No. 98-130

In the Supreme Court of the United States

OCTOBER TERM, 1997

UNITED STATES OF AMERICA, PETITIONER

v.

CONTINENTAL AIRLINES
THOMAS E. ROSS, TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. a. To justify the minority view that a creditor's setoff rights become extinguished with the confirmation of a plan of reorganization, respondent has devised a novel reading of the Bankruptcy Code. Respondent maintains that a "conflict" exists between Sections 506 and 553 of the Bankruptcy Code (11 U.S.C. 101 *et seq.*) and that this conflict may be "reconciled" by an inference that Congress intended to treat setoff rights the same as secured claims that may be discharged upon confirmation of a plan under Section 1141(c) of the Bankruptcy Code. Br. in Opp. 15-17. None of the cases cited by respondent (*ibid.*) interprets the Code that way and its theory does not comport with the Code's text.

On its face, Section 506 simply determines how much of a creditor's claim involving a setoff right should be afforded status as a "secured" claim: an allowed claim subject to setoff is "a secured claim * * * to the extent of the amount subject to setoff, * * * and is an unsecured claim to the extent that the value of * * * the amount so subject to setoff is less than the amount of such allowed claim." 11 U.S.C. 506. From that language, respondent asserts that a setoff should be treated like any other secured claim, which

may be discharged under Section 1141(c). Br. in Opp. 17. That novel construction, however, is flawed. A setoff enjoys the benefits of a secured claim under the Code, but it is more than that. Judge Friendly has described a right of setoff as "security of the most perfect kind," *In re Yale Express System, Inc.*, 362 F.2d 111, 114 (2d Cir. 1966), and "the finest kind of security," *In re Lehigh & Hudson River Ry.*, 468 F.2d 430, 434 (2d Cir. 1972). Whereas other forms of secured claims, such as liens or mortgages, may be discharged, a setoff right is unaffected by a discharge of debts through liquidation or confirmation of a reorganization plan. Those other forms of secured claims are not subject to any provision comparable to Section 553, which states that "[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title, this title *does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor*." 11 U.S.C. 553(a) (emphasis added). Nothing in Section 506 suggests an intent by Congress to negate the plain language of Section 553.[1] Indeed, nowhere in its opinion does the court below even cite, much less discuss, Section 506. See Pet. App. 1a-17a.

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[1] As 4 *Collier on Bankruptcy* ¶ 506.03[1][b] (15th rev. ed. 1998) explains:

> Conceivably, Congress might have abrogated setoff rights in all bankruptcy proceedings. In practice, Congress has not done so, and two principal policies explain Congress' favorable treatment of setoff rights under the Code. First, a right of setoff is a remedy that has long been recognized and enforced in the commercial world at large, as well as under every one of the nation's bankruptcy acts, in part as a matter of essential fairness, but more importantly in recognition of the right as part of the bundle of substantive rights that may comprise a creditor's claim. Second, recognizing and preserving rights of setoff is thought to lessen the likelihood of a debtor's filing for bankruptcy relief in the first place, thus promoting the policy of bankruptcy avoidance.

b. Ultimately, even respondent's alternative theory turns on the interrelationship between Sections 553 and 1141, because Section 1141 concerns the discharge of secured claims. Yet having adopted for purposes of the brief in opposition a theory of setoff rights not passed upon by any court, respondent essentially abandons the reasoning of the court of appeals in this case. As we explain in the petition (Pet. 10-11), the court below grounded its decision on the erroneous view that property held by the creditor that is subject to a setoff right is nonetheless "property of the estate" under Section 1141. In *Citizens Bank of Maryland* v. *Strumpf*, 516 U.S. 16, 21 (1995), this Court decided as a matter of law that funds held by a creditor subject to a setoff claim are not "property of the estate" for purposes of the automatic stay provision, Section 362(a)(3). As the Court emphasized, a chose in action is not the kind of "property" that nullifies a creditor's setoff right under Section 553: the creditor's "temporary refusal to pay was neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise," which "§ 542(b)'s 'except[ion]' and § 553's general rule were plainly intended to permit." 516 U.S. at 21.

The Court's explanation for that holding is equally applicable in construing "property of the estate" under Section 1141. The reason a secured creditor loses its collateral if not preserved in a confirmed plan is because the debtor's estate owns the property in question. Section 1141(b) applies to cut off the secured creditor's unreserved rights. In the case of setoff, as *Strumpf* makes clear, the debtor's estate owns only a chose in action to recover the funds, not the funds themselves. If a temporary refusal to pay funds that are subject to a setoff claim does not encompass "property of the estate" for purposes of the automatic stay provision, there is no reason why it should be "property of the estate" subject to discharge under Section 1141. The court of appeals' rationale, therefore, is inconsistent with *Strumpf*.

