

IN THE UNITED STATES DISTRICT COURT
DISTRICT OF NEBRASKA

IN THE MATTER OF:)	
)	Case No. 8:06CV602
)	BK Case No. BK04-84228
FLORENCE ROMONA MCCLINTON,)	Adv. Pro. No. 06-8101-TJM
Debtor.)	
)	
)	

BRIEF
IN OPPOSITION TO NEBRASKA WORKFORCE DEVELOPMENT-
DEPARTMENT OF LABOR'S APPEAL OF BANKRUPTCY COURT ORDER

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I. STATEMENT OF ISSUES PRESENTED

Appellee FLORENCE ROMONA MCCLINTON agrees that Appellant NEBRASKA WORKFORCE DEVELOPMENT-DEPARTMENT OF LABOR has satisfactorily stated the legal issue presented by this case through the three questions Appellant posed in its Brief (Doc. No. 8, pages 4-5). Appellee naturally does not adopt the answers Appellant poses to these questions.

II. STATEMENT OF THE CASE

Appellee filed a Motion to Reopen her Chapter 7 Bankruptcy seeking the Bankruptcy Court's permission to file an Adversary Proceeding alleging Appellant violated the bankruptcy discharge injunction through its collection of Appellee's pre-petition unemployment compensation overpayment from Appellee's post-discharge unemployment compensation benefits. (BK Doc. No. 18). On August 29, 2006, the Bankruptcy Court granted the Appellee's Motion to Reopen. (BK Doc. No. 29).

Appellant subsequently filed its Motion for Leave to Appeal, and elected to have its appeal heard by this United States District Court. (BK Docs. No. 33 and 34). While this Motion was pending in the United States District Court, Appellee filed and served her Adversary Complaint on Appellant. (AP Doc. No. 1). Appellant timely answered the Complaint. (AP Doc. No. 6).

Appellee filed a Motion for Summary Judgment on her Adversary Complaint requesting a judgment that Appellant is required as a matter of law to return the money seized post-discharge to Appellee, and enjoining the Appellant from undertaking any further collection activity on the Appellee's pre-petition debt. (AP Doc. No. 10 and 11).

Appellant timely filed its opposition brief pursuant to an extension of time from the Bankruptcy Court. (AP Doc. No. 13 and 15).

The Bankruptcy Court has taken Appellee's Motion for Summary Judgment under advisement. (AP Doc. No. 16). The Adversary Proceeding is stayed until this Court renders its decision. (AP Doc. No. 18).

III. ARGUMENT

Appellee adopts the Standard of Review set forth in Appellant's Brief as the standard applicable to review of her Motion to Reopen. (See, Apex Oil Co. v. Sparks (In re Apex Oil Co.), 406 F.3d 538, 542 (8th Cir. 2005); In re Canal Street Ltd. Partnership 269 B.R. 375, 379 (8th Cir. BAP 2001). This Court must therefore decide whether the Bankruptcy Court made a clear error of judgment by reopening Appellee's bankruptcy case.

Upon consideration of the applicable standard of review, this Court should affirm the Bankruptcy Court's order reopening the case. The Bankruptcy Court was well within its discretion in deciding that the Appellee's unemployment claims before and after her bankruptcy were separate transactions with the Appellant, and concluding that the doctrine of recoupment cannot apply.

Furthermore, this Court should decline to create the purportedly narrowly tailored discharge exception promoted by Appellant for "at-fault" unemployment compensation overpayments. Appellant's argument that fault justifies the application of recoupment ignores this doctrine's prerequisite that a single transaction exists between the parties: this Court need not reach the issue of the relevance of fraud to recoupment because the transactions between the parties were multiple. Additionally, any such exception based

on an unemployment claimant's fault would be factually unsupported in the instant case.

Appellant seeks preferential treatment from this Court because it does not want to be limited to recovering overpayments from only those debtors in whose cases Appellant can plead and prove a fraud discharge exception. States are no less bound by federal bankruptcy law than private parties. This Court should not allow Appellant to grant itself preferential bankruptcy protection.

