UNIVERSITY OF HOUSTON LAW CENTER

BANKRUPTCY TAX

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Priority of Tax Claims; Interest and Penalties on Tax Claims

Assignment – Class 5 – September 13, 2016 5:30

Assigned reading—All:

1. FOREWORD TO CLASS 5
2. Bankruptcy Code §§ 503(b), 506(b)(2), 507(a)(2), 507(a)(8), 510(c)
3. *United States v. Ron Pair Enterprises*, 489 U.S. 235 (1989)
4. *In re Gift*, 469 B.R. 800 (Bankr. M.D. Tenn. 2012)

Individual reading (to be assigned in class):

1. *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996)
2. *United States v. Noland*, 517 U.S. 535 (1996)

Food for thought (the following questions will form part of the class discussion. Think about them):

Q – On August 1, 2008, Corporation X files a petition under chapter 11 of the Bankruptcy Code. For the tax year 2005, for which a return was timely filed on September 15, 2006, there is a deficiency. Where in the Bankruptcy Code does it say that the IRS is entitled to interest up to the petition date?

Q – Where in the Bankruptcy Code does it say that prepetition penalties on unsecured tax claims are allowed?

Q – Does interest continue to accrue beyond the petition date?

Q – Should X pay the tax, interest and penalties that it owes?

Q – X's return for 2008 is due March 15, 2009. X fails to file a return until May 1, 2009. The return shows a liability. Is X liable for a late filing penalty?

Q – What about postpetition interest?

Q – Should X pay the tax, interest and penalties that it owes?

Q – Prepetition interest on secured tax claims is part of the secured claim. What about postpetition interest?

Q – Do penalties run up to the petition date?

Q – Do penalties on secured tax claims continue to run after the petition?

Q – What would you do to stop the running of postpetition interest [and penalties]?

Q – What is the priority of a claim for prepetition interest?

Q – What about prepetition penalties?

FOREWORD TO CLASS 5

As we saw in Class 1, one of the principles of bankruptcy is equality of treatment of creditors. This doesn't mean that ALL claims receive the same percentage distribution. The Bankruptcy Code generally respects priorities established by either private agreement or by statute. In addition, the Bankruptcy Code sets some of its own priorities.

Let's begin with a simple proposition. The Bankruptcy Code does not create liabilities to creditors. If upon filing a petition the debtor has liabilities to third parties, the claims are generally "allowed" (in most cases the creditor will have to file a "proof of claim" with the court, but the validity of the claim is determined by applicable nonbankruptcy law). For purposes of priority, we should think of all claims as falling into one of five groups.

The first group consists of secured claims. A typical such claim is a mortgage. If appropriately filed in a recording office, the property securing the underlying debt may be sold in the event of default to satisfy the claim of the secured creditor before other creditors are paid out of the proceeds. Depending on the terms of the debt instrument, the secured creditor may have a claim for a deficiency if the proceeds of sale are insufficient, but as to this portion, the creditor has no priority over other unsecured creditors. Tax claims may be secured claims. Tax authorities may file a lien against a delinquent taxpayer after tax has been assessed but not paid. Under just about every local property tax law, real estate taxes are secured by the property subject to tax, and come ahead of consensual mortgages even if the tax liability arises after the mortgage is recorded (that's why the bank makes the mortgagor escrow real estate taxes monthly as part of the mortgage payment).

The next group consists of administrative expense claims. These include the expenses of the bankruptcy, such as professional fees, and expenses incurred in operating the business during the case. These claims do not get satisfied out of the proceeds of the sale of property securing secured claims until the secured creditor is paid his full entitlement from the proceeds. It is theoretically possible that there are not sufficient assets in the estate to pay these claims in full ("administrative insolvency"), but this is rare. Most important, these claims get paid before priority claims of unsecured creditors (discussed next). Accordingly, the bankruptcy lawyers may get paid before the tax collector.

The next group consists of priority unsecured claims. These come behind administrative expense claims but ahead of general unsecured claims. These include a variety of unrelated claims that Congress thought should get paid before other unsecured creditors. Child support is one. Certain unpaid wages and benefits are another. BC § 507(a) sets forth a pecking order. You should look at it. Most important for our purposes is that most taxes receive an eighth priority under BC § 507(a)(8). For example, if there are unpaid income taxes, they will be paid ahead of general unsecured creditors (certain taxes don't receive a priority, generally those that have been sitting around for awhile).

Now we come to general unsecured creditors. These may be investors and lenders who do not have a mortgage, or those who furnished goods and services to the debtor ("trade creditors"). These will be paid the same percentage distribution unless a plan of reorganization gives a particular subgroup more or less favorable treatment. In some cases, the estate turns out to be solvent, and these creditors will receive 100 cents on the dollar, and perhaps interest as well.

The final group is subordinated claims. These claims may be subordinated by contract. Also, the Bankruptcy Code allows the court to subordinate particular claims on equitable grounds. As we will see in class, for awhile, some courts used this power to subordinate all tax penalties to general unsecured claims, but the Supreme Court held that the statute could not tolerate that reading.

How do the foregoing principles relate to tax claims?

When the debtor files, he may have a liability for back taxes, interest and penalties. If there is a dispute, the bankruptcy court may resolve it, but having done so, the tax authority is entitled to be paid the same as any other creditor who is owed money. The question will usually be whether the claim is entitled to a priority.

Under BC § 507(a)(8)(A), most prepetition income taxes are entitled to this priority. Curiously, the section does not explicitly give claims for prepetition interest a priority. Could it be that the claim for prepetition interest is a general unsecured claim? The courts have uniformly reached the conclusion that this would be illogical, and it is now clear that a claim for prepetition interest is entitled to the same priority as the underlying tax.

The same is NOT true for prepetition penalties. BC § 507(a)(8)(G) provides that only penalties for the tax collector's pecuniary loss are entitled to the priority. Thus, if the penalty is in the nature of interest or reimburses the tax authority for actual expenses, it gets the priority. If it is merely punitive, like an add-on late filing penalty or a negligence penalty, the claim is allowed, but it is a general unsecured claim.

Like other prepetition unsecured claims, tax claims are not entitled to postpetition interest on unsecured claims unless there are assets available at the end of the case. This is a big advantage of bankruptcy over an out-of-court workout. Like all other prepetition unsecured claims, tax claims cannot be paid until the liquidation or the consummation of a plan of reorganization except in the rare case that a court orders them to be paid (remember the "first day orders" that allow trust fund taxes to be paid).

In *Ron Pair Enterprises*, that you will read, the Supreme Court held that a secured tax claim is entitled to postpetition interest if the value of the security is sufficient to cover the principal and the interest. Read BC § 506(b) and understand why the court held that postpetition interest on statutory secured claims is allowable the same as interest on any private consensual

secured claim. What would the *Ron Pair* court have said about penalties? What impact does the addition of the words "or state statute" to BC § 506(b) in 2005 have on the answer to that question.

Now let's move to administrative expense taxes, which have their own rules. Under BC § 503(b)(1)(B)(i), an administrative expense includes "any tax…incurred by the estate, whether secured or unsecured…[except for a prepetition tax described in BC § 507(a)(8)]." Thus, postpetition taxes get paid in the ordinary course of business. In somewhat of a surprise, BC § 503(b)(1)(C) sweeps in any fine or penalty relating to such a tax. The administrative priority is not confined to pecuniary loss claims. It is generally understood that the reason for tis is that if penalties are possible the creditors will be diligent in monitoring the debtor's affairs to make sure the debtor keeps current on his tax obligations. Finally, as in the case of BC § 507(a)(8), the statute makes no mention of interest. Once again, the courts have held that if Congress included tax and penalties, it must have intended to include interest as well.

P.H.A.

Supreme Court of the United States
UNITED STATES, Petitioner
v.
RON PAIR ENTERPRISES, INC.
No. 87-1043.

Argued Oct. 31, 1988.
Decided Feb. 22, 1989.

*237 Justice BLACKMUN delivered the opinion of the Court.

In this case we must decide the narrow statutory issue whether § 506(b) of the Bankruptcy Code of 1978, 11 U.S.C. § 506(b) (1982 ed., Supp. IV), entitles a creditor to receive postpetition interest on a nonconsensual oversecured claim allowed in a bankruptcy proceeding. We conclude that it does, and we therefore reverse the judgment of the Court of Appeals.

I

Respondent Ron Pair Enterprises, Inc., filed a petition for reorganization under Chapter 11 of the Bankruptcy Code on May 1, 1984, in the United States Bankruptcy Court for the Eastern District of Michigan. The Government filed timely proof of a prepetition claim of $52,277.93, comprised of assessments for unpaid withholding and Social Security taxes, penalties, and prepetition interest. The claim was perfected through a tax lien on property owned by respondent. Respondent's First Amended Plan of Reorganization, filed October 1, 1985, provided for full payment of the prepetition claim, but did not provide for postpetition interest on that claim. The Government filed a timely objection, claiming that § 506(b) allowed recovery of postpetition interest, since the property securing the claim had a value greater than the amount of the principal debt. At the Bankruptcy Court hearing, the parties stipulated that the claim was oversecured, but the court subsequently overruled the Government's objection. The Government appealed to the United States District Court for the Eastern District of Michigan. That court reversed the Bankruptcy Court's judgment, concluding that the plain language of § 506(b) entitled the Government to postpetition interest.

The United States Court of Appeals for the Sixth Circuit, in its turn, reversed the District Court. 828 F.2d 367 (1987). While not directly ruling that the language of § 506(b) was ambiguous, the court reasoned that reference to pre-Code law was appropriate "in order to better understand *238 the context in which the provision was drafted and therefore the language itself." *Id.*, at 370. The court went on to note that under pre-Code law the general rule was that postpetition interest on an oversecured prepetition claim was allowable only where the lien was consensual in nature. In light of this practice, and of the lack of any legislative history evincing an intent to change the standard, the court held that § 506(b) codified the pre-existing standard, and that postpetition interest was allowable only on consensual claims. Because this result was in direct conflict with the view of the Court of Appeals for the Fourth Circuit, see *Best Repair Co. v. United States*, 789 F.2d 1080 (1986), and with the **1029 views of other courts,[FN1] we granted certiorari, 485 U.S. 958, 108 S.Ct. 1218, 99 L.Ed.2d 420 (1988), to resolve the conflict.

