), and *Langenkamp v. Culp*, 498 U.S. 42, 44–45 (1990), that Article III authorizes bankruptcy judges to handle avoidance actions against claimants.") (citing 11 U.S.C. § 502(d)) (cleaned up).

[2] References to "Doc. __" are to docket entries in Nealey's bankruptcy case, No. 22-52488. References to "Adv. Doc. __" are to docket entries in this adversary proceeding, No. 24-2016.

2021 federal tax refund[3] to the State based on a debt Nealey owed the State for overpaid unemployment benefits. *See id.* The Court will refer to this transfer as the "Federal Payment."

Believing she had a right to recover the money received by the State through both the Ohio Setoff and the Federal Payment, Nealey initiated this adversary proceeding. Compl. at 1, 3. The Court proceeded to try the merits of the Complaint.[4]

The trial was not long. Nealey testified on her own behalf that she believed, because the Ohio Setoff and the Federal Payment were completed within 90 days of the Petition Date, she had a right to recover all the money taken through those transactions. *See* Trial at 9:50:54–9:52:24. On cross-examination, she verified her Chapter 7 petition and schedules, including the value of property she claimed as exempt. *Id.* at 9:53:17–9:54:30. The State then presented the testimony and affidavit of Kevin Whitacre, the Deputy Director of Legal Support for the Collections Enforcement Section of the Ohio Attorney General's Office. Whitacre's testimony and affidavit established that the State (1) set off $1,311 from Nealey's 2020 and 2021 Ohio tax refunds, and (2) received a payment of $4,299.20 that the Treasury took from Nealey's federal tax refund on account of her debt to the State. *Id.* at 9:57:22–9:59:55; Adv. Doc. 14-1 at 2 ("Whitacre Affidavit").[5] The evidence also established that the Ohio Setoff and the Federal Payment occurred through different legal mechanisms. The Ohio Setoff took place after the State certified Nealey's

[3] Nealey did not specify the tax year to which her "intercepted" federal tax refund pertained. But in her Schedule A/B, she listed her 2021 Ohio and federal tax refunds as being owed to her, and said both "were intercepted by the Ohio Attorney General[.]" Doc. 31 at 7. The Court will presume that Nealey's complaint also refers to her 2021 federal tax refund.

[4] No transcript of the trial has been prepared. The audio recording of the trial will be cited as "Trial at [timestamp]."

[5] In the Complaint, Nealey said she "was due a federal refund in the amount of $4,337 and a state refund in the amount of $552." Compl. at 3. At trial, however, Nealey declined to cross examine Whitacre or present any evidence as to the amounts set off or received by the State. Whitacre's Affidavit and testimony appeared wholly credible, and with no evidence to the contrary, the Court finds that the amounts attested to by Whitacre are accurate.

debts for collection by the Ohio Attorney General, while the Federal Payment was authorized by the "Treasury Offset Program" (described below). Trial at 9:56:57–9:57:21; State's Trial Br. at 2–3.

IV. Legal Analysis

A. The Relationship Between Setoff and the Avoidance of Preferential Transfers

This case involves a "collision between [the] avoidance of preferential transfers under 11 U.S.C. § 547 and setoff under 11 U.S.C. § 553." *Jarboe v. U.S. Small Bus. Admin (In re Hancock)*, 137 B.R. 835, 837 (Bankr. N.D. Okla. 1992). To cut to the chase, setoffs of debts that are mutual under applicable nonbankruptcy law are not avoidable as preferential transfers, but payments of debts that are not mutual under that same standard may be avoidable as preferences. Support for this proposition begins with § 553 of the Bankruptcy Code, which provides that, subject to several inapplicable exceptions, the Code

> 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 . . . .

11 U.S.C. § 553(a) (emphasis added). As the emphasized language makes clear, "[t]he mutuality requirement stems from section 553(a)'s reference to 'a mutual debt' owed by a creditor to the debtor against the creditor's claim against the debtor[.]" *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996). But what law controls whether a debt and a claim are mutual, bankruptcy law or applicable nonbankruptcy law?

To answer that question, the Court begins by noting that, as classically understood, setoff (also called offset) "allows entities that owe each other money to apply their *mutual debts* against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'" *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S.

523, 528 (1913) (emphasis added)). There are, however, so-called setoffs that do not involve mutuality, and consideration of them leads to the conclusion that it is applicable nonbankruptcy law, not bankruptcy law, that controls whether debts are mutual for the purpose of determining whether a purported setoff is avoidable as a preferential transfer. There is the "triangular setoff"—where, for example, a parent company attempts to set off a debt of its subsidiary against a debt owed to the parent. *See, e.g.*, *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748, 751 (3d Cir. 2021). In *Orexigen*, the Third Circuit held, in the context of a request for approval of a *postpetition* setoff, that in order for § 553 to apply, "strict bilateral mutuality" is required and that "'mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff.'" *Id.* at 755 (quoting *In re SemCrude, L.P.*, 399 B.R. 388, 397 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010)). This raises the question of whether a *prepetition* setoff can be avoided as a preference, "not because the setoff was invalid under applicable nonbankruptcy law, but because the setoff does not qualify under the requirements of section 553(a)." 5 *Collier on Bankruptcy* ¶ 553.09[1][c] (Richard Levin & Henry J. Sommer eds., 16th ed. 2025). "For example, a relevant claim and debt might not be 'mutual' under the Code's definition, even though they might be mutual under applicable state law." *Id.* The answer is that "the requirements of section 553(a) do not apply retroactively to affect *prepetition setoffs*. Thus, an otherwise valid *prepetition setoff* is not invalid, and thereby subject to avoidance, on the ground that it was not 'mutual' *within the meaning of the Code*." *Id.* (emphasis added).

So while the requirement of mutuality is found in § 553 itself, the determination of whether a debt and a claim are mutual is made based on applicable nonbankruptcy law. *See, e.g.*, *Durham v. SMI Indus. Corp.*, 882 F.2d 881, 883 (4th Cir. 1989) ("Section 553 does not create a right of setoff or prescribe the means by which a setoff must be executed in order to be effective. It merely preserves any right of setoff accorded by state law[.]"). That is, for § 553 to apply in the context of prepetition setoffs, the transaction at issue must be a "setoff under relevant nonbankruptcy law[.]" 5 *Collier on Bankruptcy* ¶ 553.09[1][b] (cleaned up). Of course, for purposes of the Ohio Setoff, the applicable nonbankruptcy law is Ohio law. Under Ohio law, "mutuality of the parties is an essential condition of a valid set-off," and for there to be mutuality "the debts must be to and from the same persons and in the same capacity." *Nichols v. Metro. Life Ins. Co.*, 31 N.E.2d 224, 225 (Ohio 1941); *see also Schalmo Constr., Inc. v. A. Bonamase Contracting*, No. 2009-CA-0037, 2009 WL 3004052, at *1 (Ohio Ct. App. Sept. 21, 2009) ("The trial court correctly cited *Nichols v. Metropolitan Life Insurance Company* . . . for the proposition that a set-off, whether legal or equitable, must relate to cross demands in the same right and where there is mutuality of obligation. This means the debts must be to and from the same persons and in the same capacity."). Deciding whether Ohio or federal common law applies to the Federal Payment would require more analysis, but that analysis need not be undertaken here because federal common law, like Ohio law, also requires mutuality, which means that the debts are held by the same parties in the same capacity. *See In re Doctors Hosp. of Hyde Park, Inc.*, 337 F.3d 951, 955 (7th Cir. 2003) ("[C]ommon law setoffs 'are permitted only when the debts are mutual.' [T]he general rule is that mutuality is satisfied when the offsetting obligations are held by the same parties in the same capacity[.]") (cleaned up) (quoting *Soo Line R.R. v. Escanaba & Lake Superior R.R.*, 840 F.2d 546, 551 (7th Cir. 1988)).