A. Two Separate Claims for Unemployment Benefits Are Not the Same Transaction

The sole legal issue presented to the Bankruptcy Court upon Appellee's Motion to Reopen was whether Appellant's withholding from Appellee's post-discharge unemployment benefits to recover a pre-petition debt violated the permanent discharge injunction. The Bankruptcy Court allowed Appellee to reopen her case because it found that Appellant's conduct was not a permissible recoupment. Specifically, the Bankruptcy Court decided that two separate claims for unemployment benefits do not constitute one transaction, as is required for recoupment. This decision was within the Bankruptcy Court's discretion and has sound factual and legal bases. Appellant should not be permitted to improperly invoke recoupment to circumvent the protection afforded to Appellee by her Chapter 7 Bankruptcy discharge.

Recoupment is an equitable doctrine which effectively allows a creditor to counterclaim for money owed by the debtor to the creditor as a result of the same transaction. (See, Reiter v. Cooper, 507 U.S. 258, 265 fn.2, 113 S.Ct. 1213 (1994)). It serves as a mitigation of the creditor's damages. (See, PPM Finance, Inc. v. Norandal USA, Inc., 297 F.Supp.2d 1072, 1098 (N.D. Ill. 2004)). Recoupment is defensive, and

does not seek an affirmative judgment. (See, Ed Miller & Sons, Inc. v. Earl, 243 Neb. 708, 502 N.W. 2d 444, 452 (1993).

To justify recoupment in bankruptcy, “both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.” (University Medical Center v. Sullivan (In re University Medical Center), 973 F.2d 1065, 1081 (3rd Cir. 1992); see also, U.S. on Behalf of U.S. Postal Service v. Dewey Freight System, Inc. 31 F.3d 620, 622-623 (8th Cir. 1994); In re NWFEX, Inc., 864 F.2d 593, 597 (8th Cir. 1989). If the claims are two separate transactions, recoupment is inapplicable, and any set-off of a debtor’s pre-petition debt against the creditor’s post-petition obligation is prohibited. (See, In re Gaither, 200 B.R. 847 (Bankr. S.D. Ohio 1996). The involvement of the same parties and a similar subject matter in two claims does not mean that the claims arose from a single transaction. (See, Lee v. Schweiker, 739 F.2d 870 (3rd Cir. 1984); In re Photo Mechanical Services, 179 B.R. 604, 613 (Bankr. D. Minn. 1995).

Recoupment therefore provides an exception to the general rule that all unsecured creditors stand on equal footing in terms of any distribution from the debtor’s estate. (See, In re Centergas, Inc., 172 B.R. 844 (Bankr. N.D. Tex. 1994). In essence, recoupment elevates the creditor to a preferential status over other unsecured creditors. (See, In re NWFEX, Inc., 864 F.2d. 593, 597(8th Cir. 1989).

As such, recoupment should be applied sparingly: “In the bankruptcy setting, permitting a creditor to recoup a pre-petition claim by reducing its obligation to pay for a bankrupt's post-petition services raises serious concerns: ‘A fundamental tenet of bankruptcy law is that a petition for bankruptcy operates as a ‘cleavage’ in time. Once a

petition is filed, debts that arose before the petition may not be satisfied through postpetition transactions.... Any recoupment exception to this general principle perhaps should be narrowly construed.” (U.S. on Behalf of U.S. Postal Service v. Dewey Freight System, Inc. 31 F.3d 620, 623 (8th Cir. 1994) (citation omitted); see, Herod v. Southwest Gas Corp. (In re Gasmark) 193 F.3d 371 (5th Cir. 1999); Conoco, Inc. v. Styler (In re Peterson Distributing, Inc.), 82 F.3d 956 (10th Cir. 1996).

Since recoupment is only applied with caution, this Court must rigorously scrutinize Appellant’s claim that only a single transaction exists between the parties: “Use of this stricter standard for delineating the bounds of a transaction in the context of recoupment is in accord with the principle that this doctrine, as a non-statutory, equitable exception to the automatic stay, should be narrowly construed.” (In re University Medical Center v. Sullivan (In re University Medical Center), 973 F.2d 1065, 1081 (3rd Cir. 1992) (holding defendant Health and Human Services agency could not recoup debtor’s pre-petition debt from post-petition benefits due to the debtor.)