FN1. Most bankruptcy courts interpreting § 506(b) have permitted the holder of an oversecured claim to recover postpetition interest. These courts have considered both state and federal tax liens, see, *e.g.*, *In re Brandenburg*, 71 B.R. 719 (SD 1987); *In re Busone*, 71 B.R. 201 (ED NY 1987); *In*

re Gilliland, 67 B.R. 410 (ND Tex.1986); *In re Hoffman*, 28 B.R. 503 (Md.1983), and private nonconsensual liens, such as judicial and mechanic's liens, see, *e.g.*, *In re Charter Co.*, 63 B.R. 568 (MD Fla.1986); *In re Romano*, 51 B.R. 813 (MD Fla.1985); *In re Morrissey*, 37 B.R. 571 (ED Va.1984). One other Court of Appeals and a leading commentator have taken the position that § 506(b) codifies pre-Code law and distinguishes between consensual and nonconsensual liens in determining the allowance of postpetition interest. See *In re Newbury Cafe, Inc.*, 841 F.2d 20 (CA1 1988), cert. pending, No. 87-1784; 3 Collier on Bankruptcy ¶ 506.05, p. 506-41, and n. 5b (15th ed. 1988).

II

Section 506,[FN2] enacted as part of the extensive 1978 revision of the bankruptcy laws, governs the definition and treatment *239 of secured claims, *i.e.*, claims by creditors against the estate that are secured by a lien on property in which the estate has an interest. Subsection (a) of § 506 provides that a claim is secured only to the extent of the value of the property on which the lien is fixed; the remainder of that claim is considered unsecured.[FN3] Subsection (b) is concerned specifically with oversecured claims, that is, any claim that is for an amount less than the value of the property securing it. Thus, if a $50,000 claim were secured by a lien on property having a value of $75,000, the claim would be oversecured, provided the trustee's costs of preserving or disposing of the property were less than $25,000. Section 506(b) allows a *240 holder of an oversecured claim to recover, in addition to the prepetition amount of the claim, "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."

FN2. Section 506, as amended, reads:

"(a) 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, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value should be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

"(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

"(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

"(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless-

"(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

"(2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." 11 U.S.C. § 506 (1982 ed. and Supp.IV).

FN3. Thus, a $100,000 claim, secured by a lien on property of a value of $60,000, is considered to be a secured claim to the extent of $60,000, and to be an unsecured claim for $40,000. See 3 Collier on Bankruptcy ¶ 506.04, p. 506-15 (15th ed. 1988) ("[S]ection 506(a) requires a bifurcation of a 'partially secured' or 'undersecured' claim into separate and independent secured claim and unsecured claim components").

The question before us today arises because there are two types of secured claims: (1) voluntary (or consensual) secured claims, each created by agreement between the debtor and the creditor and called a "security interest" by the Code, 11 U.S.C. § 101(45) (1982 ed., Supp.IV), and (2) involuntary secured claims, such as a judicial or statutory lien, see **103011 U.S.C. §§ 101(32) and (47) (1982 ed., Supp.IV), which are fixed by operation of law and do not require the consent of the debtor. The claim against respondent's estate was of this latter kind. Prior to the passage of the 1978 Code, some Courts of Appeals drew a distinction between the two types for purposes of determining postpetition interest. The question we must answer is whether the 1978 Code recognizes and enforces this distinction, or whether Congress intended that all oversecured claims be treated the same way for purposes of postpetition interest.

III

Initially, it is worth recalling that Congress worked on the formulation of the Code for nearly a decade. It was intended to modernize the bankruptcy laws, see H.R.Rep. No. 95-595, p. 3 (1977) U.S.Code Cong. & Admin.News 1978 pp. 5787, 5963, 5964 (Report), and as a result made significant changes in both the substantive and procedural laws of bankruptcy. See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 52-53, 102 S.Ct. 2858, 2861-2862, 73 L.Ed.2d 598 (1982) (plurality opinion). In particular, Congress intended "significant changes from current law in ... the treatment of secured creditors and secured claims." Report, at 180. In such a substantial overhaul of the system, it is not appropriate or realistic to expect Congress to have explained with particularity each step it took. Rather, as long as the statutory scheme is coherent and consistent, there generally is no *241 need for a court to inquire beyond the plain language of the statute.

A

[1] The task of resolving the dispute over the meaning of § 506(b) begins where all such inquiries must begin: with the language of the statute itself. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685, 105 S.Ct. 2297, 2301, 85 L.Ed.2d 692 (1985). In this case it is also where the inquiry should end, for where, as here, the statute's language is plain, "the sole function of the courts is to enforce it according to its terms." *Caminetti v. United States*, 242 U.S. 470, 485, 37 S.Ct. 192, 194, 61 L.Ed. 442 (1917). The language before us expresses Congress' intent-that postpetition interest be available-with sufficient precision so that reference to legislative history and to pre-Code practice is hardly necessary.

The relevant phrase in § 506(b) is: "[T]here shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." "Such claim" refers to an oversecured claim. The natural reading of the phrase entitles the holder of an oversecured claim to postpetition interest and, in addition, gives one having a secured claim created pursuant to an agreement the right to reasonable fees, costs, and charges provided for in that agreement. Recovery

of postpetition interest is unqualified. Recovery of fees, costs, and charges, however, is allowed only if they are reasonable and provided for in the agreement under which the claim arose. Therefore, in the absence of an agreement, postpetition interest is the only added recovery available.

This reading is also mandated by the grammatical structure of the statute. The phrase "interest on such claim" is set aside by commas, and separated from the reference to fees, costs, and charges by the conjunctive words "and any." As a result, the phrase "interest on such claim" stands independent of the language that follows. "[I]nterest on such claim" is not part of the list made up of "fees, costs, or *242 charges," nor is it joined to the following clause so that the final "provided for under the agreement" modifies it as well. See *Best Repair Co. v. United States*, 789 F.2d, at 1082. The language and punctuation Congress used cannot be read in any other **1031 way.[FN4] By the plain language of the statute, the two types of recovery are distinct.[FN5]

FN4. The United States Court of Appeals for the Fourth Circuit pointed out in *Best Repair Co.* that, had Congress intended to limit postpetition interest to consensual liens, § 506(b) could have said: "there shall be allowed to the holder of such claim, as provided for under the agreement under which such claim arose, interest on such claim and any reasonable fees, costs or charges." 789 F.2d, at 1082, n. 2. A less clear way of stating this, closer to the actual language, would be: "there shall be allowed to the holder of such claim, interest on such claim and reasonable fees, costs, and charges provided for under the agreement under which such claim arose." *Ibid.*

FN5. It seems to us that the interpretation adopted by the Court of Appeals in this case not only requires that the statutory language be read in an unnatural way, but that it is inconsistent with the remainder of § 506 and with terminology used throughout the Code. Adopting the Court of Appeals' view would mean that § 506(b) is operative only in regard to consensual liens, *i.e.*, that only a holder of an oversecured claim arising from an agreement is entitled to any added recovery. But the other portions of § 506 make no distinction between consensual and nonconsensual liens. Moreover, had Congress intended § 506(b) to apply only to consensual liens, it would have clarified its intent by using the specific phrase, "security interest," which the Code employs to refer to liens created by agreement. 11 U.S.C. § 101(45) (1982 ed., Supp.IV). When Congress wanted to restrict the application of a particular provision of the Code to such liens, it used the term "security interest." See, *e.g.*, 11 U.S.C. §§ 362(b)(12) and (13), 363(a), 547(c)(3)-(5), 552, 752(c), 1110(a), 1168(a), 1322(b)(2) (1982 ed. and Supp.IV).

B

[2] The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 102 S.Ct. 3245, 3250, 73 L.Ed.2d 973 (1982). In such cases, the intention of the drafters, rather than the strict language, controls. *Ibid.* It is clear that allowing postpetition interest on *243 nonconsensual oversecured liens does not contravene the intent of the framers of the Code. Allowing such interest does not conflict with any other section of the Code, or with any important state or federal interest; nor is a contrary view suggested by the legislative history.[FN6] Respondent has not articulated, nor can we discern, any significant reason why Congress would have intended, or any policy reason would compel, that the two types of secured claims be treated differently in allowing postpetition interest.

FN6. See H.R. 6, 95th Cong., 1st Sess. (1977); H.R. 8200, 95th Cong., 1st Sess. (1977); S. 2266, 95th Cong., 1st Sess. (1977). Because the final version of the statute contained the same language as that initially introduced, there was no change during the legislative process that could shed light on the meaning of the allowance of interest. See generally 3 Collier on Bankruptcy ¶ 506.03, pp. 506-7 to 506-12. Neither the Committee Reports nor the statements by the managers of the legislation discuss the question of postpetition interest at all. See Report, at 356; S.Rep. No. 95-989, p. 68 (1978); 124 Cong.Rec. 32398 (1978) (statement of Rep. Edwards); *id.*, at 33997 (statement of Sen. DeConcini).

Justice O'CONNOR, with whom Justice BRENNAN, Justice MARSHALL, and Justice STEVENS join, dissenting.

The Court's decision is based on two distinct lines of argument. First, the Court concludes that the language of § 506(b) of the Bankruptcy Code, 11 U.S.C. § 506(b), is clear and unambiguous. Second, the Court takes a very narrow view of *Midlantic National Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), and its progeny. I disagree with both aspects of the Court's opinion, and with the conclusion to which they lead.

The relevant portion of § 506(b) provides that "there shall be allowed to the holder of [an oversecured] claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." The Court concludes that the only natural reading of § 506(b) is that recovery of postpetition interest is "unqualified." *Ante*, at 1030. As Justice Frankfurter remarked some time ago, however: "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification." *United States v. Monia*, 317 U.S. 424, 431, 63 S.Ct. 409, 412, 87 L.Ed. 376 (1943) (dissenting opinion).

**1035 Although "the use of the comma is exceedingly arbitrary and indefinite," *United States v. Palmer*, 3 Wheat. 610, 638, 4 L.Ed. 471 (1818) (separate opinion of Johnson, J.), the Court is able to read § 506(b) the way that it does only because of the comma following the phrase "interest on such claim." Without this "capricious" bit of punctuation, *In re Newbury Cafe, Inc.*, 841 F.2d 20, 22 (CA1 1988), cert. pending, No. 87-1784, the relevant portion of § 506(b) would read as follows: "there shall be allowed to the holder of [an oversecured] claim, interest on such claim and any reasonable fees, costs, or charges provided*250 for under the agreement under which such claim arose." The phrase "interest on such claim" would be qualified by the phrase "provided for under the agreement under which such claim arose," and nonconsensual liens would not accrue postpetition interest. See *Porto Rico Railway, Light & Power Co. v. Mor*, 253 U.S. 345, 348, 40 S.Ct. 516, 518, 64 L.Ed. 944 (1920) ("When several words are followed by a clause which is applicable as much to the first and other words as to the last, the natural construction of the language demands that the clause be read as applicable to all"). This conclusion is not altered by the fact that the words "and any" follow the phrase "interest on such claim." Those words simply indicate that interest accrues only on the amount of the claim, and not on "fees, costs, or charges" that happen to be incurred by the creditor.