If a prepetition transaction is a valid setoff under applicable nonbankruptcy law, § 553 provides the only avenue for recovery from the offsetting creditor. That is, a valid setoff cannot be avoided as a preferential transfer under § 547(b). *See Lee v. Schweiker*, 739 F.2d 870, 873 n.4 (3d Cir. 1984) ("[W]here a setoff right is being asserted, section 553, rather than section 547, governs the creditor's rights."); *Faasoa v. Army & Air Force Exch. Serv. (In re Faasoa)*, 576 B.R. 631, 647 (Bankr. S.D. Cal. 2017) (citing cases, including *Lee*). There is a textual reason for this. The preference provisions apply only if there is a "transfer," 11 U.S.C. § 547(b), and "[c]onspicuously missing from th[e] definition [of transfer] is the term 'setoff.'" *Holyoke Nursing Home, Inc. v. Health Care Fin. Admin. (In re Holyoke Nursing Home, Inc.)*, 273 B.R. 305, 309 (Bankr. D. Mass. 2002), *aff'd*, 372 F.3d 1 (1st Cir. 2004).[6] "The omission was no accident. The legislative history of . . . § 101(54) clearly illustrates that Congress intended to exclude setoff from the 'transfer' definition in order to assure that setoff would be treated exclusively under the provisions of § 553." *Id.*

Also, there are at least two fundamental reasons why this makes sense. First, § 506(a) of the Bankruptcy Code affords the creditor having a right of setoff with secured status to the extent of the amount of the setoff.[7] A prepetition setoff therefore would not enable the creditor to receive

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[6] Under the Bankruptcy Code, the term "transfer" means

> (A) the creation of a lien;
> (B) the retention of title as a security interest;
> (C) the foreclosure of a debtor's equity of redemption; or
> (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—
> (i) property; or
> (ii) an interest in property.

11 U.S.C. § 101(54).

[7] Section 506(a) of the Bankruptcy Code states:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be[.]

more than it would receive in a Chapter 7 case. And under the Bankruptcy Code, there can be no preferential transfer where the transferee would not receive more than it would recover in Chapter 7. *See* 11 U.S.C. § 547(b)(5)(A). Second, because it must involve the offset of mutual debts, a setoff can be thought of as simply a netting transaction. *Campos v. Wells Fargo Bank, N.A.*, 345 B.R. 678, 686 n.8 (E.D. Cal. 2005) ("[U]nder the Federal Bankruptcy code, a set off involves a mere netting-out of counterclaims or reconciliation of accounts and not a transfer of money or property") (cleaned up).

By contrast, if a purported setoff is not found to be a setoff under applicable nonbankruptcy law, it may be avoidable under § 547. *See Durham*, 882 F.2d at 882; *Sarachek v. Luana Sav. Bank (In re Agriprocessors, Inc.)*, 546 B.R. 811, 826 (Bankr. N.D. Iowa 2015), *aff'd*, 547 B.R. 292 (N.D. Iowa 2016), *aff'd sub nom. In re AgriProcessors, Inc.*, 859 F.3d 599 (8th Cir. 2017); s*ee also* 5 *Collier on Bankruptcy* ¶ 553.09[1][b] ("[A]pplication of . . . the preference provisions of section 547 . . . depends on the threshold determination that the 'transfer' in question was not a . . . 'setoff' under relevant nonbankruptcy law and therefore not subject to the limitations on the Code's definition of transfer set forth in section 101."); 3 *Norton Bankr. L. & Prac.* § 73:17 (3d ed. 2025) (emphasis added) ("Where mutuality of debt cannot be established an attempted setoff falls outside the ambit of Code § 553 altogether, although in such a situation the creditor's action may be vulnerable to preference attack under Code § 547.") (cleaned up).

Hancock illustrates how § 547(b) comes into play in the context of purported setoffs involving nonmutual debts. In that case, one federal agency—the IRS—applied the debtors' tax overpayment to a debt they owed another federal agency—the Small Business Administration. *Hancock*, 137 B.R. at 836. The IRS did so based on 31 U.S.C. § 3720A—a statute much like the

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11 U.S.C. § 506(a)(1).

Treasury Offset Program codified in 26 U.S.C. § 6402. *Id.* After reviewing the history and nature of setoff, the *Hancock* court determined that while the IRS's payment to the SBA "was undoubtedly legal and, in ordinary circumstances, would have been unobjectionable," the "debtors' bankruptcy [took that] case out of the realm of ordinary circumstances." *Id.* at 847. The statute, which purported to give the creditor a setoff right, was "not the only Federal statute or Federal policy to be reckoned with here; in the extraordinary circumstances of bankruptcy, Federal bankruptcy laws and bankruptcy policies must also be taken into account." *Id.* Intercepting the debtors' tax refund "had the effect of paying the unsecured debt of SBA in preference to unsecured debts owed to other creditors of the [debtors], in violation of the prime bankruptcy policy of equality of distribution among creditors. Such payments, legal outside bankruptcy, are avoidable in bankruptcy." *Id.* (cleaned up).

The *Hancock* court rejected the unitary creditor theory, seeing "no reason why it should not consider SBA as an entity separate from the IRS[.]" *Id.* Because it saw the federal agencies as two separate entities, *Hancock* concluded that "the obligations [between the SBA and IRS] were not mutual," and "their disposition according to 31 U.S.C. § 3720A [did] not qualify as an allowable setoff." *Id.* The "transaction, whatever it was, was not a 'setoff' for bankruptcy purposes, because . . . there was no mutuality of obligations." *Id.* And since "there [was] no setoff in the first place, no portion of 11 U.S.C. § 553 applies." *Id.* "Therefore, the matter should be dealt with as a preferential transfer under 11 U.S.C. § 547." *Id.*

Though *Hancock*'s take on the unitary creditor theory has not carried the day,[8] its reasoning as to mutuality is airtight. Courts have consistently held that if a purported setoff is not in fact a

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[8] *See In re Nuclear Imaging Sys., Inc.*, 260 B.R. 724, 733–34 (Bankr. E.D. Pa. 2000) ("[T]he vast majority of courts have concluded, within the confines of a bankruptcy case, that all agencies of the United States constitute a single 'unitary creditor' for purposes of setoff under

valid setoff due to lack of mutuality, then it is subject to potential avoidance as a preferential transfer. *See Durham*, 882 F.2d at 882; *Agriprocessors*, 546 B.R. at 826–27; *Nase v. GNC Cmty. Fed. Credit Union (In re Nase)*, 297 B.R. 12, 18–20 (Bankr. W.D. Pa. 2003); *French v. Bank One, Lima N.A. (In re Rehab Project, Inc.)*, 238 B.R. 363, 372–73 (Bankr. N.D. Ohio 1999); *Talbot v. Ohio Student Loan Comm'n (In re Stall)*, 125 B.R. 754, 756–57 (Bankr. S.D. Ohio 1991).[9]

Against this backdrop, the Court must now decide (1) whether the Ohio Setoff and the Federal Payment involved mutual debts, and (2) whether Nealey may recover the money taken through them. The Court will address both the Ohio Setoff and the Federal Payment in turn.

B. The Ohio Setoff

First, the Ohio Setoff. As explained below, because it involved the offset of mutual debts between the State and Nealey, and the State did not improve its position, no part of the Ohio Setoff is recoverable.

Ohio has codified the right of "the state or a political subdivision" to satisfy a debt "for a certified claim . . . that has been filed with the attorney general" by applying a person's state tax refund to that debt. Ohio Rev. Code § 5747.12(A)(2). Here, Whitacre's undisputed testimony established that Nealey's debts to the State were certified for collection by the Ohio Attorney General. Trial at 9:57:22–9:59:55. The State therefore had the right to set off Nealey's 2020 and

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section 553."); s*ee also* 5 *Collier on Bankruptcy* ¶ 553.03 ("A majority of courts apply the unitary creditor theory, reasoning in part that there is only one United States and that all of its agencies act on its behalf as part of a unified government.") (cleaned up).

