UNIVERSITY OF HOUSTON LAW CENTER

BANKRUPTCY TAX

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Assignment – Class 5 –February 12, 2019 – 12:30 PM

Class 5 – Priority, Interest and Penalties on Tax Claims

Assignment

Assigned reading—All:

1. FOREWORD TO CLASS 5 (AW pp. 1-3)
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)(AW pp. 3-7)
4. *In re Gift*, 469 B.R. 800 (Bankr. M.D. Tenn. 2012)(AW pp. 7-11)
5. *United States v. Noland*, 517 U.S. 535 (1996)(AW pp. 11-17)

Optional reading:

1. *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (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?

Chapter 5

Relevant Statutory and Regulatory Provisions:
Bankruptcy Code §§ 503(b), 506(b)(2), 507(a)(2), 507(a)(8), 510(c)

Foreword

Allowance and Priority of Claims for Tax, Interest and Penalties. 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. Also, 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 a while).

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 a while, 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 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 this 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.

UNITED STATES v. RON PAIR ENTERPRISES, INC.
489 U.S. 235 (1989)

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 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. ****

II

Section 506,[FN2] enacted as part of the extensive 1978 revision of the bankruptcy laws, governs the definition and treatment 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 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."

[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 11 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

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A

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 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 way.[FN4] By the plain language of the statute, the two types of recovery are distinct.

[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.

B

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 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. 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.

**** The judgment of the Court of Appeals is reversed. It is so ordered.

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

****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).

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 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 apparent, 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 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 the phrase "security interest" if it wanted to limit postpetition interest to consensual liens. **** For the reasons set forth above, I respectfully dissent.

Notes and Comments

1. Ron Pair was a five to four decision, but it has gained acceptance and may be said to be settled law. As a result, prior to 2005, postpetition interest was allowable for all secured claims if the requirements of BC § 506 were satisfied. Reasonable fees, costs and charges could be added to the secured claim if they arose out of a contract or agreement. Tax penalties were not covered under BC § 506.

In re GIFT
469 B.R. 800 (Bankr. M.D. Tenn. 2012)

RANDAL S. MASHBURN, Bankruptcy Judge.

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 that only the 12% interest rate should be applied. ****

I. Undisputed Facts

**** 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. ****

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.

II. Analysis

Based on the language in T.C.A. § 67–5–2010, Metro's lien for taxes also secures its right to payment of interest, penalties and costs.1 In other words, Metro has a nonconsensual lien imposed by state statute, and Metro asserts that all elements of the claim are covered by the lien. The dispute over confirmation arises because the debtor has not provided for the penalty reflected in the statute.

A. Claim Allowance/Disallowance

**** Section 506 provides the roadmap for determining whether and to what extent a claim is secured. A secured claim is defined by § 506(a)(1) as "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest ... to the extent of the value of such creditor's interest in the estate's interest in such property." 11 U.S.C. § 506(a)(1). Section 506(b) provides:

> (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 or State statute under which such claim arose.

11 U.S.C. § 506(b). "Section 506(b) explicitly allows oversecured creditors to recover postpetition interest[ ] on their claims, thereby exempting them from the strictures of § 502(b) to the extent their claims are oversecured." In re Dow Corning Corp., 456 F.3d 668, 681 (6th Cir.2006).

**** Metro is entitled to interest, penalties, attorney fees, and costs that accrued prepetition as part of their allowed secured claim pursuant to section 502(b)(2). Postpetition, interest, fees, costs, and charges are prioritized for secured treatment only if authorized under 11 U.S.C. § 506(b). **** In order to set Metro's claim for purposes of confirmation, the court must determine where postpetition penalties fit in, if at all, under this framework.

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).