The Court's reliance on the comma is misplaced. "[P]unctuation is not decisive of the construction of a statute." *Costanzo v. Tillinghast*, 287 U.S. 341, 344, 53 S.Ct. 152, 153, 77 L.Ed. 350 (1932). See also *Barrett v. Van Pelt*, 268 U.S. 85, 91, 45 S.Ct. 437, 439, 69 L.Ed. 857 (1925) (" 'Punctuation is a minor, and not a controlling, element in interpretation, and courts will disregard the punctuation of a statute, or re-punctuate it, if need be, to give effect to what otherwise appears to be its purpose and true meaning' "); *Ewing v. Burnet*, 11 Pet. 41, 53-54, 9 L.Ed. 624 (1837) ("Punctuation is a most fallible standard by which to interpret a writing; it may be resorted to when all other means fail; but the court will first take the instrument by its four corners, in order to ascertain its true meaning: if that is not ap-

parent, on judicially inspecting the whole, the punctuation will not be suffered to change it"). Under this rule of construction, the Court has not hesitated in the past to change or ignore the punctuation in legislation in order to effectuate congressional intent. See, *e.g., Simpson v. United States*, 435 U.S. 6, 11-12, n. 6, 98 S.Ct. 909, 912-913, n. 6, 55 L.Ed.2d 70 (1978) (ignoring punctuation and conjunction so that qualifying phrase would modify antecedent followed by comma and the word "or"); *Stephens v. Cherokee Nation*, 174 U.S. 445, 479-480, 19 S.Ct. 722, 734-735, 43 L.Ed. 1041 (1899) (ignoring *251 punctuation so that qualifying phrase would restrict antecedent set off by commas and followed by the word "and").

Although punctuation is not controlling, it can provide useful confirmation of conclusions drawn from the words of a statute. *United States v. Naftalin*, 441 U.S. 768, 774, n. 5, 99 S.Ct. 2077, 2082, n. 5, 60 L.Ed.2d 624 (1979). The Court attempts to buttress its interpretation of § 506(b) by suggesting that any other reading would be inconsistent with the remaining portions of § 506, which "make no distinction between consensual and nonconsensual liens." *Ante*, at 1031, n. 5. But § 506(b), regardless of how it is read, does distinguish between types of liens. The phrase "provided for under the agreement under which such claim arose" certainly refers to consensual liens, and must qualify some preceding language. Even under the Court's interpretation, "reasonable fees, costs, or charges" can only be awarded if provided for in a consensual lien. Thus, limiting postpetition interest to consensual liens simply reinforces a distinction that already exists in § 506(b). For the same reason, I find unavailing the Court's assertion, *ibid.*, that Congress would have used **1036 the phrase "security interest" if it wanted to limit postpetition interest to consensual liens.

In re Gift, 469 B.R. 800

Copy Citation

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March 21, 2012, Decided; March 22, 2012, Filed, Entered

Case No. 11-12310, Chapter 13

Reporter

469 B.R. 800 | 2012 Bankr. LEXIS 1217 | 2012 WL 987288

IN RE: ANNA SHENEATER GIFT, Debtor.

Opinion

[801] Memorandum Opinion

This matter is before the court on the Metropolitan Government of Nashville and Davidson County's ("Metro") Amended Objection to Confirmation of Anna Sheneater Gift's ("Debtor") Chapter 13 Plan. More specifically, Metro, as an oversecured creditor, objects because the debtor's plan does not provide for post-petition interest (12%) and post-petition **penalty** (6%) (for a total of 18% post-petition) on its tax claim pursuant to 11 U.S.C. § 506, 11 U.S.C. § 511, and Tenn. Code Ann. § 67-5-2010 ("T.C.A."). The debtor argues **[802]** that only the 12% interest rate should be applied. For the reasons contained herein, the court GRANTS IN PART AND DENIES IN PART Metro's objection to confirmation. The following constitutes the Court's findings of fact and conclusions of law.

I. Undisputed Facts

The parties submitted this matter to the Court upon stipulations, and no factual matters remain in dispute. Both parties agreed that no witnesses were required, and that they would rely upon the court record and their legal arguments. The relevant facts are limited and very straightforward.

The debtor filed a voluntary petition under Chapter 13 of Title 11 of the U.S. Code on December 13, 2011. Schedule E, attached to the debtor's petition, listed a priority claim held by Metro in the amount of $6,873.14. The debtor's chapter 13 plan provided for payment of the Metro claim in full as a priority claim.

The bankruptcy filings reflect that the debtor's assets significantly exceed her liabilities. Her summary of schedules shows assets totaling $117,725 and liabilities of less than $20,000. Thus, this is an unusual case involving a clearly solvent debtor — a fact that will become particularly important in one aspect of the analysis of the issues. As might be expected with a Chapter 13 case involving a solvent debtor, the debtor's plan provides for payment of 100% of allowed unsecured claims.

On January 9, 2012, Metro filed an objection (and an amended objection) to the debtor's plan, asserting Metro's secured claim was entitled to be paid at 18% interest. Also on January 9, 2012, Metro filed two proofs of claim. As amended on the same day, the Metro claims were for $1,188.41 for 2011 real property taxes and $8,734.93 for 2006 through 2010 property taxes. The proofs of claim both assert that the claims are secured by the debtor's real property valued at $115,100.

The parties agree that Metro is an oversecured creditor, with a statutory lien for delinquent property taxes. The debtor concedes Metro's right to post-petition interest, **see United States v. Ron Pair Enterprises**, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290 (1989), but contests Metro's claim for statutory **penalties**. The parties ask the court to determine if the debtor's plan should provide 12% interest as proposed by the debtor, or the combined 18% rate (12% default interest, plus 6% **penalty**) that Metro seeks.

B. Section 506(b) Analysis

To the extent that Metro's "**penalty**" is a fee, cost or charge, it is subject to the "reasonableness" qualifier in section **506(b)** to determine its priority. If the **penalty** is nothing more than "default interest" with veiled nomenclature, then the interest rate is set by 11 U.S.C. § 511 by reference to T.C.A. § 67-5-2010. [3] Finally, to the extent the **penalty** is not interest and also cannot be categorized as a "fee, cost or charge," then it is not entitled to secured treatment at all. Thus, it is critical to determine how Metro's "**penalty**" fits within the parameters of section **506(b)**.

The 2005 Amendments give nonconsensual lienholders equal treatment to consensual **[808]** lienholders, thereby removing the obstacle that prevented the Sixth Circuit from awarding a county tax lienor's claim for costs and attorney fees in **In re Brentwood Outpatient, Ltd.**, 43 F.3d 256 (6th Cir. 1994). Presumably the Sixth Circuit would have treated nonconsensual lienholders the same as consensual lienholders if section **506(b)** had so permitted at the time. They did not address the nature of a **penalty**, but do not appear to have disagreed with Judge Lundin's decision below that a **penalty** is not a fee, cost, or charge.

Finding that a **penalty** is not provided for in section **506(b)** and therefore not part of an oversecured creditor's postpetition claim is also consistent with the general jurisprudence that awards creditors compensatory amounts, but disallows punitive amounts that most likely are sought at the expense of other creditors. The Sixth Circuit seemed to be persuaded by the logic in Judge Lundin's opinion that it would be contrary to Congressional intent to allow a claim component that is punitive rather than compensatory. The Sixth Circuit indicated in footnote 5 of **Brentwood Outpatient** the following sentiment:

> We need not decide today . . . whether "**penalties**" are in the category of "fees, costs, or charges" created by § **506(b)**. See Judge Lundin's thorough discussion, **Brentwood Outpatient**, 134 B.R. at 272-73. It may be that Congress did not allow for **penalties** in § **506(b)** precisely because they are punitive rather than compensatory.

43 F.3d at 262 n.5.; see also In re Schwegmann Giant Super Markets, 287 B.R. 649 (E.D. La. 2002) (prepayment **penalty** was punitive rather than compensatory and disallowed for oversecured creditor under section **506(b)** as unreasonable "fee").

The Court finds that the term **penalty** has a distinct meaning that does not properly fit within the parameters of "fees, costs, or charges."

III. Summary

Section 502(b) requires the court to allow Metro's claim "as of the date of filing." As of the date of filing, Metro's allowed claim included prepetition interest, fees, costs, charges, and **penalties**. The only additions Metro can make to this amount as an oversecured creditor are exclusively provided for in section **506(b)**. The law surrounding interaction of section 502(b) **[813]** and section **506(b)** when fees, costs, and charges are found to be unreasonable is not totally settled. However, generally only two exceptions allow a creditor to tack on any additional amounts to a claim allowed as of the date of the petition: (1) section **506(b)** for the oversecured creditor, and (2) all creditors, secured or unsecured, in the unusual case where the debtor is solvent. **See In re Dow Corning Corp.**, 456 F.3d 668, 681 (6th Cir. 2006); **Gencarelli v. UPS Capital Bus. Credit**, 501 F.3d 1, 5 (1st Cir. 2007). Because the Court has found that section **506(b)** is a self-contained list and does not include postpetition **penalties**, Metro's postpetition **penalties** are not prioritized as a secured claim. However, given the solvency of the Debtor, the **penalty** is nonetheless allowed as an unsecured claim.

For all the reasons cited here, the Court finds that Metro's objection to confirmation is hereby GRANTED IN PART and DENIED IN PART. The debtor's plan must provide for the statutory interest rate of 12% pursuant to section 511 and T.C.A. § 67-5-2010 on Metro's allowed oversecured claim. Metro is also allowed an unsecured claim for the **penalties** from the petition date through confirmation because of the solvency of this particular debtor. The Court instructs counsel for the debtor to prepare an order not inconsistent with this Court's Memorandum within seven (7) days of entry of the Memorandum.

/s/ Randal S. Mashburn

Randal S. Mashburn

U.S. Bankruptcy Judge

Dated: 03/21/12

518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506, 77 A.F.T.R.2d 96-2562, 64 USLW 4548, 96-1 USTC P 50,322, 35 Collier Bankr.Cas.2d 463, 29 Bankr.Ct.Dec. 271, Bankr. L. Rep. P 76,971, 20 Employee Benefits Cas. 1289, 96 Cal. Daily Op. Serv. 4438, 96 Daily Journal D.A.R. 7158, Pens. Plan Guide (CCH) P 23920J

(Cite as: 518 U.S. 213, 116 S.Ct. 2106)

Supreme Court of the United States

UNITED STATES, Petitioner,

v.

REORGANIZED CF & I FABRICATORS OF UTAH, INC., et al.

No. 95-325.

Argued March 25, 1996.

Decided June 20, 1996.