[9] The cases cited above could be read as holding that § 553 is the touchstone for determining whether a purported setoff satisfies the mutuality requirements. As discussed above, *Collier* takes a contrary view—that courts instead should look to applicable nonbankruptcy law, which in some cases might not impose the strict mutuality requirements that would govern under § 553. *See Orexigen,* 990 F.3d at 752 (requiring strict bilateral mutuality). Here, it makes no difference whether § 553 applies or whether Ohio or federal common law apply, because they all require strict bilateral mutuality.

2021 Ohio tax refunds—that is, the debts it owed Nealey based on her excess state income tax withholdings—against the debts Nealey owed the State under Ohio law. And the State's exercise of that right, by applying those mutual obligations against one another, is a classic example of a setoff.[10] The only question is whether Nealey can recover any part of that setoff from the State.

Because the Ohio Setoff was a valid setoff, in seeking to recover it Nealey is limited to § 553(b), which "provides a basis for recovering a pre-bankruptcy setoff [where] the creditor improved its position within 90 days of bankruptcy." *Hurt v. U.S. Dep't of Hous. & Urb. Dev. (In re Hurt)*, 579 B.R. 765, 770 (Bankr. W.D. Va. 2017). Section 553(b) says that

> if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
>
> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

11 U.S.C. § 553(b)(1). "Insufficiency" is defined as the amount "by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." 11 U.S.C.

[10] One minor wrinkle with mutuality here is that Nealey owed debts to certain State agencies (*e.g.*, the Ohio Department of Job and Family Services), while another State agency (the Ohio Department of Taxation) owed her a debt based on excess income tax withholdings. But for setoff purposes, states and their various departments and agencies are, like the federal government and its departments and agencies, considered a single creditor. *See, e.g.*, *Ossen v. Dep't of Soc. Servs. (In re Charter Oak Assocs.)*, 361 F.3d 760, 772 (2d Cir. 2004) ("[L]ike the federal government, the state of Connecticut acts as a unitary creditor.") (cleaned up); *Wyoming Dep't of Transp. v. Straight (In re Straight)*, 143 F.3d 1387, 1391 (10th Cir. 1998) ("We are convinced the State of Wyoming is not an amalgam of separate, independent, and self-sustaining branches. Like the federal government, in bankruptcy it should be regarded as one unified entity with different arms through which it carries out the affairs of the state."). So the fact that Nealey owed money to one State agency, but was owed money by another, is of no consequence—the debts are mutual all the same.

§ 553(b)(2). In plain English, the insufficiency is the amount by which the creditor is "behind." For example, a creditor is $20,000 "behind" 90 days before the petition date, and there thus is a $20,000 insufficiency at that time, if the debtor owes the creditor $50,000 and the creditor owes the debtor only $30,000, because in that scenario there is $20,000 it is owed that the creditor cannot set off. *Off. Comm. of Unsecured Creditors v. Am. Sterilizer (In re Comptronix Corp.)*, 239 B.R. 357, 360 (Bankr. M.D. Tenn. 1999). But suppose a few days before bankruptcy the debtor now owes the creditor $45,000 and the creditor owes the debtor $50,000; the creditor is now ahead and can set off the full amount of its debt and so has improved its position by the $20,000 that it previously was behind. *See id.* If the creditor takes the setoff, then $20,000 of it would be recoverable.

Under § 553(b), determining whether a creditor improved its position (that is, reduced the insufficiency of its claim) "requires a comparison between the creditor's setoff position at the initial reference point and the day on which any setoff was actually taken." *Hurt*, 579 B.R. at 772 (cleaned up). "[T]he insufficiency calculation for the date of setoff must be completed before the creditor effects the setoff, not afterwards[.]" *Hopkins v. D.L. Evans Bank (In re Fox Bean Co.)*, 287 B.R. 270, 288 (Bankr. D. Idaho 2002), *aff'd*, 144 F. App'x 697 (9th Cir. 2005). The initial reference point here is 90 days before the Petition Date—May 28, 2022—and the Ohio Setoff was completed by June 21, 2022. Although the total amount of Nealey's debt to the State is not clear from the record, let's assume that she owed $10,000 to the State.[11] On both May 28, 2022 and June 21, 2022, the insufficiency would equal the amount of the State's claim against Nealey ($10,000) minus the State's debt to her ($1,311). On May 28, 2022 the insufficiency would equal

[11] This may not be far off. In another adversary proceeding Nealey brought against it, the State submitted documentation showing that the "total overpayment of benefits and mandatory penalty that [Nealey] is ordered to repay is $10,075.00." Adv. Pro. No. 24-2078, Doc. 4-2 at 2.

$8,689. On June 21, 2022, the date of the setoff, nothing had changed. Whatever the amount of the State's claim was against Nealey, there is no evidence that it changed during the period from 90 days before the petition to the date of the setoff, and the State's debt to her was still $1,311, so the insufficiency would still equal $8,689. *See U.S. Dep't of Agric. Rural Hous. Serv. v. Riley*, 485 B.R. 361, 368 (W.D. Ky. 2012) (holding that there was no improvement in position because "there was no change in value between . . . the first moment an insufficiency existed and . . . the date when setoff occurred") (cleaned up); *Comer v. U.S. Soc. Sec. Admin. (In re Comer)*, 386 B.R. 607, 610 (Bankr. W.D. Va. 2008) (same). The State thus did not improve its position.

An example of how the State could have improved its position will help illustrate why it did not do so here. The improvement-in-position test requires courts to compare the creditor's insufficiency at the time it arose (up to 90 days before the petition date) against the creditor's insufficiency on the date of the setoff. *Collier* provides several examples of how a creditor could improve its position via setoff, including this one:

> Suppose a bank had a claim against a debtor for $15,000. At 90 days before the [petition date], the debtor had $10,000 on deposit with the bank. The "insufficiency" at 90 days was thus $5,000. At 30 days before the [petition date], the debtor deposited $4,000 into the account, increasing the balance to $14,000 on deposit and reducing the insufficiency to $1,000. The bank took a setoff against the entire deposit on the 30th day. Because the insufficiency at the time of setoff ($1,000) was less than the insufficiency at 90 days prior to filing ($5,000), the bank improved its position (by $4,000). The trustee may recover the improvement ($4,000), but the bank may keep $10,000 from its setoff ($14,000 less the $4,000 recovered by the trustee).

5 *Collier on Bankruptcy* ¶ 553.09[2][b].

Though not perfectly analogous, Nealey's situation can be thought of in much the same way. Let's say, for example, that on top of her earlier tax overpayment of $1,311, Nealey—perhaps expecting an outsized tax liability—sent an additional $1,000 to the State as a tax payment on June

20, 2022. The next day, the State set off Nealey's tax overpayments (now totaling $2,311) against her various debts to the State. At the initial reference point of 90 days before the Petition Date, the State's insufficiency would have equaled Nealey's total debt of $10,000, minus $1,311. But on the date of setoff, the State's insufficiency would have been Nealey's total debt of $10,000 minus $2,311—$1,000 less than it was at § 553(b)'s initial reference point. In this scenario, Nealey could recover the additional $1,000 she sent to the State, because by also setting off her later tax payment, the State improved its position compared to where it was 90 days before the Petition Date (when it could only have set off Nealey's earlier overpayment of $1,311). The State achieved no such improvement here. The State's insufficiency—the amount by which Nealey's debt to the State exceeded the debt it owed her—did not change from 90 days before the Petition Date until the date of the Ohio Setoff, meaning the State did not improve its position.

Because § 553(b) only allows the trustee or debtor to recover the amount by which a creditor reduced its insufficiency via setoff, and the Ohio Setoff did not reduce the State's insufficiency at all, Nealey cannot recover any amount of her Ohio tax refunds. Having determined that the Ohio Setoff was a valid setoff, and that Nealey cannot recover any part of it, the Court will now turn to the Federal Payment.