In amending its opinion, the court of appeals acknowledged as a matter of fact that the funds subject to the setoff right were still held by the government when the plan of reorganization was confirmed (Pet. App. 16a); those funds thus were not "property of the estate" within the ordinary meaning of Section 1141(c). Yet the court opined that, "[e]ven though the actual funds themselves may not have passed as property of the bankruptcy estate, upon confirmation of the plan, [respondent] did acquire a claim or interest in them subject only to final resolution of the Government's appeal." Pet. App. 16a-17a. As we explain in the petition (Pet. 11-12), that conclusion turns settled expectations of setoff rights upside down. It takes property over which two entities have competing claims and awards it to the debtor without first adjudicating who rightfully owns it. A debtor's mere claim to ownership of funds held by a creditor when the plan is confirmed cannot, under the reasoning of *Strumpf*, be "property of the estate" subject to discharge under Section 1141(c) over a creditor's competing setoff claim.

2. As we explain in our petition (Pet. 12-14), this case would have come out differently in the Ninth and Tenth Circuits, see *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269 (9th Cir.), cert. denied, 506 U.S. 918 (1992); *In re Davidovich*, 901 F.2d 1533 (10th Cir. 1990) (per curiam), and in the "majority of the courts that have addressed the issue [which] answer that confirmation and discharge do not prohibit the defensive use of setoff in a subsequent action by the debtor. A minority, however, take the opposite view." 5 *Collier on Bankruptcy* ¶ 553.08[1] (15th rev. ed. 1998).

Respondent errs in contending (Br. in Opp. 4) that *In re De Laurentiis* is distinguishable. In that case the Ninth Circuit framed the issue as "which of the two code sections controls"—Section 553 or Section 1141. 963 F.2d at 1275. In adopting the "majority view['s] strong support for the primacy of section 553" (*id.* at 1276), the court expressly rejected (*id.* at 1275) the Third Circuit's decision in *United*

States v. *Norton*, 717 F.2d 767 (1983), and cited as supporting authority (963 F.2d at 1276) the Tenth Circuit's decision in *In re Davidovich, supra.* The Ninth Circuit further noted that several bankruptcy courts "have reached the opposite conclusion, however." 963 F.2d at 1276. As the Ninth Circuit summarized its holding:

> We conclude that section 553 must take precedence over section 1141. In reaching this conclusion, we rely not only on the foregoing persuasive authority, but also on the language and structure of section 553 and the policies which underlie it. Section 553 provides that, with listed exceptions not relevant here, "this title does not affect the right of any creditor to offset a mutual debt. . . ." This language not only establishes a right to setoffs in bankruptcy, subject to enumerated exceptions, but seems intended to control notwithstanding any other provision of the Bankruptcy Code. To give section 1141 precedence would be to ignore this language.

Id. at 1276-1277. Only *after* basing its holding on prevailing judicial precedents and a construction of the Bankruptcy Code did the court cite factual matters that illustrated the "unfairness" of a contrary result. See *id.* at 1277. Thus, the facts upon which respondent tries to "distinguish[]" (see Br. in Opp. 4) the court's decision were not the basis for the Ninth Circuit's ruling.[2]

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[2] In any event, the unfairness of extinguishing the United States' setoff rights here is fully comparable to that found by the court in *In re De Laurentiis* for the creditor there. The United States took steps analogous to those taken by the creditor in *In re De Laurentiis* to preserve its setoff rights. First, respondent points out that in *In re De Laurentiis*, the creditor "timely filed a proof of claim asserting setoff" (Br. in Opp. 4). Similarly here, the United States filed timely proofs of claim and through the proof of claim filed by the Federal Aviation Administration served notice to the debtor and the estate that "[t]he United States reserves its

Similarly unpersuasive is respondent's denial of a conflict with the Tenth Circuit's conclusion in *In re Davidovich*. As our petition notes (Pet. 14), Section 553 controls in Chapter 7 and Chapter 11 bankruptcies alike. The court in *In re Davidovich* made it a point to "reaffirm our holding in [*In re G.S. Omni Corp.*, 835 F.2d 1317 (10th Cir. 1987)] that filing of a proof of claim is not a prerequisite to assertion of a right to setoff under 11 U.S.C. § 553 and hold further that a discharged debt may be setoff upon compliance with the terms and conditions stated in section 553 of the Code." 901 F.2d at 1539. The judgment below cannot be squared with that holding. Whether the order discharging the debtor's debts in bankruptcy is issued under Section 524 (as in *In re Davidovich*) or Section 1141 (as here), Section 553 could not be clearer that "*this title* [Title 11 of the United States Code] *does not affect* any right of a creditor to offset" a mutual debt owed by that creditor to the debtor. 11 U.S.C. 553(a) (emphasis added). Our position is, and the Ninth and Tenth Circuits agree, that the Section 553 setoff right is unaffected by