In Chapter 11 case, Internal Revenue Service (IRS) sought priority for claim for tax liability arising under Internal Revenue Code provision imposing ten percent "tax" on any "accumulated funding deficiency" of certain pension plans. The Bankruptcy Court allowed IRS' claim but denied it priority and subordinated claim to those of all other general unsecured creditors. IRS appealed. The United States District Court for the District of Utah affirmed, and appeal was again taken. The Court of Appeals for the Tenth Circuit, Tacha, Circuit Judge, 53 F.3d 1155, affirmed. Certiorari was granted. The Supreme Court, Justice Souter, held that: (1) "tax" imposed against Chapter 11 debtor was not entitled to seventh priority as "excise tax," but instead was, for bankruptcy purposes, penalty to be dealt with as ordinary, unsecured claim, but (2) IRS' claim was improperly subordinated to claims of other general unsecured creditors.

Affirmed in part and vacated and remanded in part.

Justice Thomas concurred in part and dissented in part with opinion.

West Headnotes

[1] Bankruptcy 51 ⚿2956

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2954 Governmental Claims; Taxes
51k2956 k. Federal Claims. Most Cited Cases

"Tax" imposed against Chapter 11 debtor under Internal Revenue Code provision imposing ten percent "tax" on any accumulated funding deficiency of certain pension plans was not entitled to seventh priority as "excise tax," but instead was, for bankruptcy purposes, penalty to be dealt with as ordinary, unsecured claim; exaction was punishment for unlawful omission. Bankr.Code, 11 U.S.C.A. § 507(a)(7)(E); 26 U.S.C.A. § 4971(a).

[2] Bankruptcy 51 ⚿2956

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2954 Governmental Claims; Taxes
51k2956 k. Federal Claims. Most Cited Cases

Functional examination of Internal Revenue Code provision imposing ten percent "tax" on any accumulated funding deficiency of certain pension plans was appropriate to determine whether exaction was "tax" for priority purposes under Bankruptcy Code; Bankruptcy Act of 1978 revealed no congressional intent to reject generally the interpretive principle that characterizations in Internal Revenue Code are not dispositive in bankruptcy context, and no specific provision that would relieve Court from making functional examination of provision. Bankr.Code, 11 U.S.C.A. § 507(a)(7)(E); 26 U.S.C.A. § 4971(a).

[3] Bankruptcy 51 ⚿2954.1

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2954 Governmental Claims; Taxes
51k2954.1 k. In General. Most Cited Cases

For priority purposes, when determining whether exaction is tax, or penalty or debt, "tax" is enforced

contribution to provide for support of government while "penalty" is exaction imposed by statute as punishment for unlawful act.

[4] Bankruptcy 51 ⟹2967.1

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.1 k. In General. Most Cited Cases

Internal Revenue Service's (IRS) nonpriority, unsecured claim against Chapter 11 debtor, arising from Internal Revenue Code provision imposing ten percent "tax" on any accumulated funding deficiency of certain pension plans, was improperly subordinated to claims of other general unsecured creditors; categorical subordination of IRS' claim was beyond scope of court's authority. Bankr.Code, 11 U.S.C.A. § 510(c).

[5] Bankruptcy 51 ⟹2967.5

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.5 k. Inequitable Conduct. Most Cited Cases

Categorical reordering of priorities that takes place at legislative level of consideration is beyond scope of judicial authority to order equitable subordination. Bankr.Code, 11 U.S.C.A. § 510(c).

****2107 *213 Syllabus*** [FN*]

FN* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

The Employee Retirement Income Security Act of 1974 obligated CF & I Steel Corporation and its subsidiaries (CF & I) to make certain annual funding contributions to pension plans they sponsored. The required contribution for the 1989 plan year totaled some $12.4 million, but CF & I failed to make the payment and petitioned the Bankruptcy Court for Chapter 11 reorganization. The Government filed, *inter alia*, a proof of claim for tax liability arising under § 4971(a) of the Internal Revenue Code, 26 U.S.C. § 4971(a), which imposes a 10 percent "tax" (of $1.24 million here) on any "accumulated funding deficiency" of plans such as CF & I's. The court allowed the claim but rejected the Government's argument that the claim was entitled to seventh priority as an "excise tax" under § 507(a)(7)(E) of the Bankruptcy Code, 11 U.S.C. § 507(a)(7)(E), finding instead that § 4971 created a penalty that was not in compensation for pecuniary loss. The Bankruptcy Court also subordinated the § 4971 claim to those of all other general unsecured creditors, on the supposed authority of the Bankruptcy Code's provision for equitable subordination, 11 U.S.C. § 510(c), and later approved a reorganization plan for CF & I giving lowest priority (and no money) to claims for noncompensatory penalties. The District Court and the Tenth Circuit affirmed.

Held:

1. The "tax" under § 4971(a) was not entitled to seventh priority as an "excise tax" under § 507(a)(7)(E), but instead is, for bankruptcy purposes, a penalty to be dealt with as an ordinary, unsecured claim. Pp. 2110-2114.

**2108 (a) Here and there in the Bankruptcy Code Congress has referred to the Internal Revenue Code or other federal statutes to define or explain particular terms. It is significant that Congress included no such reference in § 507(a)(7)(E), even though the Bankruptcy Code provides no definition of "excise," "tax," or "excise tax." This absence of any explicit connection between §§ 507(a)(7)(E) and 4971 is all the more revealing in light of this Court's history of interpretive practice in determining whether a "tax" so called in the statute creating it is also a "tax" for the purposes of the bankruptcy laws. Pp. 2110-2111.

*214 (b) That history reveals that characterizations in the Internal Revenue Code are not dispositive in the bankruptcy context. In every case in which the Court considered whether a particular exaction called a "tax" in the statute creating it was a tax for bankruptcy purposes, the Court looked behind the label and rested its answer directly on the operation of the provision. See, *e.g., United States v. New York,* 315 U.S. 510, 514-517, 62 S.Ct. 712, 714-716, 86 L.Ed. 998. Congress has given no statutory indication that it intended a different interpretive method for reading terms used in the Bankruptcy Act of 1978, see *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 501, 106 S.Ct. 755, 759-760, 88 L.Ed.2d 859, and the Bankruptcy Code's specific references to the Internal Revenue Code indicates that no general cross-identity was intended. The Government suggests that the plain texts of §§ 4971 and 507(a)(7)(E) resolve this case, but this approach is inconsistent with this Court's cases, which refused to rely on statutory terminology, and is unavailing on its own terms, because the Government disavows any suggestion that the use of the words "Excise Taxes" in the title of the chapter covering § 4971 or the word "tax" in § 4971(a) is dispositive as to whether § 4971(a) is a tax for purposes of § 507(a)(7)(E). The Government also seeks to rely on a statement from the legislative history that all taxes "generally considered or expressly treated as excises are covered by"§ 507(a)(7)(E), but § 4971 does not call its exaction an excise tax, and the suggestion that taxes treated as excises are "excise tax[es]" begs the question whether the exaction is a tax to begin with. There is no basis, therefore, for avoiding the functional examination that the Court ordinarily employs. Pp. 2111-2113.

(c) The Court's cases in this area look to whether the purpose of an exaction is support of the government or punishment for an unlawful act. If the concept of a penalty means anything, it means punishment for an unlawful act or omission, and that is what this exaction is. The § 4971 exaction is imposed for violating a separate federal statute requiring the funding of pension plans, and thus has an obviously penal character. Pp. 2113-2114.

(d) The legislative history reflects the statute's punitive character. P. 2114.

2. The subordination of the Government's § 4971 claim to those of the other general unsecured creditors pursuant to § 510(c) was error. Categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c). Pp. 2114-2115.

53 F.3d 1155, vacated and remanded.

SOUTER, J., delivered the opinion for a unanimous Court with respect to Part III, the opinion of the Court with respect to Parts I, II-A, II-B, *215 and II-C, in which REHNQUIST, C.J., and STEVENS, O'CONNOR, SCALIA, KENNEDY, GINSBURG, and BREYER, JJ., joined, and the opinion of the Court with respect to Part II-D, in which REHNQUIST, C.J., and STEVENS, O'CONNOR, KENNEDY, GINSBURG,O'CONNOR, KENNEDY, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed an opinion concurring in part and dissenting in part, *post,* p. 2115.
Kent L. Jones, Washington, DC, for petitioner.

Steven Jack McCardell, Salt Lake City, UT, for respondents.

For U.S. Supreme Court briefs, see:1996 WL 27792 (Pet.Brief)1996 WL 74179 (Resp.Brief)**2109 1996 WL 115725 (Reply.Brief)

Justice SOUTER delivered the opinion of the Court.[FN*]

FN* **Justice SCALIA** joins all but Part II-D of this opinion.

This case presents two questions affecting the priority of an unsecured claim in bankruptcy to collect an exaction under 26 U.S.C. § 4971(a), requiring a

payment to the Internal Revenue Service equal to 10 percent of any accumulated funding deficiency of certain pension plans: first, whether the exaction is an "excise tax" for purposes of 11 U.S.C. § 507(a)(7)(E) (1988 ed.), [FN1] which at the time relevant here gave seventh priority to a claim for such a tax; and, second, whether principles of equitable subordination support a categorical*216 rule placing § 4971 claims at a lower priority than unsecured claims generally. We hold that § 4971(a) does not create an excise tax within the meaning of § 507(a)(7)(E), but that categorical subordination of the Government's claim to those of other unsecured creditors was error.

> FN1. Section 304(c) of the Bankruptcy Reform Act of 1994, 108 Stat. 4132, added a new seventh priority and moved the provision relevant here from seventh (§ 507(a)(7)) to eighth priority (§ 507(a)(8)), without altering any of the language germane to this case. The parties agree that this change from seventh to eighth priority does not affect this case because it arose under the pre-1994 Bankruptcy Code, and we accordingly refer to the provision in question as § 507(a)(7), to reflect its codification at the time in question.

I

The CF & I Steel Corporation and its nine subsidiaries (CF & I) sponsored two pension plans, with the consequence that CF & I was obligated by the Employee Retirement Income Security Act of 1974 (ERISA), 88 Stat. 935, 29 U.S.C. § 1001 *et seq.*, to make certain annual minimum funding contributions to the plans based on the value of the benefits earned by its employees. See 29 U.S.C. § 1082; 26 U.S.C. § 412. The annual payments were due each September 15th for the preceding plan year, see 26 CFR § 11.412(c)-12(b) (1995), and on September 15, 1990, CF & I was required to pay a total of some $12.4 million for the year ending December 31, 1989. The day passed without any such payment, and on November 7, 1990, CF & I petitioned the United States Bankruptcy Court for the District of Utah for relief under Chapter 11 of the Bankruptcy Code, in an attempt at financial reorganization prompted in large part by the company's inability to fund the pension plans. *In re CF & I Fabricators of Utah, Inc.*, 148 B.R. 332, 334 (Bkrtcy.D.Utah 1992).