C. Because It Did Not Involve Mutual Debts, the Federal Payment Was Not a Setoff Under Applicable Nonbankruptcy Law.

The State's right to receive the Federal Payment arose under 26 U.S.C. § 6402(f)(1), which says in relevant part that "[u]pon receiving notice from any State that a named person owes a covered unemployment compensation debt to such State," the Treasury "shall":

> (A) reduce the amount of any [tax] overpayment payable to such person by the amount of such covered unemployment compensation debt;
>
> (B) pay the amount by which such overpayment is reduced under subparagraph (A) to such State and notify such State of such

> person's name, taxpayer identification number, address, and the amount collected; and
>
> (C) notify the person making such overpayment that the overpayment has been reduced by an amount necessary to satisfy a covered unemployment compensation debt.

26 U.S.C. § 6402(f)(1). The statute defines "covered unemployment compensation debt" to include "past-due debt for erroneous payment of unemployment compensation due to fraud or the person's failure to report earnings which has become final under the law of a State" and "any penalties and interest assessed on such debt." 26 U.S.C. § 6402(f)(4)(A), (C).

Section 6402(f) does not provide setoff rights for one simple reason: It deals with the *federal* government's collection of debts owed to *states*. Because the Treasury and the State are not treated as a single creditor, § 6402(f) does not require mutuality and therefore does not provide a right of setoff under applicable nonbankruptcy law. Although the State owed nothing to Nealey (other than the tax refund discussed above), it nonetheless received her federal tax overpayment through the Treasury Offset Program. Such a transaction, even though authorized by the Internal Revenue Code, is not a setoff under applicable nonbankruptcy law. While the federal government's various departments and agencies are considered a single creditor, and the same holds true for the departments and agencies of state governments, there is no authority for the proposition that a state should be considered the same party as the federal government for the purpose of determining mutuality.

Because the Federal Payment did not involve a mutual debt, it was not a proper setoff under applicable nonbankruptcy law. And if it is not a setoff, then the Federal Payment is not subject to the special rules—the improvement-in-position test—established by § 553. Instead, because the Federal Payment was not based on a mutual debt, it is treated like any other transfer. And like any other transfer, it may be avoided as a preference if it meets the elements of § 547(b) and is not subject to any of the defenses set forth in § 547(c).

D. Nealey Has Standing to Seek Avoidance of the Federal Payment.

Before determining whether the Federal Payment was indeed a preferential transfer, the Court must determine whether Nealey has standing to seek its avoidance in the first place. After all, § 547(b) only enables "the trustee" to avoid preferential transfers. But this is no problem for Nealey, because a different section of the Bankruptcy Code—§ 522(h)—provides:

> *The debtor may avoid a transfer of property of the debtor* or recover a setoff to the extent that the debtor could have exempted such property under [§ 522(g)(1)] if the trustee had avoided such transfer, if—
>
> (1) *such transfer is avoidable by the trustee* under [§ 547] or recoverable by the trustee under [§ 553]; and
>
> (2) *the trustee does not attempt to avoid such transfer*.

11 U.S.C. § 522(h) (emphasis added).

As the Sixth Circuit explained in a more reader-friendly fashion, a debtor

> has standing to avoid a transfer under § 522(h) if five conditions are met: (1) the transfer was not voluntary; (2) the transfer was not concealed; (3) the trustee did not attempt to avoid the transfer; (4) the debtor seeks the avoidance pursuant to [the avoiding powers statutes]; and (5) the transferred property is of a kind that the debtor would have been able to exempt from the estate if the trustee had avoided the transfer[.]

Dickson v. Countrywide Home Loans (In re Dickson), 655 F.3d 585, 592 (6th Cir. 2011).

The Federal Payment was neither voluntary nor concealed, and the trustee never attempted to avoid it. And the transferred property—money—is of a kind that Nealey would have been able to exempt from her bankruptcy estate. As for the fourth element of *Dickson*, Nealey did "ask the Court to . . . have the intercepted tax refunds refunded or returned" as well as "reversed or returned," Compl. at 3, and during the trial she referred to the 90-day preference period. *See* Trial at 9:50:54–9:52:24. "A document filed *pro se* is to be 'liberally construed,' and 'a *pro se* complaint, however inartfully pleaded, must be held to less stringent standards than formal pleadings drafted by lawyers[.]'" *Erickson v. Pardus*, 551 U.S. 89, 94 (2007) (quoting *Estelle v. Gamble*, 429 U.S. 97, 106 (1976)). As the Tenth Circuit explained,

> if the court can reasonably read the pleadings to state a valid claim on which the plaintiff could prevail, it should do so despite the plaintiff's failure to cite proper legal authority, his confusion of various legal theories, his poor syntax and sentence construction, or his unfamiliarity with pleading requirements.

Hall v. Bellmon, 935 F.2d 1106, 1110 (10th Cir. 1991); *see also Campbell v. Bowser*, No. CV 22-3422 (CKK), 2023 WL 3646934, at *2 (D.D.C. May 25, 2023) ("Liberal construction of a *pro se* complaint simply means attempting to parse cogent legal theories from imperfect recitation of legal doctrine."); Fed. R. Civ. P. 8(e) (instructing that all pleadings "must be construed so as to do justice").

With all this in mind, the Court will read Nealey's Complaint, which asks that the Federal Payment be "reversed or returned," Compl. at 3, as seeking to avoid that transfer under § 547(b). That satisfies the only remaining element of *Dickson*, meaning Nealey has standing to seek avoidance of the Federal Payment. Now, the Court will determine whether she may in fact avoid it under § 547.

E. The Federal Payment Is Avoidable and Recoverable as a Preferential Transfer.

Section 547(b) of the Bankruptcy Code allows the trustee (and when authorized to do so by § 522(h), the debtor) to avoid prepetition transfers that meet certain statutory criteria. Subject to exceptions not applicable here, they may

> avoid any *transfer* of *an interest of the debtor in property*—
>
> (1) to or for the benefit of a creditor;

> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made . . . on or within 90 days before the date of the filing of the petition; . . . and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> > (A) the case were a case under chapter 7 of this title;
> >
> > (B) the transfer had not been made; and
> >
> > (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (emphasis added).

Section 547(b) enumerates five elements of a preference claim. But before those elements come into play, two additional, threshold elements must be met: (1) there must first be a "transfer;" and (2) the transfer must be of "an interest of the debtor in property." The Bankruptcy Code broadly defines "transfer" to include "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with . . . (i) property; or (ii) an interest in property." 11 U.S.C. § 101(54)(D). Because it was not a setoff under applicable nonbankruptcy law, the Federal Payment—by which the Treasury sent the federal tax refund to the State rather than Nealey—readily qualifies as an indirect mode of disposing of or parting with property. The Federal Payment therefore was a transfer. *See Campbell v. Small Bus. Admin. (In re Jameson's Foods, Inc.)*, 35 B.R. 433, 436 (Bankr. D.S.C. 1983) (holding that where "there was no mutuality of debt as required by § 553(a) for set off" there was a "transfer . . . within the meaning of § 547(b)").

There also must be a transfer of "an interest of the debtor in property." The Bankruptcy Code does not define that phrase, but the Supreme Court has held that it "is best understood as [describing] that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Begier v. IRS*, 496 U.S. 53, 58 (1990).[12] So when "defining 'an interest of the debtor in property,' the Sixth Circuit looks to 11 U.S.C. § 541(a)(1), which provides that the property of the estate includes all legal or equitable interests of the debtor in property as of the commencement of the case." *Spradlin v. Jarvis (In re Tri-City Turf Club, Inc.)*, 323 F.3d 439, 443 (6th Cir. 2003) (cleaned up).