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right to effect any and all appropriate setoffs." See Pet. 2-3; C.A. App. 40. Such a statement, which was filed without any objection by the debtor, estate, or any creditor, is sufficient "to preserve that right, even under the most stringent standard." See *In re Chateaugay Corp.*, 94 F.3d 772, 777 (2d Cir. 1996). Second, as in *In re De Laurentiis*, there is no question of unfair surprise. Respondent does not contest the fact that many months prior to confirmation the debtor and estate were fully aware that the United States was attempting to preserve and assert its setoff rights against any moneys owed to Continental from the *Alaska Airlines* litigation (*Alaska Airlines, Inc.* v. *Austin*, 801 F. Supp. 760 (D.D.C. 1992), aff'd in part, rev'd in part, 8 F.3d 791 (Fed. Cir. 1993)), before turning those funds over to the estate. See Pet. 4-5 (describing proceedings in the Federal Circuit to preserve the government's setoff rights before plan confirmation). Thus, as in *In re De Laurentiis*, petitioner "pursued its claim diligently before the bankruptcy court at all times" (Br. in Opp. 4 (quoting 963 F.2d at 1271)). See Pet. 5-6 (describing government appeals of orders denying preservation of setoff rights in the district court and court of appeals).

the discharge of debts in bankruptcy, whether through a liquidation or reorganization proceeding. Courts and commentators alike cite and discuss the divergent Third, Ninth, and Tenth Circuit cases to glean the meaning of Section 553 and its relationship to other provisions of the Bankruptcy Code. See Pet. App. 9a-13a; *In re De Laurentiis*, 963 F.2d at 1275-1276; 5 *Collier on Bankruptcy* ¶ 553.08[1].[3] And the Second Circuit has noted a conflict among the courts on whether a "failure to assert a setoff right specifically in a proof of claim is a waiver of that right." *In re Chateaugay Corp.*, 94 F.3d 772, 777 (1996).

3. Respondent devotes much of its brief in opposition to arguing alternative grounds on which an affirmance of the decision below might be based. Br. in Opp. 7-15. Because those assertions involve issues not passed on or decided by the court of appeals, they do not justify a denial of certiorari in light of the conflict in the circuits on the important question the court of appeals did decide. As to each of the alternative grounds, on remand respondent can renew its argument if the Court agrees with petitioner and reverses the court of appeals' judgment.

First, respondent asserts that petitioner "[c]annot [s]et [o]ff [a]gainst [f]unds [w]hich Continental [o]wns." Br. in Opp. 7. That contention addresses the merits of petitioner's underlying claim to setoff, which neither the court of appeals nor the district court addressed because both courts ruled as

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[3] Respondent further suggests that, because "the Third Circuit below merely follows its prior opinion in *Norton*, the situation has not changed since this Court denied certiorari in *De Laurentiis*." Br. in Opp. 5-6. *Strumpf* was decided after *In re De Laurentiis*, however, and it makes clear that the rationale underlying *Norton* is no longer sound. Moreover, because the court below extended *Norton* to extinguish a creditor's setoff rights *after* confirmation of a reorganization plan or discharge of claims, its decision is all the more indistinguishable from *In re DeLaurentiis* or *In re Davidovich*, which upheld the opposite rule. Nor is it consistent with this Court's decision in *Strumpf*.

a matter of law that petitioner's "set-off rights, *if any*, were extinguished upon confirmation of [respondent's] Plan of Reorganization." Pet. App. 14a (emphasis added); *id.* at 30a (emphasis added).

Next, respondent contends that the plan of reorganization "[s]pecifically [p]rohibits [s]etoff without Continental's [c]onsent." Br. in Opp. 8. That contention, on which the court of appeals did not rely (compare Pet. App. 12a-13a with Resp. C.A. Br. 25-26), misreads the plan of reorganization. See Br. in Opp. App. 20a. Paragraph 14.8 of the plan, which respondent quotes (Br. in Opp. 8), speaks only of the reorganized debtor's right to set off payments under the reorganization plan against debts owed to it. That paragraph does not address the setoff rights of creditors. It does not address the funds being sought by respondent in the *Alaska Airlines* litigation (see Pet. 3-4) or purport to distribute those funds to the creditors. Respondent's argument is that because the plan of reorganization specifically refers to the *debtor's* setoff rights against third parties, it should also be read implicitly to encompass the setoff rights of *creditors* against the debtor.[4] Even if that argument had legal support (and respondent cites none), respondent is free to re-argue it on remand after a reversal of the court of appeals' decision.