In 1991, the IRS filed several proofs of claim for tax liabilities, one of which arose under 26 U.S.C. § 4971(a), imposing a 10 percent "tax" (of $1.24 million here) on any "accumulated funding deficiency" of certain pension plans. [FN2] The *217 Government sought priority for the claim, either as an "excise tax" within the meaning of 11 U.S.C. § 507(a)(7)(E) (1988 ed.), or as a tax penalty in compensation for pecuniary loss under § 507(a)(7)(G). CF & I disputed each alternative, and by separate adversary complaint asked the Bankruptcy Court to subordinate the § 4971 claim to those of general unsecured creditors.

> FN2. The Government also filed a claim under § 4971(b), which imposes an exaction of 100 percent of the accumulated funding deficiency if the deficiency is not corrected before the notice of deficiency under § 4971(a) is mailed or the exaction under § 4971(a) is assessed. For the plan year ending December 31, 1989, the claimed tax liability under § 4971(b) was thus $12.4 million. In addition, the Government filed a claim for an accumulated funding deficiency for the plan year ending December 31, 1990, in the approximate amount of $25.6 million ($12.4 million for 1989 plus an additional deficiency of $13.2 million for 1990); the liability claimed under § 4971(a) for 1990 was therefore $2.56 million, and under § 4971(b) the full $25.6 million. The Bankruptcy Court disallowed all of these additional claims (for reasons not pertinent here), see *In re CF & I Fabricators of Utah, Inc.*, 148 B.R. 332, 341

> (Bkrtcy.Ct.C.D.Utah 1992), and the Government has not sought review of its ruling. Thus, though the Government filed four § 4971 claims in the Bankruptcy Court, we focus on the one at issue here, the § 4971(a) claim for the deficiency in the 1989 plan year.

The Bankruptcy Court allowed the Government's claim under § 4971(a) but denied it any priority under § 507(a)(7), finding the liability neither an "excise tax" under § 507(a)(7)(E) nor a tax penalty in compensation**2110 for actual pecuniary loss under § 507(a)(7)(G). Instead, the court read § 4971 as creating a noncompensatory penalty, 148 B.R., at 340, and by subsequent order subordinated the claim to those of all other general unsecured creditors, on the supposed authority of the Bankruptcy Code's provision for equitable subordination, 11 U.S.C. § 510(c).

The Government appealed to the District Court for the District of Utah, pressing its excise tax theory and objecting to equitable subordination as improper in the absence of Government misconduct. While that appeal was pending, CF & I presented the Bankruptcy Court with a reorganization plan that put the § 4971 claim in what the plan called Class 13, a special category giving lowest priority (and no money) to claims for nonpecuniary loss penalties; but it also provided that, if the court found subordination behind general unsecured claims to be inappropriate, the § 4971 claim would be ranked with them in what the reorganization plan *218 called Class 12 (which would receive some funds). Appellees' App. in No. 94-4034 et al. (CA10), pp. 96-101, 137-141, 197-200. The United States objected, but the Bankruptcy Court affirmed the plan. The Government appealed this order as well, and the District Court affirmed both the denial of excise tax treatment and the subsequent subordination to general unsecured claims. App. to Pet. for Cert. A-11. The Tenth Circuit likewise affirmed. 53 F.3d 1155 (1995).

We granted certiorari, 516 U.S. 1005, 116 S.Ct. 558, 133 L.Ed.2d 458 (1995), to resolve a conflict among the Circuits over whether § 4971(a) claims are excise taxes within the meaning of § 507(a)(7)(E), and whether such claims are categorically subject to equitable subordination under § 510(c).[FN3] We affirm on the first question but on the second vacate the judgment and remand.

> FN3. Compare *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (C.A.6 1991), cert. denied*sub nom. Krugliak v. United States*, 502 U.S. 1092, 112 S.Ct. 1165, 117 L.Ed.2d 412 (1992), with *In re Cassidy*, 983 F.2d 161 (C.A.10 1992); *In re C-T of Va., Inc.*, 977 F.2d 137 (C.A.4 1992).

II

[1] The provisions for priorities among a bankrupt debtor's claimants are found in 11 U.S.C. § 507, subsection (a)(7) of which read, in relevant part, that seventh priority would be accorded to

"allowed unsecured claims of governmental units, only to the extent that such claims are for-

. . . . .

"(E) an excise tax on-

"(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

"(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition."

*219 What the Government here claims to be an excise tax obligation arose under 26 U.S.C. § 4971(a), which provides that

"[f]or each taxable year of an employer who maintains a [pension] plan ... there is hereby imposed a tax of 10 percent (5 percent in the case of a

> multiemployer plan) on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year."

No one denies that Congress could have included a provision in the Bankruptcy Code calling a § 4971 exaction an excise tax (thereby affording it the priority claimed by the Government); the only question is whether the exaction ought to be treated as a tax (and, if so, an excise) without some such dispositive direction.

A

Here and there in the Bankruptcy Code Congress has included specific directions that establish the significance for bankruptcy law of a term used elsewhere in the federal statutes. Some bankruptcy provisions deal specifically with subjects as identified by terms defined outside the Bankruptcy Code; 11 U.S.C. § 523(a)(13), for example, addresses "restitution issued under title 18, United **2111 States Code," and § 507(a)(1) refers to "any fees and charges assessed against the estate under chapter 123 of title 28." Other bankruptcy provisions directly adopt definitions contained in other statutes; thus §§ 761(5), (7), and (8) adopt the Commodity Exchange Act's definitions of "commodity option," "contract market," "contract of sale," and so on. Not surprisingly, there are places where the Bankruptcy Code makes referential use of the Internal Revenue Code, as 11 U.S.C. § 101(41)(C)(i) does in referring to "an employee pension benefit plan that is a governmental plan, as defined in section 414(d) of the Internal Revenue Code," and as § 346(g)(1)(C) does in providing for recognition of a gain or loss "to the *220 same extent that such transfer results in the recognition of gain or loss under section 371 of the Internal Revenue Code."

It is significant, therefore, that Congress included no such reference in § 507(a)(7)(E), even though the Bankruptcy Code itself provides no definition of "excise," "tax," or "excise tax." This absence of any explicit connector between §§ 507(a)(7)(E) and 4971 is all the more revealing in light of the following history of interpretive practice in determining whether a "tax" so called in the statute creating it is also a "tax" (as distinct from a debt or penalty) for the purpose of setting the priority of a claim under the bankruptcy laws.

B

[2] Although § 507(a)(7), giving seventh priority to several different kinds of taxes, was enacted as part of the Bankruptcy Act of 1978, 92 Stat. 2590 (1978 Act), a priority provision for taxes was nothing new. Section 64(a) of the Bankruptcy Act of 1898 (1898 Act), which governed (as frequently amended) until 1978, gave priority to "taxes legally due and owing by the bankrupt to the United States [or a] State, county, district, or municipality." 30 Stat. 544, 563.[FN4] On a number of occasions, this Court considered whether a particular exaction, whether or not called a "tax" in the statute creating it, was a tax for purposes of § 64(a), and in every one of those cases the Court looked behind the label placed on the exaction and rested its answer directly on the operation of the provision using the term in question.

> FN4. This provision was modified slightly between 1898 and 1978, most notably in 1938, when it was moved to § 64(a)(4) (and given fourth priority) and amended to apply to "taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof." 52 Stat. 874.

The earliest such cases involved state taxes and are exemplified by *City of New York v. Feiring*, 313 U.S. 283, 61 S.Ct. 1028, 85 L.Ed. 1333 (1941). In considering whether a New York sales tax was a "tax" entitled to priority under § 64(a), the Court placed no weight on the "tax" label in the New York law, and looked to the *221 state statute only

"to ascertain whether its incidents are such as to constitute a tax within the meaning of § 64." *Id.*, at 285, 61 S.Ct., at 1029. See also *New Jersey v. Anderson*, 203 U.S. 483, 492, 27 S.Ct. 137, 140, 51 L.Ed. 284 (1906); *New York v. Jersawit*, 263 U.S. 493, 495-496, 44 S.Ct. 167, 167-168, 68 L.Ed. 405 (1924). The Court later followed the same course when a federal statute created the exaction. In *United States v. New York*, 315 U.S. 510, 62 S.Ct. 712, 86 L.Ed. 998 (1942), the Court considered whether " 'tax[es]' " so called in two federal statutes, *id.*, at 512, n. 2, 62 S.Ct., at 713, n. 2, were entitled to priority as "taxes" under § 64(a). In each instance the decision turned on the actual effects of the exactions, *id.*, at 514-517, 62 S.Ct., at 714-716, with the Court citing *Feiring* and *Anderson* as authority for its enquiry. 315 U.S., at 514-516, 62 S.Ct., at 714-715. See also *United States v. Childs*, 266 U.S. 304, 309-310, 45 S.Ct. 110, 111, 69 L.Ed. 299 (1924); *United States v. Sotelo*, 436 U.S. 268, 275, 98 S.Ct. 1795, 1800, 56 L.Ed.2d 275 (1978) ("We ... cannot agree with the Court of Appeals that the 'penalty' language of Internal Revenue Code § 6672 is dispositive of the status of respondent's debt under Bankruptcy Act § 17(a)(1)(e)").[FN5]

FN5. As the Court stated in a different context: "[A]lthough the statute ... terms the money demanded as 'a further sum,' and does not describe it as a penalty, still the use of those words does not change the nature and character of the enactment. Congress may enact that such a provision shall not be considered as a penalty or in the nature of one, ... and it is the duty of the court to be governed by such statutory direction, but the intrinsic nature of the provision remains, and, in the absence of any declaration by Congress affecting the manner in which the provision shall be treated, courts must decide the matter in accordance with their views of the nature of the act." *Helwig v. United States*, 188 U.S. 605, 612-613, 23 S.Ct. 427, 429-430, 47 L.Ed. 614 (1903).

**2112 Congress could, of course, have intended a different interpretive method for reading terms used in the Bankruptcy Code it created in 1978. But if it had so intended we would expect some statutory indication, see *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501, 106 S.Ct. 755, 759-760, 88 L.Ed.2d 859 (1986), whereas the most obvious statutory indicator is very much to the contrary: in the specific instances noted before, it would have been redundant for Congress to refer *222 specifically to Internal Revenue Code definitions of given terms if such cross-identity were to be assumed or presumed, as a matter of interpretive course.

While the Government does not directly challenge the continuing vitality of the cases in the *Feiring* line, it seeks to sidestep them by arguing, first, that similarities between the plain texts of §§ 4971 and 507(a)(7)(E) resolve this case. This approach, however, is inconsistent with *New York* and *Sotelo*, in each of which the Court refused to rely on the terminology used in the relevant tax and bankruptcy provisions.[FN6] The argument is also unavailing on its own terms, for even if we were to accept the proposition that comparable use of similar terms is dispositive, the Government's plain text argument still would fail.