Property interests are created and defined by state law, unless some federal interest demands otherwise. *Butner v. United States*, 440 U.S. 48, 55 (1979). But the potential property at issue here is a federal tax refund, so any interest Nealey may have in that refund will be defined by federal law. *See, e.g.*, *In re Richardson*, 216 B.R. 206, 211 (Bankr. S.D. Ohio 1997) ("In general, the existence and scope of the debtor's interest in a given asset is determined by state law. However, a claim to a federal tax refund arises under federal law; its nature and existence is determined by federal law."); *Sticka v. Mellon Bank (In re Martin)*, 167 B.R. 609, 612 (Bankr. D. Or. 1994) (same). Because Nealey's interest (if any) in her federal tax refund arises under federal law, that law applies here.

Thus far, the Court has generally used the term "refund" when referring to the amount by which Nealey's federal tax withholding exceeded her tax liabilities for the 2021 tax year. But federal tax law—the law applicable to defining Nealey's interest, if any, in her excess withholdings—distinguishes between tax overpayments and tax refunds. An overpayment is the

[12] *Begier*, and the former version of § 547(b), used the term "property of the debtor," while the current statutory language refers to "an interest of the debtor in property." *See Begier*, 496 U.S. at 56 n.1. But the *Begier* Court "read both the older language ('property of the debtor') and the current language ('an interest of the debtor in property') as coextensive with 'interests of the debtor in property' as that term is used in 11 U.S.C. § 541(a)(1)[.]" *Id.* at 59 n.3. Because the Supreme Court views "property of the debtor" to be synonymous with "an interest of the debtor in property," this Court must do likewise.

amount by which a person's withholdings exceed her tax liabilities in a given tax year. *See Gen. Elec. Co. & Subsidiaries v. United States*, 384 F.3d 1307, 1312 (Fed. Cir. 2004) ("The Internal Revenue Code does not contain a general definition of 'overpayment,' but the Supreme Court has defined the term to mean 'any payment in excess of that which is properly due.'") (quoting *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947)). A refund, on the other hand, "represents the actual amount the government returns to the taxpayer when the taxes collected exceed her liability." *Sexton v. Dep't of Treasury (In re Sexton)*, 508 B.R. 646, 664 (Bankr. W.D. Va. 2014).

Usually, but not always, a person's tax overpayment and refund amount to the same thing. The Internal Revenue Code—indeed, the same statute that authorizes the Treasury Offset Program—provides that "[i]n the case of any overpayment, the Secretary . . . shall, subject to subsections (c), (d), (e), and (f), refund any balance to such person." 26 U.S.C. § 6402(a). Put differently, a person who overpays her income taxes is generally entitled to a refund of the amount she overpaid.

But there is an important caveat to that general principle: Under § 6402(a), a person who makes a tax overpayment is only entitled to a refund "subject to" the application of § 6402(c)–(f).[13] That is, before a person's tax overpayment becomes a tax refund under § 6402(a), the amount of their overpayment "shall" be reduced by, among other debts, the amount of "a covered unemployment compensation debt to [a] State." 26 U.S.C § 6402(f).[14] The statutory requirement that the Treasury apply tax overpayments against certain debts means, in other words, that "a tax refund is the net remaining, after satisfaction of taxpayer's current year's tax liability and other

[13] The right to a refund is also subject to the Treasury's discretion to apply a person's overpayment to any other federal tax liabilities that person may have. *See* 26 U.S.C. § 6402(a).

[14] This assumes that the state or federal agency in question notified the Treasury about the relevant debt, as required by § 6402(c)–(f). Whitacre's testimony and Affidavit, again, established that the State did so as to Nealey's unemployment compensation debt.

government indebtedness certified to the IRS under [the Treasury Offset Program], which the government must then return to the debtor." *Sexton*, 508 B.R. at 664.

Here, Nealey overpaid her federal taxes by $4,299.20. If she had no debts covered by § 6402(c)–(f), she would have become entitled to a tax refund in the full amount of her overpayment. But because Nealey owed the State "a covered unemployment compensation debt," § 6402(f) applied, which in turn required the Treasury to offset Nealey's tax overpayment against that debt. Since § 6402(a) made her right to receive a refund "subject to" § 6402(f), Nealey would only have become entitled to a refund if her tax overpayment exceeded her debt. Unfortunately for Nealey, she owed more to the State than she overpaid in federal income taxes, so she was not entitled to a refund following the application of § 6402(f).[15]

Because she never became entitled to a tax refund under § 6402(a), the Treasury could only have transferred whatever interest Nealey had, if any, in her tax overpayment. But based on a straightforward reading of § 6402(a), debtors have property interests in tax overpayments because they have a contingent right to receive the amount of that overpayment back in the form of a refund. *See, e.g.*, *Lyle v. Santa Clara Cnty. Dep't of Child Support Servs. (In re Lyle)*, 324 B.R. 128, 131 (Bankr. N.D. Cal. 2005) ("[T]he express provisions of the Internal Revenue Code make it clear that the debtor's interest in a refund is contingent on the subsequent statutory determination of what portion of the overpayment, if any, the debtor is entitled to receive as a refund.").

In *Sexton*, the bankruptcy court, without disagreeing that the right to an overpayment is contingent, held that "[t]he debtor's interest in the overpayment and the debtor's right to a refund

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[15] Section 6402(g) bars federal courts from hearing "any action, whether legal or equitable, brought to restrain or review a reduction authorized by subsection (c), (d), (e), or (f)." 26 U.S.C. § 6402(g). But that subsection "does not preclude any . . . action against the Federal agency or State to which the amount of such reduction was paid[.]" *Id.* Because Nealey seeks to recover from the State, to which the overpayment was paid, § 6402(g) does not bar this action.

are both property interests" that "vest in the debtor's bankruptcy estate just as any other interest does." *Sexton*, 508 B.R. at 665. The *Sexton* court explained that "Congress . . . expressly excluded specific property interests from the bankruptcy estate" under § 541(b), and "any property interest not expressly excluded becomes property of the bankruptcy estate—including a debtor's tax overpayment." *Id.* at 662, 664. Later decisions have adopted *Sexton*'s reasoning. *See, e.g.*, *Porter v. IRS (In re Porter)*, 562 B.R. 658, 661 (Bankr. E.D. Va. 2016) (following *Sexton*), *as amended* (Feb. 2, 2017); *Addison v. U.S. Dep't of Agric. (In re Addison)*, 533 B.R. 520, 528 (Bankr. W.D. Va. 2015) (same). And in 2020, the Fourth Circuit, while vacating and remanding a decision that followed *Sexton*, also agreed with *Sexton*'s conclusion that tax overpayments are property of the estate. *See Copley v. United States*, 959 F.3d 118, 122 (4th Cir. 2020). Just one year later, the Fourth Circuit reiterated this view: "The [debtors'] bankruptcy estate . . . includes their tax overpayment, even though the government currently holds those funds." *Wood*, 993 F.3d at 249 (citing *Sexton* and *Addison*).[16]

[16] Some courts, including the Fifth Circuit, have held that when a debtor's "liability exceed[s] the amount of the overpayment, the debtor [is] not entitled to a refund and the tax refund [does] not become property of the estate." *IRS v. Luongo (In re Luongo)*, 259 F.3d 323, 335 (5th Cir. 2001). As *Sexton* pointed out, however, *Luongo* was decided before § 362(b)(26) was added to the Bankruptcy Code in 2005:

> [Under] 11 U.S.C. § 362(b)(26) . . . "the filing of a petition . . . does not operate as a stay . . . of the setoff under applicable nonbankruptcy law of an income tax refund, by a governmental unit, with respect to a taxable period that ended before the date of the order for relief against an income tax liability[.]" Notable to the matters before the Court, Congress enacted section 362(b)(26) *after* the Fifth Circuit's decision in *Luongo*.
>
> [So] the *Luongo* court did not have section 362(b)(26) to consider when it issued its ruling. To now apply its holding that any governmental right to set off under [the Treasury Offset Program] is outside the protections of the Bankruptcy Code because the property did not become a part of the bankruptcy estate renders section