C. The Brentwood Outpatient Cases

Bondholder Comm. v. Williamson County (In re Brentwood Outpatient, Ltd.), 43 F.3d 256 (6th Cir.1994) involved a chapter 11 debtor that owed delinquent property taxes that accrued postpetition. Like the present case, all parties agreed that the County was oversecured. The Chapter 11 plan provided for the County to be paid in full on the effective date of the plan. After confirmation of the plan, the Bondholder Committee paid the base tax, plus prepetition and postpetition interest, but objected to payment of the statutory penalties, attorneys' fees, and costs. In that case, the precise issue was:

> We must decide whether in a Chapter 11 proceeding a local government may collect statutory (1) costs and attorneys' fees and (2) penalties of 1/2% per month which accrue on delinquent property taxes after the filing of the bankruptcy petition; and (3) whether any allowable penalties, costs, and fees are due up to the time the delinquent property taxes are paid or only up to the effective date of the Chapter 11 plan.

43 F.3d at 258. The Sixth Circuit held that section 506(b) as it was worded at that time, addressed only consensual lienholder****

Ron Pair held that oversecured creditors are entitled to postpetition interest without qualification under section 506(b). United States v. Ron Pair Enters., Inc. 489 U.S. 235, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989). "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." Id. at 241, 109 S.Ct. 1026.

In light of Ron Pair, the Sixth Circuit **** reluctantly concluded that the only allowable postpetition addition for nonconsensual lienholders was interest based on the Supreme Court ruling in Ron Pair and § 506(b).

The Sixth Circuit opinion in Brentwood Outpatient was rendered more than a decade before the law was changed to allow nonconsensual lienholders to tack on post-petition fees, costs, or charges to a claim. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") in 2005, recovery of postpetition interest, fees, costs, or charges was only in the context of consensual liens. BAPCPA amended section 506(b) by adding "or State statute," thereby effectively putting consensual and nonconsensual liens on a level playing field. In short, the primary ruling in Brentwood Outpatient was rendered moot by the legislative changes, but it nevertheless provides significant guidance to the issue this Court is now asked to address.

The Sixth Circuit's decision in Brentwood Outpatient was appealed from a decision by Judge Lundin in the bankruptcy court. Judge Lundin held that "penalties are not 'fees, costs, [or] charges' for purposes of § 506(b)." 134 B.R. 267, 271 (Bankr.M.D.Tenn.1991), aff'd,152 B.R. 727 (M.D.Tenn.1993), rev'd,43 F.3d 256 (6th Cir.1994). Even after twenty years, his decision most directly addresses the precise issue now before this Court, and that aspect of his decision was not directly overruled by the Sixth Circuit. To the contrary, some of the Sixth Circuit's decision seems to approve of Judge Lundin's definitional interpretation of the word "penalty" in the context of section 506(b). Even though the primary rulings in the Brentwood Outpatient cases have been rendered inapplicable by the legislative changes in 2005, the analysis in both decisions is quite persuasive.

Judge Lundin found that the drafters of the Code knew how to use and distinguish between fees, costs, charges, and penalties and did so elsewhere in the Bankruptcy Code, and the entire United States Code. Specifically, Judge Lundin held:

> The legislative history to § 506(b) does not reveal that "fees, costs [or] charges" were intended to include "penalties." The drafters of the Bankruptcy Code elsewhere used the words "penalties," "fees," "costs" or "charges" as if their meanings are distinct. See, e.g.,11 U.S.C. § 107(a) (access to court records

without "charge"); 11 U.S.C. § 322(c) (trustee not liable personally for "penalty or forfeiture"); 11 U.S.C. § 328(a) ("contingent fee"); 28 U.S.C.A. § 1930 (Law. Co-op. 1989) (bankruptcy "fees"); 28 U.S.C.A. § 1930 note on Bankruptcy Court Fee Schedule 819 (Law. Co-op. Supp. 1991) ("The clerk shall assess a charge of up to three percent....") (emphasis added); 11 U.S.C. § 507(a)(7)(G) ("the actual, necessary costs"); 11 U.S.C. § 503(b)(1)(C) ("any fine, penalty"); 11 U.S.C. § 503(b)(6) ("the fees and mileage"); 11 U.S.C. § 505(a) ("the amount ... of any ... penalty"); 11 U.S.C. § 507(a)(1) ("any fees and charges"); 11 U.S.C. § 726(a)(4) ("fine, penalty, or forfeiture"). See alsoFed.R.Bankr.P. 7054(b) ("The court may allow costs....").