FN6. Justice THOMAS's suggestion that no case "has denied bankruptcy priority to a congressionally enacted tax,"*post*, at 2116, is true, but not on point. *United States v. New York*, 315 U.S., at 514-517, 62 S.Ct., at 714-716, employed the *Feiring- Anderson* analysis to the exactions at issue there; the Court did not rely on the label that Congress gave. See also *United States v. Sotelo*, 436 U.S., at 275, 98 S.Ct., at 1800; *United States v. Childs*, 266 U.S. 304, 309-310, 45 S.Ct. 110, 111, 69 L.Ed. 299 (1924). The Court's conclusion that the exactions functioned as taxes does not change the fact that it employed a

functional analysis.

The word "excise" appears nowhere in § 4971 (whereas, by contrast, 26 U.S.C. § 4401 explicitly states that it imposes "an excise tax"). And although there is one reference to "excise taxes" that applies to § 4971 in the heading of the subtitle covering that section ("Subtitle D-Miscellaneous Excise Taxes"), the Government disclaims any reliance on that caption. Tr. of Oral Arg. 14, 17-20; see also 26 U.S.C. § 7806(b) ("No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title"). Furthermore, though § 4971(a) does explicitly refer to its exaction as a "tax," the Government disavows any suggestion that this language is dispositive as to whether § 4971(a) is a tax for purposes of § 507(a)(7)(E); while *223 § 4971(b)"impos[es] a tax equal to 100 percent of [the] accumulated funding deficiency to the extent not corrected," the Government says that this explicit language does not answer the question whether § 4971(b) is, in fact, a tax under § 507(a)(7)(E). Reply Brief for United States 13-14; Tr. of Oral Arg. 19-24. The Government's positions, then, undermine its suggestion that the statutes' texts standing together demonstrate that § 4971(a) imposes an excise tax.

The Government's second effort to avoid a *New York* and *Sotelo* interpretive enquiry relies on a statement from the legislative history of the 1978 Act, that "[a]ll Federal, State or local taxes generally considered or expressly treated as excises are covered by"§ 507(a)(7)(E). 124 Cong. Rec. 32416 (1978) (remarks of Rep. Edwards); *id.*, at 34016 (remarks of Sen. DeConcini). But even taking this statement as authoritative, it would provide little support for the Government's position. Although the statement may mean that all exactions called "excise taxes" [FN7] **2113 should be covered by § 507(a)(7)(E), [FN8] § 4971 does not call its exaction an excise tax. And although the section occurs in a subtitle with a heading of "Miscellaneous Excise Taxes," the Government has disclaimed reliance on the subtitle heading as authority for its position in this case, recognizing the provision of 26 U.S.C. § 7806(b) that no inference of legislative construction should be drawn from the placement of a provision in the Internal Revenue Code. See *supra,* at 2112; Tr. of Oral Arg. 19. If, on the other hand, the statement in the legislative*224 history is read more literally, its apparent upshot is that, among those exactions that are taxes, the ones that are expressly treated as excises are "excise tax[es]" within the meaning of § 507(a)(7)(E). But that proposition fails, of course, to answer the question whether the exaction is a tax to begin with.

FN7. Assuming that an exaction would not be "generally considered" an excise tax unless it would be reasonable to consider it such, the possible application of this first prong of the legislators' statement of intent is answered by the analysis of § 4971, below.

FN8. It should be noted, though, that such an interpretation may prove too much: the Government suggests that this statement from the legislative history does not affect the rule of construction that courts will look behind the denomination of state and local taxes, Reply Brief for United States 6, n. 4, but it is difficult to read that sentence as applying one rule for federal taxes and another for state and local ones.

In sum, we conclude that the 1978 Act reveals no congressional intent to reject generally the interpretive principle that characterizations in the Internal Revenue Code are not dispositive in the bankruptcy context, and no specific provision that would relieve us from making a functional examination of § 4971(a). We proceed to that examination.

C

[3] *Anderson* and *New York* applied the same test in

determining whether an exaction was a tax under § 64(a), or a penalty or debt: "a tax is a pecuniary burden laid upon individuals or property for the purpose of supporting the Government." *Anderson*, 203 U.S., at 492, 27 S.Ct., at 140; *New York*, 315 U.S., at 515, 62 S.Ct., at 714-715; accord, *Feiring*, 313 U.S., at 285, 61 S.Ct., at 1029 ("§ 64 extends to those pecuniary burdens laid upon individuals or their property ... for the purpose of defraying the expenses of government or of undertakings authorized by it"). Or, as the Court noted in a somewhat different context, "[a] tax is an enforced contribution to provide for the support of government; a penalty, as the word is here used, is an exaction imposed by statute as punishment for an unlawful act." *United States v. La Franca*, 282 U.S. 568, 572, 51 S.Ct. 278, 280, 75 L.Ed. 551 (1931).

We take *La Franca* 's statement of the distinction to be sufficient for the decision of this case; if the concept of penalty means anything, it means punishment for an unlawful act or omission, and a punishment for an unlawful omission is what this exaction is. Title 29 U.S.C. § 1082 requires a pension plan sponsor to fund potential plan liability according to a complex statutory formula, see also 26 U.S.C. § 412, and 26 U.S.C. § 4971(a) requires employers who maintain a *225 pension plan to pay the Government 10 percent of any accumulated funding deficiency. If the employer fails to correct the deficiency before the earlier of a notice of deficiency under § 4971(a) or an assessment of the § 4971(a) exaction, the employer is obligated to pay an additional "tax" of 100 percent of the accumulated funding deficiency. § 4971(b).[FN9] The obviously penal character of these exactions is underscored by other provisions, including one giving the Pension Benefit Guaranty Corporation (PBGC) an entirely independent claim against the employer for "the total amount of the unfunded **2114 benefit liabilities,"29 U.S.C. § 1362(b)(1)(A) (a claim which in this case the PBGC has asserted and which is still pending, see *Pension Benefit Guaranty Corporation v. Reorganized CF & I Fabricators of Utah, Inc.*, 179 B.R. 704 (N.D.Utah 1994)); see also §§ 1306-1307. We are, indeed, unable to find any provision in the statutory scheme that would cast the "tax" at issue here in anything but this punitive light.

FN9. The Government contends that § 4971(b) is more similar to a penalty than § 4971(a) is, because the Secretary of the Treasury can waive liability under the former but not the latter. The suggestion is that the Secretary can waive the imposition of the 100 percent tax, under ERISA § 3002(b), 88 Stat. 997, or can eliminate a violation by reducing the employer's funding requirement, see 26 U.S.C. § 412(d); see also 29 U.S.C. § 1083(a). But §§ 412(d) and 1083(a) provide for waiver of the minimum funding requirements, so their application would avoid a violation of either §§ 4971(a) or (b); there simply would be no "accumulated funding deficiency" for purposes of either §§ 4971(a) or (b). Thus the Government is incorrect in suggesting that the Secretary has the ability to waive the exaction under § 4971(b) but not under § 4971(a).

More fundamentally, even if the Secretary could waive only § 4971(b), it is not clear why this would make any difference, as the exaction would still serve to reinforce a federal prohibition.

D

The legislative history reflects the statute's punitive character:

*226 "The bill also provides new and more effective penalties where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employees' rights, to the extent funded, under plans which do not meet these standards. This procedure, however, has

> proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs-namely, the employer." H.R.Rep. No. 93-807, p. 28 (1974) U.S.Code Cong. & Admin.News 1974, pp. 4670, 4694.

Accord, S.Rep. No. 93-383, p. 24 (1973). The Committee Reports also stated that, "[s]ince the employer remains liable for the contributions necessary to meet the funding standards even after the payment of the excise taxes, it is anticipated that few, if any, employers will willfully violate these standards." H.R.Rep. No. 93-807, *supra*, at 28; S.Rep. No. 93-383, *supra*, at 24-25.

Given the patently punitive function of § 4971, we conclude that § 4971 must be treated as imposing a penalty, not authorizing a tax. Accordingly, we hold that the "tax" under § 4971(a) was not entitled to seventh priority as an "excise tax" under § 507(a)(7)(E), but instead is, for bankruptcy purposes, a penalty to be dealt with as an ordinary, unsecured claim.

III

[4] Hence, the next question: whether the Court of Appeals improperly subordinated the Government's § 4971 claim to those of the other general unsecured creditors. Though we have rejected the argument that the § 4971 claim is for an "excise tax" within the meaning of § 507(a)(7)(E), both parties agree that the § 4971 claim is allowable on a nonpriority *227 unsecured basis.[FN10] CF & I's reorganization plan did not lump all unsecured claims in one nonpriority class, however, but instead created four classes of unsecured creditors, only the first two of which would receive funds: Class 11 comprised small claims ($1,500 or less) grouped together for administrative convenience, see 11 U.S.C. § 1122(b); Class 12 comprised general unsecured claims (except for those assigned to other classes); Class 13 covered the § 4971 claim and some other (much smaller) subordinated penalty claims; and Class 14, claims between the CF & I Steel Corporation and its subsidiaries (all of which were bankrupt), the net value of which was zero. The plan provided, nonetheless, that if a court determined that a Class 13 claim should not be subordinated, or that the Class 13 claims should not be separately classified, the claim or claims would be placed in Class 12. Appellees' App. in No. 94-4034 et al., at 95-101, 137-141, 196-200.

> FN10. Cf. § 57(j) of the 1898 Act, 30 Stat. 561 ("Debts owing to the United States, a State, a county, a district, or a municipality as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose").

When the Government challenged the proposal to subordinate its claim, the Bankruptcy Court confirmed the reorganization plan, App. to Pet. for Cert. A-31, and ordered that the § 4971 claim be "subordinated to the claims of all other general unsecured creditors of [CF & I] pursuant to 11 U.S.C. § 510(c)." *Id.*, at A-21.The District Court subsequently ruled that the § 4971 claim "should be equitably subordinated to the claims of the general creditors under Section 510(c)." *Id.*, at A-18.In the Tenth Circuit, the Government again contested subordination**2115 under § 510(c), which CF & I defended, even as it sought to sustain the Bankruptcy Court's result with two new, alternative arguments: first, that 11 U.S.C. § 1122(a), restricting a given class to substantially similar claims, prohibited placement of the § 4971 claim in Class 12, because of its dissimilarity to other *228 unsecured claims; and second, that, because 11 U.S.C. § 1129(a)(7) authorizes creditors with impaired claims (*i.e.*, those getting less than full payment under the plan, like those in Class 12 here) to reject a plan that would give them less than they would get from a Chapter 7 liquidation, courts must have the power to assign a claim the same priority it would have in

a Chapter 7 liquidation (in which a noncompensatory prepetition penalty claim would be subordinated, 11 U.S.C. § 726(a)(4)). The Court of Appeals addressed neither of these arguments, however, relying instead on the broad construction given § 510(c) in *In re Virtual Network Servs. Corp.*, 902 F.2d 1246 (C.A.7 1990) (subordinating a claim otherwise entitled to priority under § 507(a)(7) to those of general unsecured creditors), and holding specifically that "section 510(c)(1) does not require a finding of claimant misconduct to subordinate nonpecuniary loss tax penalty claims." 53 F.3d, at 1159. The Court of Appeals took note of the Bankruptcy Court's finding that "[d]eclining to subordinate the IRS's penalty claim would harm innocent creditors rather than punish the debtor" and concluded that "the bankruptcy court correctly addressed the equities in this case." *Ibid.*

Nothing in the opinion of the Court of Appeals (or, for that matter, in the rulings of the Bankruptcy Court and the District Court) addresses the arguments that the Bankruptcy Court's result was sustainable without reliance on § 510(c). The court never suggested that either § 1122(a) or the Chapter 7 liquidation provisions were relevant. We thus necessarily review the subordination on the assumption that the Court of Appeals placed no reliance on the possibility that the Bankruptcy Code might permit the subordination on any basis except equitable subordination under § 510(c).