Some courts, when faced with the issue of whether a single transaction exists for purposes of recoupment, have distinguished between contract cases and social benefit cases. Under this line of decisions, if a social welfare statute entitles the debtor to a monetary benefit, recoupment does not apply and the pre-filing overpayment discharges in the bankruptcy. (See, Lee v. Schweiker, 739 F.2d 870 (3rd Cir. 1984); Neavear v. Schweiker, 674 F.2d 1201 (7th Cir. 1982); In re Rowan, 15 B.R. 834 (Bankr. N.D. Ohio 1981). These courts did not allow post-bankruptcy recoupment of overpayments by the Social Security Administration because two separate claims for benefits (even for the same type of social benefits) are not a single transaction.

The case on which Appellant primarily relies, In re Ross, 104 B.R. 171 (E.D. Mo. 1989), departed from the social welfare line of cases in that it allowed recoupment of unemployment benefits overpaid to the debtor before a bankruptcy discharge from the debtor's post-discharge benefits. The In re Ross decision reasoned that unemployment benefits are different from Social Security benefits because they are not the product of the employee's labor. (Id. at 173.) As the debtor had no property right to future benefits, the state's "quasi-contractual" pre-petition claim could be recouped through withholding from post-discharge benefits. (Id.)

Appellant asks this Court to adopt In re Ross so that Appellee's two separate claims for unemployment benefits may be characterized as one transaction with Appellant, and Appellant's post-discharge debt collection was permissible recoupment. However, this Court should decline to extend the In re Ross decision because it draws inaccurate distinctions between Social Security and unemployment benefits, does not recognize that unemployment benefits are directly related to a claimant's labor, and eliminates the necessity of a single transaction for purposes of recoupment.

It should first be noted that In re Ross mistakenly asserts that Social Security benefits are solely the product of the claimant's labor; this is not legally accurate. More specifically, Supplemental Security Income ("SSI") benefits, are awarded under the Social Security Act to those individuals whose disabilities prevent them from sustaining full-time employment, regardless of any employment history. (See, 20 CFR §416.202). A disabled claimant may receive SSI benefits without ever having worked. (Id.)

Furthermore, it is misleading to contend that Nebraska workers do not qualify for unemployment benefits based on their labor history. Appellant would not award a

claimant unemployment benefits if he or she did not have sufficient work history: Nebraska's unemployment law provides that a claimant must have earned \$2,500 in a base period prior to the termination of the claimant's employment to be eligible for benefits. (See, Neb. Rev. Stat. §48-627). The amount of benefits received is also dependent on the claimant's earnings. (See, Neb. Rev. Stat. §48-624). The claimant's labor is therefore directly related to whether he or she is entitled to receive unemployment benefits, and the amount of those benefits.

Significantly, Nebraska's unemployment compensation system is funded in part under the Social Security Act. (See, Neb. Rev. Stat. §48-617). In re Ross, 104 B.R. 171 does not contemplate a state unemployment system administering benefits through the federal Social Security Act. The dependency of Nebraska's unemployment benefit administration on the Social Security Act demonstrates that the distinction drawn by the In re Ross decision between these two types of social benefits is merely illusive. Unemployment benefits fall within the category of social welfare benefits afforded by the Social Security Act.

Finally, the Ross court did not engage in any analysis as to why it implicitly found the debtor's two separate unemployment claims were one transaction so as to allow recoupment. In support of recoupment, the decision states that the debtor did not have a property interest in unemployment benefits, and was at fault in the overpayment. (In re Ross, 104 B.R. 171, 173.) There is no discussion of how either factor affected the court's analysis that the transactions between the parties were single, or any analysis of the stricter standard to be applied in cases of recoupment. Adoption of the In re Ross

standard would eliminate the essential requirement of recoupment, i.e., that a single transaction exists.