Third, respondent maintains that petitioner "[w]aived [i]ts [r]ight of [s]etoff," while acknowledging that "[t]he District Court and the Third Circuit did not find it necessary to reach this point." Br. in Opp. 11. That contention too can be ad-

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[4] Respondent also contends that the district court made findings of fact that foreclose petitioner's contention. See Br. in Opp. 10-11 (discussing Pet. App. 29a-30a). Those findings, however, were based on the court's reading of the plan, and petitioner contested that construction in the court of appeals. See Gov't C.A. Br. 26-30; Gov't C.A. Reply 13-14. By deciding the case only on the ground that confirmation of the plan extinguished petitioner's setoff rights, the court of appeals left open any arguments that might be made on remand about how the plan language should be interpreted. See Pet. App. 13a-14a.

dressed on remand. In any event, in arguing that "[t]he right to setoff is waived if not asserted when the creditor elects to participate in the bankruptcy case by filing a claim" (*ibid.*), respondent is merely restating the question on which the courts are divided and which we have presented for this Court's review. See, *e.g.*, *In re Davidovich*, 901 F.2d at 1539 ("filing of a proof of claim is not a prerequisite to assertion of a right to setoff under 11 U.S.C. § 553"). As a factual matter, there was neither any waiver of setoff rights by petitioner nor any unfairness to respondent in the way petitioner sought to preserve those rights. When ordered by the district court in *Alaska Airlines* to pay the estate the funds (before asserting a setoff right), petitioner filed an immediate appeal and (on December 23, 1992) obtained both an emergency stay as to the airlines in the bankruptcy proceedings and, thereafter, a modification of the district court's order from the Court of Appeals for the Federal Circuit. C.A. App. 26-27; *In re Trans World Airlines, Inc.*, 18 F.3d 208, 214-215 (3d Cir. 1994). Four days after the Federal Circuit's order, on April 16, 1993, the reorganization plan was confirmed. Thus, when the plan was confirmed, the debtor was well aware that petitioner had preserved its setoff rights and had no intention of waiving those rights.

Finally, respondent contends that the "[o]bligations [h]ere [l]ack the [m]utuality [r]equired for [s]etoff." Br. in Opp. 13. Respondent's premise is that each federal agency should be treated as a separate creditor. See *id.* at 13-14. The great weight of authority is to the contrary. As this Court held in analogous circumstances in *Cherry Cotton Mills, Inc.* v. *United States*, 327 U.S. 536, 539 (1946), "[w]e have no doubt but that the set-off and counterclaim jurisdiction of the Court of Claims was intended to permit the Government to have adjudicated in one suit all controversies between it and those granted permission to sue it, whether the Government's interest had been entrusted to its agencies of one kind or another." Although *Cherry Cotton Mills* was

decided prior to enactment of the Bankruptcy Code, post-Code court of appeals decisions have applied its reasoning to bankruptcy cases involving multiple federal agencies. See, *e.g.*, *In re HAL, Inc.*, 122 F.3d 851, 853 (9th Cir. 1997); *Turner* v. *Small Bus. Admin.*, 84 F.3d 1294, 1297-1298 (10th Cir. 1996) (en banc).

4. Respondent does not contest the importance of the question presented for the administration of the bankruptcy laws. See Pet. 14-19. Indeed, respondent's rule (Br. in Opp. 17)—that petitioner "needed to object just like any other holder of a secured claim"—invites the very problems we identify in the petition. It is impracticable for the government to monitor every reorganization plan filed in the bankruptcy courts of the Nation and to file an objection to its entry on the chance that a debtor may attempt to assert a claim for monetary payment from a government agency that may be subject to a setoff. It is also contrary to sound practice to promote a rule that will protract bankruptcy proceedings by requiring the holders of setoff rights—both governmental and non-governmental—to monitor, litigate, and object to plans that do not adequately protect those rights. And it is contrary to fundamental principles of bankruptcy law to permit a debtor such as respondent to shield assets from its estate while denying to creditors the opportunity to offset mutual pre-petition debts. Congress sought to prevent such results and to retain the centuries-old protection of creditors' setoff rights when it enacted Section 553.

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For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

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