[5] So understood, the subordination was error. In *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996), we reversed a judgment said to rely on § 510(c) when the subordination turned ***229** on nothing other than the very characteristic that entitled the Government's claim to priority under §§ 507(a)(1) and 503(b)(1)(C). We held that the subordination fell beyond the scope of a court's authority under the doctrine of equitable subordination, because categorical subordination at the same level of generality assumed by Congress in establishing relative priorities among creditors was tantamount to a legislative act and therefore was outside the scope of any leeway under § 510(c) for judicial development of the equitable subordination doctrine. See *id.*, at 543, 116 S.Ct., at 1528. Of course it is true that *Noland* passed on the subordination from a higher priority class to the residual category of general unsecured creditors at the end of the line, whereas here the subordination was imposed upon a disfavored subgroup within the residual category. But the principle of *Noland* has nothing to do with transfer between classes, as distinct from ranking within one of them. The principle is simply that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c). The order in this case was as much a violation of that principle as *Noland*'s order was.

Without passing on the merits of CF & I's arguments that the § 4971 claim is not similar to the other unsecured claims and that courts dealing with Chapter 11 plans should be guided by Chapter 7 provisions, we vacate the judgment of the Court of Appeals, and remand the case for further proceedings consistent with this opinion.

It is so ordered.

Justice THOMAS, concurring in part and dissenting in part.

I agree with the majority that the Bankruptcy Court improperly relied on 11 U.S.C. § 510(c) to subordinate the United States' claims, and I join Part III of the Court's opinion. I cannot agree, however, with the ****2116** majority's determination***230** that assessments under 26 U.S.C. § 4971(a) are not "excise taxes" within the meaning of 11 U.S.C. § 507(a)(7)(E) (1988 ed.). I would hold that every congressionally enacted tax that is generally considered an excise tax is entitled to bankruptcy priority under § 507(a)(7)(E).

Section 507(a)(7)(E) creates a bankruptcy priority for excise taxes. Congress, in enacting § 4971, purported to enact a tax, see 26 U.S.C. § 4971(a) ("[T]here is hereby imposed a tax ..."), and the tax it enacted is properly considered an excise tax. See

Commissioner v. Keystone Consol. Industries, Inc., 508 U.S. 152, 161, 113 S.Ct. 2006, 2012-2013, 124 L.Ed.2d 71 (1993) (stating, in dicta, that § 4971 imposes an excise tax). It is true that *New Jersey v. Anderson*, 203 U.S. 483, 27 S.Ct. 137, 51 L.Ed. 284 (1906), and its progeny held that whether a state assessment is entitled to bankruptcy priority as a tax is a federal question. See *id.*, at 492, 27 S.Ct., at 140; *City of New York v. Feiring*, 313 U.S. 283, 285, 61 S.Ct. 1028, 1029, 85 L.Ed. 1333 (1941). It is not appropriate, however, for federal courts to perform a similar inquiry into valid taxes passed by Congress, and the majority cites no case in which this Court has denied bankruptcy priority to a congressionally enacted tax. I respectfully dissent.

U.S.Utah,1996.
U.S. v. Reorganized CF & I Fabricators of Utah, Inc.
518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506, 77 A.F.T.R.2d 96-2562, 64 USLW 4548, 96-1 USTC P 50,322, 35 Collier Bankr.Cas.2d 463, 29 Bankr.Ct.Dec. 271, Bankr. L. Rep. P 76,971, 20 Employee Benefits Cas. 1289, 96 Cal. Daily Op. Serv. 4438, 96 Daily Journal D.A.R. 7158, Pens. Plan Guide (CCH) P 23920J

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116 S.Ct. 1524
517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748, 77 A.F.T.R.2d 96-2143, 64 USLW 4328, 96-1 USTC P 50,252, 35 Collier Bankr.Cas.2d 1, 28 Bankr.Ct.Dec. 1331, Bankr. L. Rep. P 76,920, 1996-2 C.B. 179, 96 Cal. Daily Op. Serv. 3357, 96 Daily Journal D.A.R. 5442
(Cite as: 517 U.S. 535, 116 S.Ct. 1524)

Supreme Court of the United States
UNITED STATES, Petitioner,
v.
Thomas R. NOLAND, Trustee for Debtor First Truck Lines, Inc.
No. 95-323.

Argued March 25, 1996.
Decided May 13, 1996.

Chapter 7 trustee objected to claims of Internal Revenue Service (IRS) for FUTA and FICA taxes, interest, and penalties as administrative expenses. The Bankruptcy Court, Thomas F. Waldron, J., 141 B.R. 621, ruled that postpetition, preconversion nonpecuniary loss tax penalties were first priority administrative expenses, but could be subordinated to claims of general unsecured creditors. IRS appealed. The United States District Court for the Southern District of Ohio, Walter Herbert Rice, J., affirmed. The United States appealed. The Court of Appeals for the Sixth Circuit, Boyce F. Martin, Jr., Circuit Judge, 48 F.3d 210, affirmed. Certiorari was granted. The Supreme Court, Justice Souter, granted certiorari and held that IRS' claims could not be equitably subordinated on categorical basis in derogation of Congress' scheme of priorities.

Reversed and Remanded.

West Headnotes

[1] Bankruptcy 51 ⚿2967.5

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.5 k. Inequitable Conduct.
Most Cited Cases
Internal Revenue Service's (IRS) postpetition, noncompensatory tax penalty claims could not be equitably subordinated on categorical basis in derogation of Congress' scheme of priorities. Bankr.Code, 11 U.S.C.A. §§ 503(b), 507(a)(1), 510(c), 726(a)(1).

[2] Bankruptcy 51 ⚿2967.5

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.5 k. Inequitable Conduct.
Most Cited Cases
Principles of equitable subordination may allow bankruptcy court to reorder tax penalty when justified by particular facts. Bankr.Code, 11 U.S.C.A. § 510(c).

[3] Bankruptcy 51 ⚿2967.5

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.5 k. Inequitable Conduct.
Most Cited Cases
Decisions about treatment of categories of claims in bankruptcy proceedings are not dictated or illuminated by principles of equity and do not fall within judicial power of equitable subordination.

[4] Statutes 361 ⚿217.4

361 Statutes
361VI Construction and Operation
361VI(A) General Rules of Construction
361k213 Extrinsic Aids to Construction
361k217.4 k. Legislative History in General. Most Cited Cases
Statements in legislative history cannot be read to convert statutory leeway for judicial development of rule on particularized exceptions into delegated authority to revise statutory categorization, untethered to any obligation to preserve coherence of substantive congressional judgments.

[5] Bankruptcy 51 ⟹2967.5

51 Bankruptcy
51VII Claims
51VII(F) Priorities
51k2967 Subordination
51k2967.5 k. Inequitable Conduct.
Most Cited Cases
Circumstances that prompt court to order equitable subordination must not occur at level of policy choice at which Congress itself operated in drafting Bankruptcy Code.

***1524 *535 Syllabus** FN*

FN* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

The Internal Revenue Service filed claims in the Bankruptcy Court for taxes, interest, and penalties that accrued after debtor First Truck Lines, Inc., sought relief under Chapter 11 of the Bankruptcy Code (Code) but before the case was converted to a Chapter 7 bankruptcy. The court found that all of the IRS's claims were entitled to first priority as administrative expenses under 11 U.S.C. §§ 503(b)(1)(C) and 507(a)(1), but held that the penalty claim was subject to "equitable subordination" under § 510(c), which the court interpreted as giving it authority not only to deal with inequitable Government conduct, but also to adjust a statutory priority of a category of claims. The court's decision to subordinate the penalty claim to the claims of the general unsecured creditors was affirmed by the District Court and the Sixth Circuit, which concluded that postpetition, nonpecuniary loss tax penalty claims are susceptible to subordination by their very nature.

Held: A bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's priorities **1525 scheme. The language of § 510(c), principles of statutory construction, and legislative history clearly indicate Congress's intent in its 1978 revision of the Code to use the existing judge-made doctrine of equitable subordination as the starting point for deciding when subordination is appropriate. By adopting "principles of equitable subordination," § 510(c) allows a bankruptcy court to reorder a tax penalty when justified by particular facts. It is also clear that Congress meant to give courts some leeway to develop the doctrine. However, a reading of the statute that would give courts leeway broad enough to allow subordination at odds with the congressional ordering of priorities by category is improbable in the extreme. The statute would then empower a court to modify the priority provision's operation at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place, thus delegating legislative revision, not authorizing equitable exception. Nonetheless, just such a legislative type of decision underlies the reordering of priorities here. The Sixth Circuit's decision runs directly counter to Congress's policy judgment that a postpetition tax penalty should receive the priority of an *536 administrative expense. Since the Sixth Circuit's rationale was inappropriately categorical in nature, this Court need not decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. Pp. 1526-1529.

48 F.3d 210 (C.A.6 1995), reversed and remanded.

SOUTER, J., delivered the opinion for a unanimous Court.

Kent L. Jones, Washington, DC, for Petitioner.

Raymond J. Pikna, Jr., Dayton, OH, for Respondent.

For U.S. Supreme Court briefs, see:1996 WL 27693 (Pet.Brief)1996 WL 74181 (Resp.Brief)1996 WL 109642 (Reply.Brief)

Justice SOUTER delivered the opinion of the Court.

The issue in this case is the scope of a bankruptcy court's power of equitable subordination under 11 U.S.C. § 510(c). Here, in the absence of any finding of inequitable conduct on the part of the Government, the Bankruptcy Court subordinated the Government's claim for a postpetition, noncompensatory tax penalty, which would normally receive first priority in bankruptcy as an "administrative expense," §§ 503(b)(1)(C), 507(a)(1). We hold that the bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's scheme of priorities.