Malinowski v. New York State Dept. of Labor (In re Malinowski), 156 F.3d 131 (2nd Cir. 1998) addressed and rejected the rationale applied in the Ross decision. The Malinowski decision, authored by Eighth Circuit Judge John R. Gibson sitting by designation in the Second Circuit, reasoned that since the state's unemployment scheme required claimant to file two different claims based on two discrete periods of employment, these two claims could not also be a single integrated transaction, as is required before the equitable remedy of recoupment can be invoked. While the Malinowski decision discusses the significance of the absence of fraud on the debtor's part, it reaches the conclusion that the two claims are separate transactions independently of that factor: "We simply cannot stretch the requirement of a single transaction, which is central to recoupment, to a lifetime government insurance scheme, which in practical application must be based upon eligibility created by a specific period of employment."

This Court should adopt the Malinowski approach, which explicitly analyzes the nature of the transactions between the parties as is required by the doctrine of recoupment. In re Ross, 104 B.R. 171 (E.D. Mo. 1989) ignores this requirement by basing its decision on the type of social benefits claimed, not the transactions between the parties. For the Appellant to argue that payment of unemployment benefits is a single transaction for purposes of collection, but require claimants to file separate claims based on different periods of employment, is inconsistent and inequitable. Appellee's first unemployment claim is not logically related to her second; the claims involved different amounts of remuneration, benefits payable, employers, and periods of employment.

Instead, these two claims merely involved the same parties, which is an insufficient basis to invoke recoupment.

Thus, a *de novo* review of the Bankruptcy Court's ruling that Appellee's two claims for unemployment benefits from Appellant were not a single transaction leads to the conclusion that the Bankruptcy Court acted within its discretion. This Court should decline to adopt the distinction drawn by the Ross court between cases of unemployment and Social Security benefit overpayments as this distinction is not based in fact, and the Ross decision contains no analysis supporting a finding that the transactions between Appellee and Appellant were multiple.

B. Nebraska's Overpayment Recovery Statute Does Not Defeat Appellee's Bankruptcy Discharge

Appellant contends that it is authorized to recoup Appellee's pre-petition debt from unemployment benefits post-discharge by Neb. Rev. Stat. § 48-665, which states in pertinent part:

“Any person who has received any sum as benefits under the Employment Security Law to which he or she was not entitled shall be liable to repay such sum to the commissioner for the fund. Any such erroneous benefit payments shall be collectible... (2) by offset against any future benefits payable to the claimant...”

It should be noted that this statute does not explicitly authorize “recoupment”: “offset” is the method allowed, which is more similar in definition to setoff than recoupment. (Id.) Contrary to Appellant's current application of this law, Nebraska's statute does not authorize recoupment. This statute's plain and ordinary meaning should be enforced by this Court. (See e.g., BP America Production Co. v. Burton, 127 S.Ct.

638, 643 (2006). Accordingly, recoupment does not exist in the Nebraska statutory scheme for unemployment overpayment recovery.

Even if recoupment were statutorily authorized, Neb. Rev. Stat. § 48-665 bases the recovery methods established therein on the claimant's personal liability for the overpayment. However, it is a fundamental tenet of federal bankruptcy law that Appellee ceased being personally liable for all debts which were not excepted from discharge upon her Chapter 7 discharge. (11 U.S.C. §§523, 524 and 727). This Court should preserve the integrity and importance of the Chapter 7 discharge, which is intended to give the debtor a "fresh start" without further liability for pre-petition debt. (See e.g., Central Virginia Community College v. Katz, 546 U.S. 356, 126 S.Ct. 990, 996 (2006).

11 U.S.C. § 523 lists those debts which are excepted from discharge in a Chapter 7 bankruptcy: unemployment benefit overpayments are not excepted from discharge by Section 523. If the Appellant wished to avail itself of the fraud exception to discharge, it was required by Federal Rule of Bankruptcy Procedure 4007 to file a complaint to determine dischargeability of this debt within 60 days of the first meeting of creditors. (See, Fed R. Bankr. P. 4007(c); see e.g., In re Everly, 346 B.R. 791, 797 (8th Cir. BAP 2006) Appellant did not file such any such complaint in this case, and strongly resists the Bankruptcy Court's decision that Appellant is subject to these requirements simply because a Nebraska statute allowing unemployment overpayment recovery exists.