The *Sexton* court's approach is consistent with Sixth Circuit law, which is that "[a] contingent interest is an interest in property that becomes property of the estate under 11 U.S.C. § 541(a)(1) when a bankruptcy petition is filed." *Rankin v. Brian Lavan & Assocs., P.C. (In re Rankin)*, 438 F. App'x 420, 425 (6th Cir. 2011); *see also Williamson v. Jones (In re Montgomery)*, 224 F.3d 1193, 1194–95 (10th Cir. 2000) (observing "Congress' clear intent that contingent interests are to be included in the property of a bankruptcy estate"); 5 *Collier on Bankruptcy* ¶ 553.06[3][b] ("A potential right to a tax refund, even one that is wholly contingent or speculative, nonetheless . . . becomes property of the debtor's bankruptcy estate[.]"). And many courts have applied that principle to tax credits, holding that a debtor's interest in such credits, even if they are not yet payable as a refund, is property of the estate. *See, e.g.*, *Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (In re Prudential Lines Inc.)*, 928 F.2d 565, 572 (2d Cir. 1991) ("The fact that the right to a NOL carryforward is intangible and has not yet been reduced to a tax refund also does not exclude it from the definition of property of the estate. In short, interests whose value is speculative and interests that involve intangible rights that are subject to regulation may be included as property of the estate.") (cleaned up).

Indeed, the Sixth Circuit has held that contingent interests in earned income tax credits are property of the estate despite not being payable as of the petition date. *Johnston v. Hazlett (In re Johnston)*, 209 F.3d 611, 612–13 (6th Cir. 2000); *see also In re Minton*, 348 B.R. 467, 473 (Bankr.

> 362(b)(26) wholly superfluous. If the debtor's interest in a tax overpayment did not become property of that debtor's bankruptcy estate until after the government applied its offset under section 6402(a) of the Tax Code, Congress had no reason to enact section 362(b)(26) to except from the protections of the automatic stay such an offset.

Sexton, 508 B.R. 657, 662–63 (cleaned up).

S.D. Ohio 2006) (collecting cases). So contingent interests are interests of the debtor in property. Debtors have contingent interests in their tax overpayments—even if those overpayments have not been reduced to a refund and it later turns out the debtor is not entitled to any refund under § 6402(a). Because debtors have contingent interests in their tax overpayments, such an overpayment—like Nealey's federal tax overpayment here—is an interest of the debtor in property for purposes of § 547(b). And Nealey's contingent interest in her federal tax overpayment was transferred to the State when the Treasury made the Federal Payment. That is, the Treasury transferred Nealey's overpayment to the State based on a debt Nealey owed the State for unemployment benefits she should not have received. Without that payment, Nealey's interest in her federal tax refund would have vested in Nealey's bankruptcy estate on the Petition Date. *See Sexton*, 508 B.R. at 662 ("By filing her bankruptcy petition on February 13, 2013, which was prior to the Secretary of the Treasury redirecting her overpayment to the Department of Agriculture, all of Ms. Sexton's eligible property, including her interest in the overpayment, vested in her bankruptcy estate and instantly acquired the protections of the automatic stay."). Nealey would have been entitled to exempt her interest in the refund up to the statutory limits, *see Sexton*, 508 B..R. at 666 n.24, and because of the lack of mutuality, the State would not have been entitled to take a postpetition setoff, *see Orexigen*, 990 F.3d at 753. But by way of the Federal Payment, the Treasury took a sum of money Nealey otherwise would have been entitled to receive and remitted it to the State in partial satisfaction of her unemployment compensation debt. And so there was a transfer here.

Having established that the Federal Payment was a transfer of an interest of the debtor in property, the Court can now move to the enumerated elements of a preference claim set forth in § 547(b). The first four of those elements state that to be avoided as a preference, a transfer must have been "(1) to or for the benefit of a creditor," "(2) for or on account of an antecedent debt owed by the debtor before such transfer was made," "(3) made while the debtor was insolvent," and "(4) made . . . on or within 90 days before the [petition date]." 11 U.S.C. § 547(b). Each of those elements is met here.

First, the transfer was made to a creditor. Under the Treasury Offset Program, the Treasury transferred Nealey's federal tax overpayment to the State. 26 U.S.C. § 6402(f)(1)(A). And the State is a creditor of Nealey. The Bankruptcy Code defines "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the [petition date]." 11 U.S.C. § 101(10). As explained above, the State had a claim against (*i.e.*, a right to payment from) Nealey for her overpaid unemployment compensation—a claim that arose long before her bankruptcy. That makes the State a creditor of Nealey. Because the Treasury transferred Nealey's overpayment to the State, and the State was a creditor of Nealey's, the Federal Payment was a transfer to or for the benefit of a creditor.

It was also made for or on account of an antecedent debt. Although the Bankruptcy Code does not define "antecedent debt," courts generally agree it means "a debt incurred before the transfer." *SKK Liquidation Tr. v. Green & Green, LPA (In re Spinnaker Indus., Inc.)*, 328 B.R. 755, 765 (Bankr. S.D. Ohio 2005) (cleaned up). Nealey incurred her debt to the State before the transfer occurred, and the nature of that transfer further supports that conclusion. The Treasury Offset Program, as relevant here, only allows the Treasury to send a person's tax overpayment to a state after receiving notice that the person owes that state a covered unemployment compensation debt. *See* 26 U.S.C. § 6402(f)(1). The transfer happened only after the State provided that notice, so Nealey must have already owed the State a debt when the Treasury transferred her tax overpayment. The Federal Payment was thus made for or on account of an antecedent debt.

As for timing, the State conceded that the Federal Payment took place less than 90 days before the Petition Date. State's Trial Br. at 3. And this bears on Nealey's insolvency as well, because § 547 presumes that debtors were "insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 547(f). The party seeking avoidance is entitled to rely on this presumption absent any evidence to rebut it. *See Spinnaker*, 328 B.R. at 765. The State presented no such evidence, meaning Nealey was presumptively insolvent under § 547(f). The Court therefore finds that the transfer was made within 90 days of the Petition Date and while Nealey was insolvent. Now, on to the last element of a preference.

"Under § 547(b)(5), the plaintiff asserting a preference claim must establish what a creditor would receive in a hypothetical chapter 7 case," and "unless the estate is sufficient to provide a 100% distribution, any unsecured creditor who receives a payment during the preference period is in a position to receive more than it would have received under a chapter 7 liquidation." *Spinnaker*, 328 B.R. at 765 (cleaned up). Here, the State would not have been permitted to set off its nonmutual debt postpetition, *see Orexigen*, 990 F.3d at 753, so the State necessarily received more from the Federal Payment than it would have received in Chapter 7.

The Federal Payment met all the elements of a preference under § 547(b), but that does not necessarily make it avoidable. Section 547(c) of the Bankruptcy Code sets forth preference defenses that prevent certain transfers from being avoided even if they meet all the elements of a preference. But there is no need to undertake a lengthy analysis of those defenses here for two reasons. First, preference defendants must raise § 547(c)'s defenses, and the State failed to do so. And second, even if the State had raised those defenses, they are all inapplicable. The transfer was not intended by Nealey and the State to be a contemporaneous exchange for new value. 11 U.S.C. § 547(c)(1). Nealey's debt to the State arose after she received an overpayment of unemployment compensation benefits, which is not in the ordinary course of business or financial affairs of either party. 11 U.S.C. § 547(c)(2). No security interest was created by the Federal Payment, 11 U.S.C. § 547(c)(3) and (5), nor did the State give new value to or for the benefit of Nealey after the transfer, 11 U.S.C. § 547(c)(4). No statutory lien was fixed here, 11 U.S.C. § 547(c)(6), and while the transfer may well have been a bona fide payment of a debt, Nealey's debt was not for a domestic support obligation, 11 U.S.C. § 547(c)(7). Finally, the value of the transferred property exceeds $600, 11 U.S.C. § 547(c)(8), and Nealey's debts are primarily consumer debts, so the higher $7,575 monetary threshold for avoidability in nonconsumer cases, 11 U.S.C. § 547(c)(9), is not applicable here.