In April 1986, First Truck Lines, Inc., voluntarily filed for relief under Chapter 11 of the Bankruptcy Code, and in the subsequent operation of its business as a debtor-in-possession incurred, but failed to discharge, tax liabilities to the Internal Revenue Service (IRS). First Truck moved to convert the case to a Chapter 7 liquidation in June 1988, and in August 1988 the Bankruptcy Court granted that motion and appointed respondent Thomas R. Noland as trustee. The liquidation of the estate's assets raised insufficient funds to pay all of the creditors.

*537 After the conversion, the IRS filed claims for taxes, interest, and penalties that accrued after the Chapter 11 filing but before the Chapter 7 conversion, and although the parties agreed that the claims for taxes and interest were entitled to priority as administrative expenses, §§ 503(b), 507(a)(1), and 726(a)(1),[FN1] they disagreed about the priority to be given tax penalties. The Bankruptcy Court determined that the penalties (like the taxes and interest) were administrative**1526 expenses under § 503(b) but held them to be subject to equitable subordination under § 510(c).[FN2] In so doing, the court read that section to provide authority not only to deal with inequitable conduct on the Government's part, but also to adjust a statutory priority of a category of claims. The Bankruptcy Court accordingly weighed the relative equities that seemed to flow from what it described as "the Code's preference for compensating actual loss claims," and subordinated the tax penalty claim to those of the general unsecured creditors. *In re First Truck Lines, Inc.*, 141 B.R. 621, 629 (Bkrtcy.S.D.Ohio 1992). The District Court affirmed. *Internal Revenue Service v. Noland*, 190 B.R. 827 (S.D.Ohio 1993).

FN1. Section 507(a)(1) provides, in relevant part: "(a) The following expenses and claims have priority in the following order: (1) First, administrative expenses allowed under section 503(b) of this title...." Under § 503(b)(1), administrative expenses include "any tax ... incurred by the estate" (with certain exceptions not relevant here), as well as "any fine [or] penalty ... relating to [such] a tax...." Section 726(a)(1) adopts the order of payment specified in § 507 for Chapter 7 proceedings.

FN2. Section 510(c) provides that "the court may ... under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim...."

After reviewing the legislative history of the 1978 revision to the Bankruptcy Code and several recent appeals cases on equitable subordination of tax penalties, the Sixth Circuit affirmed, as well. *In re First Truck Lines, Inc.*, 48 F.3d 210 (1995). The Sixth Circuit stated that it did

*538 "not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have

supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around." *Id.*, at 218.

See also *Burden v. United States*, 917 F.2d 115, 120 (C.A.3 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (C.A.8 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (C.A.7 1990). We granted certiorari to determine the appropriate scope of the power under the Bankruptcy Code (Code) to subordinate a tax penalty, 516 U.S. 1005, 116 S.Ct. 558, 133 L.Ed.2d 458 (1995), and we now reverse.

[1] The judge-made doctrine of equitable subordination predates Congress's revision of the Code in 1978. Relying in part on our earlier cases, see, *e.g.*, *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 68 S.Ct. 1454, 92 L.Ed. 1911 (1948); *Pepper v. Litton*, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 59 S.Ct. 543, 83 L.Ed. 669 (1939), the Fifth Circuit, in its influential opinion in *In re Mobile Steel Co.*, 563 F.2d 692, 700 (1977), observed that the application of the doctrine was generally triggered by a showing that the creditor had engaged in "some type of inequitable conduct." *Mobile Steel* discussed two further conditions relating to the application of the doctrine: that the misconduct have "resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant," and that the subordination "not be inconsistent*539 with the provisions of the Bankruptcy Act." *Ibid.* This last requirement has been read as a "reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." DeNatale & Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, 40 Bus. Law. 417, 428 (1985). The District Courts and Courts of Appeals have generally followed the *Mobile Steel* formulation, *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712, 717 (C.A.6 1992).

Although Congress included no explicit criteria for equitable subordination when it enacted § 510(c)(1), the reference in § 510(c) to "principles of equitable subordination" clearly indicates congressional intent at least to start with existing doctrine. This conclusion is confirmed both by principles of statutory construction, see **1527*Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501, 106 S.Ct. 755, 759, 88 L.Ed.2d 859 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications") (citation omitted), and by statements in the legislative history that Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle,"124 Cong. Rec. 32398 (1978) (Rep.Edwards); see also *id.*, at 33998 (Sen.DeConcini). In keeping with pre-1978 doctrine, many Courts of Appeals have continued to require inequitable conduct before allowing the equitable subordination of most claims, see, *e.g.*, *In re Fabricators, Inc.*, 926 F.2d 1458, 1464 (C.A.5 1991); *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1282-1283 (C.A.8 1988), although several have done away with the requirement when the claim in question was a tax penalty. *540 See, *e.g.*, *Burden, supra*, at 120; *Schultz, supra*, at 234; *In re Virtual Network, supra*, at 1250.

[2] Section 510(c) may of course be applied to subordinate a tax penalty, since the Code's requirement that a Chapter 7 trustee must distribute assets "in the order specified in ...section 507" (which gives a first priority to administrative expense tax penalties) is subject to the qualification, "[e]xcept as provided in section 510 of this title...." 11 U.S.C. § 726(a). Thus, "principles of equitable subordination" may allow a bankruptcy court to reorder a tax penalty in a given case. It is almost as clear that

Congress meant to give courts some leeway to develop the doctrine, 124 Cong. Rec. 33998 (1978), rather than to freeze the pre-1978 law in place. The question is whether that leeway is broad enough to allow subordination at odds with the congressional ordering of priorities by category.

[3] The answer turns on Congress's probable intent to preserve the distinction between the relative levels of generality at which trial courts and legislatures respectively function in the normal course. Hence, the adoption in § 510(c) of "principles of equitable subordination" permits a court to make exceptions to a general rule when justified by particular facts, cf. *Hecht Co. v. Bowles,* 321 U.S. 321, 329, 64 S.Ct. 587, 592, 88 L.Ed. 754 (1944) ("The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case"). But if the provision also authorized a court to conclude on a general, categorical level that tax penalties should not be treated as administrative expenses to be paid first, it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place. That is, the distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception. We find such a reading improbable*541 in the extreme. "Decisions about the treatment of categories of claims in bankruptcy proceedings ... are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination...." *Burden,* 917 F.2d, at 122 (Alito, J., concurring in part and dissenting in part).

Just such a legislative type of decision, however, underlies the Bankruptcy Court's reordering of priorities in question here, as approved by the District Court and the Court of Appeals. Despite language in its opinion about requiring a balancing of the equities in individual cases, the Court of Appeals actually concluded that "postpetition, nonpecuniary loss tax penalty claims" are "susceptible to subordination" by their very "nature." 48 F.3d, at 218. And although the court said that not every tax penalty would be equitably subordinated, *ibid.*, that would be the inevitable result of consistent applications of the rule employed here, which depends not on individual equities but on the supposedly general unfairness of satisfying "postpetition, nonpecuniary loss tax penalty claims" before the claims of a general creditor.

The Court of Appeals's decision thus runs directly counter to Congress's policy judgment**1528 that a postpetition tax penalty should receive the priority of an administrative expense, 11 U.S.C. §§ 503(b)(1)(C), 507(a)(1), and 726(a)(1). This is true regardless of Noland's argument that the Bankruptcy Court made a distinction between compensatory and noncompensatory tax penalties, for this was itself a categorical distinction at a legislative level of generality. Indeed, Congress recognized and employed that distinction elsewhere in the priority provisions: Congress specifically assigned 8th priority to certain compensatory tax penalties, see § 507(a)(8)(G), and 12th priority to prepetition, noncompensatory penalties, see §§ 726(a)(1) and (4).[FN3]

FN3. Noland argues that "although the penalties at issue arose postpetition," this claim should be viewed as a prepetition penalty because a "reorganized debtor is in many respects similar to a prepetition debtor ... [and] the conversion of [this] case to chapter 7 was tantamount to the filing of a new petition." Brief for Respondent 16, n. 7. But we agree with the Sixth Circuit, see *In re First Truck Lines, Inc.,* 48 F.3d 210, 214 (1995), that the penalties at issue here are postpetition administrative expenses pursuant to 11 U.S.C. §§ 348(d), 503(b)(1). Although § 348(d) provides that a "claim against the estate or the debtor that arises after the order for relief but be-

> fore conversion in a case that is converted under section 1112, 1208, or 1307 of this title, other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition," the claim for priority here is "specified in section 503(b)" and Congress has already determined that it is not to be treated like prepetition penalties. Noland may or may not have a valid policy argument, but it is up to Congress, not this Court, to revise the determination if it so chooses.

[4] *542 The Sixth Circuit, to be sure, invoked a more modest authority than legislative revision when it relied on statements by the congressional leaders of the 1978 Code revisions, see 48 F.3d, at 215, 217-218, and it is true that Representative Edwards and Senator DeConcini stated that "under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor." 124 Cong. Rec. 32398 (1978) (Rep.Edwards); see also *id.*, at 33998 (Sen.DeConcini). But their remarks were not statements of existing law and the Sixth Circuit's reliance on the unexplained reference to subordinated penalties ran counter to this Court's previous endorsement of priority treatment for postpetition tax penalties. See *Nicholas v. United States*, 384 U.S. 678, 692-695, 86 S.Ct. 1674, 1684-1686, 16 L.Ed.2d 853 (1966). More fundamentally, statements in legislative history cannot be read to convert statutory leeway for judicial development of a rule on particularized exceptions into delegated authority to revise statutory categorization, untethered to any obligation to preserve the coherence of substantive congressional judgments.

[5] *543 Given our conclusion that the Sixth Circuit's rationale was inappropriately categorical in nature, we need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. We do hold that (in the absence of a need to reconcile conflicting congressional choices) the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Code. Cf. *In re Ahlswede*, 516 F.2d 784, 787 (C.A.9) ("[T]he [equity] chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule"), cert. denied *sub nom. Stebbins v. Crocker Citizens Nat. Bank*, 423 U.S. 913, 96 S.Ct. 218, 46 L.Ed.2d 142 (1975); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (C.A.3 1941) (court cannot "set up a subclassification of claims ... and fix an order of priority for the sub-classes according to its theory of equity").

In this instance, Congress could have, but did not, deny noncompensatory, postpetition tax penalties the first priority given to other administrative expenses, and bankruptcy courts may not take it upon themselves to make that categorical determination under the guise of equitable subordination. The judgment of the Court of Appeals is reversed,**1529 and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

U.S.Ohio,1996.
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517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748, 77 A.F.T.R.2d 96-2143, 64 USLW 4328, 96-1 USTC P 50,252, 35 Collier Bankr.Cas.2d 1, 28 Bankr.Ct.Dec. 1331, Bankr. L. Rep. P 76,920, 1996-2 C.B. 179, 96 Cal. Daily Op. Serv. 3357, 96 Daily Journal D.A.R. 5442

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