State actors are not excepted from complying with bankruptcy law: "Under our longstanding precedent, States, whether or not they choose to participate in the proceeding, are bound by a bankruptcy court's discharge order no less than other creditors." (Tennessee Student Assistance Corp. v. Hood, 541 U.S. 440, 448 124 S.Ct.

1905, 1911 (2004) (citation omitted) (holding sovereign immunity doctrine inapplicable to Trustee's adversary proceeding to set aside preferential transfers Debtor made to state schools.) A State must submit to the same bankruptcy requirements as any other party: "If a state desires to participate in the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated." (People of State of New York v. Irving Trust Co., 288 U.S. 329, 333 53 S.Ct. 389, 391 (1933).

Accordingly, a literal application of 11 U.S.C. §523 requires the finding that the Appellee's debt to Appellant discharged. (See e.g., Baker v. United States, 100 B.R. 80, 83 (M.D. Fla. 1989). Appellant's insistence that the Nebraska statute authorizing unemployment overpayment recovery is not affected by federal bankruptcy law ignores the supremacy of the Bankruptcy Act. While there is no actual conflict between Neb. Rev. Stat. § 48-665 and federal bankruptcy law, the Appellant's interpretation and enforcement of this Nebraska statute directly conflicts with federal bankruptcy law. When a state law prevents the accomplishment of the full purpose of a federal law, the state law is preempted. (See e.g., Sears, Roebuck & Co v. O'Brien, 173 F.3d 962 (8th Cir. 1999).

In summary, bankruptcy courts which have allowed recoupment in light of a state's overpayment recovery laws "missed a key distinction between the power of Congress and the power of states to override federal bankruptcy laws." (Malinowski v. New York State Dept. of Labor (In re Malinowski), 156 F.3d 131, fn.2 (2nd Cir. 1998). The Court should not allow Appellant to ignore the federal bankruptcy scheme through

its interpretation and enforcement of Nebraska's unemployment overpayment recovery statute.

C. All Relevant Facts were Undisputed and Properly Considered

11 U.S.C. §350(b) allows a bankruptcy court to reopen a case to accord relief to the debtor. A debtor may reopen a case to file an adversary proceeding seeking relief from a creditor which engages in post-discharge debt collection. (See e.g., In re Hairopoulos 118 F.3d 1240, 1244-1245 (8th Cir. 1997). The bankruptcy court should examine the specific facts and equities of that case in reaching its decision on whether to reopen a case. (See, Apex Oil Co. v. Sparks (In re Apex Oil Co.), 406 F.3d 538, 542 (8th Cir. 2005). It is appropriate to deny a motion to reopen if the movant's position is baseless, and does not involve "any realities in bankruptcy administration." (In re Johnson, 291 F.2d 910, 911 (8th Cir. 1961) (declining to reopen a case since there was no possibility movant would prevail.)

Since Appellee alleged undisputed facts in her Motion to Reopen which demonstrated the likelihood she would prevail in her adversary proceeding, the Bankruptcy Court's decision to reopen the case was factually sound. To prevail on an adversary proceeding seeking damages for violation of this discharge injunction, Appellee must prove that Appellant: 1) had actual knowledge of her bankruptcy, and 2) violated the discharge injunction through collection activities upon discharged debt. (See e.g., In re Hairopoulos 118 F.3d 1240, 1244-1245 (8th Cir. 1997); In re Everly 346 B.R. 791, 797 (8th Cir. BAP 2006); In re Goodfellow 298 B.R. 358, 362 (N.D.Iowa 2003).

In this case, there is no dispute that the Appellant had actual knowledge of the bankruptcy or that it engaged in post-discharge collection activities. These facts squarely

support the Bankruptcy Court's decision to reopen the case, as there was undisputed evidence that a former bankruptcy debtor sought relief from post-discharge collection activities. As discussed above, there is legal basis for the Bankruptcy Court's decision that Appellant did violate the discharge injunction through its post-discharge collection activities. Thus, there was sufficient evidence before the court that Appellee would prevail on her adversary proceeding to support the decision to reopen the case.