With the elements of § 547(b) satisfied, and no § 547(c) defenses applicable, the Court holds that the Federal Payment was an avoidable preferential transfer. The Court must now determine whether Nealey may recover that transfer from the State.

When it comes to preferential transfers, "avoidance and recovery are distinct concepts and processes." *Suhar v. Burns (In re Burns)*, 322 F.3d 421, 427 (6th Cir. 2003).[17] "[I]f a transfer is preferential under § 547(b) . . . and the exceptions under § 547(c) do not apply, the Court then must look to § 550(a) to determine from whom the trustee may recover either the property transferred or its value." *Spinnaker*, 328 B.R. at 764 (citing *Harrison v. Brent Towing Co. (In re H & S Transp. Co.)*, 939 F.2d 355, 358 (6th Cir. 1991)).

Section 550(a) of the Bankruptcy Code provides that:

> Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 547, . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

[17] Distinct as those concepts may be, "it is appropriate to file an action that seeks both to avoid a transfer under § 547(b) and recover . . . under § 550[.]" *Spinnaker*, 328 B.R. at 764.

> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a).

At first blush, it might seem that Nealey lacks standing to recover under that statute. Just as § 547(b) appears to allow only the trustee to avoid a preferential transfer, § 550(a) appears to allow only the trustee—not the debtor—to recover such a transfer (or its value). But just as § 522(h) allows a debtor to step into the trustee's shoes and avoid a transfer under § 547(b), § 522(i) allows a debtor to step into the trustee's shoes and recover avoided transfers under § 550(a):

> If the debtor avoids a transfer or recovers a setoff under [§ 522(f) or (h)], the debtor may recover in the manner prescribed by, and subject to the limitations of, section 550 of this title, the same as if the trustee had avoided such transfer, and may exempt any property so recovered under [§ 522(b)].

11 U.S.C. § 522(i)(1).

In short, both debtors and trustees may recover avoidable transfers under § 550. And debtors may do even more than that. Although trustees may only recover avoidable transfers "for the benefit of the estate" under § 550(a), a debtor who steps into the trustee's shoes via § 522(i)(1) may claim "any property so recovered" as exempt from her bankruptcy estate. Because exempted assets are not property of the estate, a debtor may retain any property she recovers under § 550 and exempts under § 522(b) for her own benefit. But as the Court will explain in greater detail below, a debtor may only avoid a transfer "to the extent" she can exempt the transferred property, limiting her recovery to what she may exempt under applicable law.

With Nealey's standing to seek recovery under § 550(a) established, the Court must now determine whether and to what extent she can recover the Federal Payment.

Under § 550, preferential transfers (or the value of the transferred property) may be recovered from "the initial transferee of such transfer or the entity for whose benefit such transfer was made." 11 U.S.C. § 550(a)(1). "An initial transferee is one who receives money from a person or entity later in bankruptcy, and has dominion over the funds." *First Nat'l Bank of Barnesville v. Rafoth (In re Baker & Getty Fin. Servs., Inc.)*, 974 F.2d 712, 722 (6th Cir. 1992). "To be deemed an initial transferee for purposes of § 550(a)(1), '[t]he minimum requirement of status as a transferee is dominion over the money or other asset, the right to put the money to one's own purposes.'" *Spinnaker*, 328 B.R. at 766 (quoting *Baker & Getty*, 974 F.2d at 722).

The State was an initial transferee. Although Nealey first sent the overpayment to the Treasury, the preferential transfer at issue here was made between the Treasury and the State. The Treasury sent Nealey's overpayment to the State, which then had total dominion and control over that money and was free to "put the money to [its] own purposes." *Id.* Because the State was an initial transferee of an avoidable preference, Nealey may recover the property transferred to it (*i.e.*, the Federal Payment). But for the reasons explained in the next section, she may not recover the entire amount transferred to the State.

F. The Amount Nealey May Recover Based on the Federal Payment Is Limited to What She May Claim as Exempt.

During the trial, the State's counsel argued that even if Nealey could recover the Federal Payment, § 522(h) would limit her recovery to the amount available for her to exempt. Trial at 10:11:02–10:14:40. The State's position, which Nealey did not dispute, is correct.

While § 522 enables debtors to wield the trustee's avoidance powers and recover preferential transfers, it also limits the extent of that avoidance (and thereby, recovery). First, § 522(h) allows debtors to avoid certain transfers of their property, but only "*to the extent* that the debtor could have exempted such property under [§ 522(g)(1)]." 11 U.S.C. § 522(h) (emphasis added). Section 522(i) then provides that "[i]f the debtor avoids a transfer . . . under [§ 522(h)], the debtor may recover in the manner prescribed by, and subject to the limitations of, section 550[.]" 11 U.S.C. § 522(i). Section 550, in turn, says that a trustee (or debtor, via § 522(i)) may recover the transferred property or its value, but only "*to the extent* that a transfer is avoided[.]" 11 U.S.C. § 550(a) (emphasis added). But as § 522(h) makes clear, a debtor may only avoid preferential transfers "*to the extent* that the debtor could have exempted such property[.]" 11 U.S.C. § 522(h) (emphasis added). So a debtor's recovery is limited to the extent a transfer is avoided, and a debtor may only avoid a transfer to the extent she can claim the transferred property as exempt.

All this means that even when a debtor successfully avoids a preferential transfer, she "can only recover to the extent of any valid exemptions." *Nealy v. Ivy Holdings, LLC (In re Nealy)*, 623 B.R. 278, 284 (Bankr. D.N.J. 2021). As one court explained: "The key words in section 550(a), again, are 'to the extent that a transfer is avoided.' That means only to the extent of the debtor's exemption. It is axiomatic that one can only recover what one has avoided. Thus, [the debtor] can only recover the amount of his exemption." *Wright v. Trystone Cap. Assets, LLC (In re Wright)*, 649 B.R. 625, 630 (Bankr. D.N.J. 2023); *see also In re Andrews*, 605 B.R. 491, 493 (Bankr. S.D. Ohio 2019) ("[T]he Bankruptcy Code gives the Debtor the right to exempt property recovered by the Trustee *only to the extent that he could have exempted such property if such property had not been transferred*.") (emphasis added) (cleaned up).

In short, a debtor may recover an avoidable transfer only to the extent she could have exempted the transferred property (or its value). For Nealey, this means she can recover the Federal Payment only to the extent she could have exempted her tax overpayment. Determining the extent to which Nealey could have exempted her federal tax overpayment will require reviewing Ohio exemption law, along with the exemptions Nealey has already claimed.

Besides enabling debtors to recover avoidable transfers under § 550, § 522(i) of the Bankruptcy Code provides that debtors "may exempt any property so recovered under [§ 522(b)]." 11 U.S.C. § 522(i)(1). Because Ohio has opted out of the federal exemption scheme, the only exemptions available to Nealey are those provided by Ohio law. *Andrews*, 605 B.R. at 493 (citing *Storer v. French (In re Storer)*, 58 F.3d 1125, 1127 (6th Cir. 1995)).