The Appellant raises the argument that the Bankruptcy Court erroneously failed to discuss the weight it gave the fact that Appellee is an "at-fault debtor." It is critical to Appellant's argument that it characterizes Appellee thusly, since Appellant asks this Court to adopt a line of cases which apply equitable recoupment in cases of benefit overpayment arising from the debtors' fraud. (See, In re Adamic, 291 B.R. 175 (Bankr. D. Colo. 2003), In re Stratman, 217 B.R. 250 (Bankr. S.D. Ill. 1998); In re Gaither 200 B.R. 847 (Bankr. S.D. Ohio 1996); In re Ross, 104 B.R. 171 (E.D. Mo. 1989); and In re Maine 32 B.R. 452 (Bankr. W.D.N.Y. 1983). The Bankruptcy Court did not err by omitting discussion in its decision of an unproven allegation, especially when that allegation is not relevant to whether a single transaction exists for purposes of recoupment.

Appellant assures this Court it only wants to recoup from those debtors who are "at-fault," and raises this request on a case in which the undisputed evidence is that Appellee incorrectly reported her wages in the total amount of \$144.00. Appellant itself concedes that "fraud on the claimant's part is not proven." (Doc. No. 8, page 16.) Rather, the Notice of Adjudication issued to Appellee by the State of Nebraska stated that she incorrectly reported her wages. (BK Doc. No. 19, Exhibit 1.) The Notice did not inform

Appellee that there was any allegation by the Appellant of misconduct or fraud on the Appellee's part. An incorrect report, or the mere existence of an overpayment, is not evidence of fault. Absent any administrative or judicial finding, there is no evidence of Appellee's fraud, willful misconduct, fault, or misrepresentation in this case.

Even if the Court is disposed to consider Appellant's request that recoupment be allowed pursuant to authority Appellant cites, those cases do not support recoupment in the case at hand. In re Maine, In re Ross, In re Gaither, In re Adamic, and In re Stratman, *supra*, are not on point factually as they each involve specific findings of debtors' fraud or willful misconduct. Without any such evidence in this case, this line of cases is not on point.

Appellant also asks this Court to reverse the Bankruptcy Court based on its failure to find as a matter of fact that the parties were involved in multiple transactions. However, it is a question of law if two obligations result from one transaction so that recoupment may apply. (See e.g., In re American Cent. Airlines Inc., 60 B.R. 587, 591 (Bankr. D. N.D. Iowa 1986). While Appellant disagrees with the Bankruptcy Court's legal conclusion that the two claims were separate, it cannot accurately characterize that conclusion as a mistake of fact.

In summary, this Court should affirm the Bankruptcy Court's decision to afford federal bankruptcy protection to Appellee in response to Appellant's improper attempts to offset Appellee's discharged overpayment from her subsequent claim for benefits. While it is safe to assume that many creditors wish they were not subject to the Bankruptcy Act, there was no error in the Bankruptcy Court's decision that Appellant is subject to the permanent discharge injunction.

IV. CONCLUSION

Appellee FLORENCE ROMONA MCCLINTON respectfully requests that the Court affirm the Order entered by the Bankruptcy Court granting Appellee's Motion to Reopen as Appellant has failed to establish that the Bankruptcy Court abused its discretion.

Appellee Florence Romona McClinton

Dated: March 12, 2007

By: /s/ Katherine Owen

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CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that on this 12th day of March, 2007, I electronically filed the foregoing with the Clerk of the United States District Court using the CM/ECF system, which sent notification of such filing to: John Albin at jalbin@dol.state.ne.us, Thomas A. Ukinski at tukinski@dol.state.ne.us, W. Russell Barger at WBarger@dol.state.ne.us, and the Chapter 7 and U.S. Trustees.

/s/ Katherine Owen

Katherine Owen, #22800