Ohio's exemptions are codified in Section 2329.66 of the Ohio Revised Code. Like other exemption statutes, Section 2329.66 allows a debtor to exempt various property interests, up to specified dollar values. Relevant here, Ohio allows a debtor to exempt up to $550[18] in, among other cash equivalents, tax refunds. Ohio Rev. Code § 2329.66(A)(3). Through what is commonly known as Ohio's wildcard exemption, a debtor may also exempt up to $1,475 of her "aggregate interest in *any property*[.]" Ohio Rev. Code § 2329.66(A)(18) (emphasis added). Between these exemptions, which are the only ones available under Ohio law that might apply to Nealey's tax overpayment, her recovery is limited to $2,025 at most.

The key phrase there is "at most." Nealey can only recover the full $2,025 if she has not already claimed exemptions that reduce the amounts available for her to exempt under Ohio's tax refund and wildcard exemptions. *See Campbell v. Jones (In re Jones)*, 21 B.R. 469, 472 (Bankr. D.S.C. 1982) ("Because the debtors have already claimed, and received, their maximum

[18] The statute lists a maximum exemption amount of $400, but Ohio law provides that the dollar amounts a debtor may claim as exempt are adjusted every three years without any amendment to the statute itself. *See* Ohio Rev. Code § 2329.66(B); *see also In re Breece*, No. 12–8018, 2013 WL 197399, at *3 n.2 (B.A.P. 6th Cir. 2013) (discussing that statute). The current allowances for each type of exemption can be found on the Register of Ohio's website, https://www.registerofohio.state.oh.us/, by clicking the "Ohio Judicial Conference RC 2329.66 Memorandum" link under the "Public Notices" tab.

exemptions in the real estate, they may not now exempt any of the proceeds of the real estate if they were to be recovered (as a voidable preference)[.]"). Section § 522(j) clarifies that if a debtor recovers property via §§ 522(i) and 550, "the debtor may exempt a particular kind of property . . . only to the extent that the debtor has exempted less property in value of such kind than that to which the debtor is entitled under [§ 522(b)]." 11 U.S.C. § 522(j). The meaning of this provision is straightforward:

> [T]he debtor's use of the avoiding powers does not expand the extent of exemptions. . . . If the debtor avoids a transfer of property, and the value of that property exceeds the amount that may be claimed as exempt under the applicable exemption provision, the excess value of the property would remain subject to the transfer. Presumably, the trustee would have some interest in recovering the excess value for the benefit of the estate, but in the absence of such action, the creditor would retain the right to that property.

4 *Collier on Bankruptcy* ¶ 522.12[5]; *see also, e.g.*, *Salaymeh v. Plaza Centro LLC (In re Salaymeh)*, 361 B.R. 822, 831 (Bankr. S.D. Tex. 2007) ("Combined, § 522(g), (h) and (j) make clear that the Debtors may avoid the transfer of the Property only to the extent that they could have exempted the Property. Because the Debtors could only exempt $2,130 in value of the Property, the excess value would remain subject to the transfer to [the transferee].")

This means, in short, that Nealey can only recover what she can still exempt under § 522(b), which, because Ohio law does not authorize debtors to use federal exemptions, is whatever remains available for her to exempt under Ohio law. The Court must therefore consider whether the exemptions Nealey has already claimed draw from either the tax refund or wildcard exemptions, thereby reducing the amount she can recover from the Federal Payment.

On her Schedule C, Nealey claimed just a few exemptions. She claimed exemptions of "100% of fair market value, up to any applicable statutory limit" in "household items" valued at

$1,000, and in "electronic devices" valued at $500. Doc. 31 at 11. She also claimed an exemption in a 2016 Ford Focus, in which she apparently had no equity. *Id.* at 12. Despite listing her 2021 federal and state tax refunds as property on her Schedule A/B, *see id.* at 7, Nealey did not claim those refunds as exempt on her Schedule C, *id.* at 11–12.

Nealey, in sum, has already exempted $1,000 of "household items" and $500 of "electronic devices" from her bankruptcy estate. If those exemptions drew from the tax refund and wildcard exemptions, Nealey's recovery of the Federal Payment would be reduced by the amounts she has already claimed as exempt under Ohio Revised Code Section 2329.66(A)(3) and (18). In other words, if the $1,500 in exempt property Nealey claimed was based on Ohio's tax refund and wildcard exemption statutes, the amount she could further exempt under those categories (based on her avoidance and recovery of the Federal Payment) would be significantly reduced.

Nealey provided no statutory basis for the exemptions she claimed in "household items" and "electronic devices." While the exemption for tax refunds under Ohio Revised Code Section 2329.66(A)(3) is clearly inapplicable to either of those types of property, the wildcard exemption under Section 2329.66(A)(18) could apply to both. But Nealey's already-claimed exemptions also fit under a different subsection of that statute. Subsection (A)(4)(a) allows a debtor to exempt up to "[$700] in any particular item or [$14,875] in aggregate value, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, firearms, and hunting and fishing equipment that are held primarily for the personal, family, or household use of the person[.]" Ohio Rev. Code § 2329.66(A)(4)(a).

Nealey's "household items" would certainly fit under subsection (A)(4)(a), meaning her $1,000 exemption in those items will not reduce the amount she can exempt under Ohio's wildcard exemption. Electronic devices, which do not seem to fall under any other exemption category, are a less obvious fit for the term "household goods." One bankruptcy decision from the Northern District of Ohio defined "household goods" for purposes of Section 2329.66(A)(4)(a) as "items of personal property reasonably necessary for the day to day existence of people in the context of their homes." *In re Szydlowski*, 186 B.R. 907, 911 (Bankr. N.D. Ohio 1995) (cleaned up). Courts applying the "reasonably necessary" test "have repeatedly found TV's and VCR's [*i.e.*, electronics] to be 'necessary' property," making them household goods. *Id.* (collecting cases). At least one Ohio appellate court rejected the "reasonably necessary" test, instead adopting a "functional nexus" test under which property is considered a household good "'where—and only where—the good is used to support and facilitate daily life within the house.'" *Est. of Hersh v. Schwartz*, 959 N.E.2d 1061, 1063 (Ohio Ct. App. 2011) (quoting *McGreevy v. ITT Fin. Servs. (In re McGreevy)*, 955 F.2d 957, 961 (4th Cir. 1992)).

Electronic devices satisfy both tests. In the modern world, electronics are both "reasonably necessary" to people's day to day existence in their homes and "used to support and facilitate daily life within the house" (and beyond). Because Nealey's already-claimed exemptions were plausibly based on different exemption categories, they do not further limit her recovery under the tax refund or wildcard exemptions of Ohio Revised Code Section 2329.66(A)(3) and (18).

In the end, Nealey can recover $2,025—the total amount remaining available for her to exempt under Section 2329.66(A)(3) and (18) of the Ohio Revised Code—but no more. Debtors can only avoid preferential transfers "*to the extent* that the debtor could have exempted such property," 11 U.S.C. § 522(h) (emphasis added), and they can only recover such transfers "to the extent that a transfer is avoided," 11 U.S.C. § 550(a). Thus, debtors can only recover an avoidable transfer to the extent they can exempt the transferred property (or its value). Under Ohio's exemption statutes, a debtor may exempt up to $550 of any tax refund, and up to $1,475 in any property. Ohio Rev. Code § 2329.66(A)(3), (18). With no other exemptions available, $2,025 is all Nealey may recover from the State based on the Federal Payment.

V. Conclusion

Given that the Ohio Setoff was based on a mutual debt and the State did not improve its position by taking that setoff, Nealey cannot recover the Ohio Setoff. Nealey, however, can recover part of the Federal Payment because (1) it was not based on a mutual debt and was therefore not protected as a setoff, and (2) it satisfied all the elements of a preferential transfer while not being subject to any preference defenses. But since a debtor may only avoid preferential transfers to the extent she can exempt the transferred property, Nealey's recovery is limited to what she can exempt under Ohio law—a total of $2,025. Because she can recover no more than that, any amount the State received through the Federal Payment in excess of that $2,025 will remain with the State. The Court will enter a separate judgment entry in accordance with this memorandum opinion and order.

IT IS SO ORDERED.

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