...

In many other contexts, Congress has recognized that "penalties" are different from "fees", "costs" or "charges." See, e.g.,5 U.S.C.A. § 551(10) (Law. Co-op. 1989) ("sanction" for purposes of the Administrative Procedure Act includes "imposition of penalty or fine;" assessment of costs, charges, or fees are separately allowed); 16 U.S.C.A. § 810(b) (Law. Co-op. 1978) ("charges and penalties" with respect to licensees under Federal Power Act) (emphasis added); 22 U.S.C.A. § 4209 (Law. Co-op. 1982) (collection of unlawful charges and penalties by consular officers); 43 U.S.C.A. § 465 (Law. Co-op. 1980) (charges and penalties payable to the Secretary of Interior); 43 U.S.C.A. § 478 (Law. Coop. 1980) (construction charges and "a penalty of [one] per centum thereof" payable by any water right applicant or entryman) (emphasis added); 47 U.S.C.A. § 205 (Law. Co-op. 1981) (charges and penalties payable to Federal Communication Commission).

134 B.R. at 271–73. Furthermore, a penalty is inherently different from a fee, cost, or charge:

> The dictionary definitions of these words are dissimilar. "Penalties" conventionally include some concept of punishment. BLACK'S LAW DICTIONARY 1290 (4th ed. rev. 1968). "Charges" involve ordinary duties, burdens or obligations. BLACK'S at 294–95. A "fee" usually includes compensation for goods or services. BLACK'S at 740–41. "Costs" typically include reimbursement of expenses to an officer or agency. BLACK'S at 415–16.

Id. Judge Lundin concluded that section 506 is not a source for oversecured creditors to recover penalties. Ultimately, he also found that no "applicable law" disallowed claims for tax penalties, and it was on this specific ruling that the Sixth Circuit reversed:

> The bankruptcy court suggested that § 506(b) "does not address penalties," Id. at 273, and concluded from this silence that the section does not govern the allowability of penalties. The court therefore ruled that the penalties were an allowable claim. Because of our discussion above, in which we found that no postpetition additions to claims are allowable in Chapter 11 cases except as provided by § 506(b), we draw the opposite conclusion-that penalties which accrue postpetition are not allowed to a nonconsensual oversecured claim in bankruptcy

43 F.3d at 263.

The 2005 Amendments give nonconsensual lienholders equal treatment to consensual 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 Court finds that the term penalty has a distinct meaning that does not properly fit within the parameters of "fees, costs, or charges."

*****

E. Conclusion that Penalty Is Not Covered by Section 506(b)

This Court finds that consistency in the law is best achieved in keeping with Congress' apparent attempt to treat consensual and nonconsensual lienholders equally, but also to recognize the historical and logical distinction between a true penalty and various other fees, costs, and charges. The Court concludes that the penalty sought by Metro is not a fee, cost, or charge under section 506(b). ****

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) 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); UPS Capital Bus. Credit v. Gencarelli, 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.****

Notes and Comments

1. In 2005, Congress added the words "or State statute" to BC § 506. What effect does that have on state tax penalties? Gift holds that penalties do not come within the meaning of "fees, costs and charges," and therefore are not part of the secured claim. This seems right, since otherwise state penalties would be allowed but federal not. Gift will probably not be the last word on the subject. Other taxing authorities are likely to raise this question before other bankruptcy judges.

UNITED STATES v. NOLAND

517 U.S. 535 (1996)

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.

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), they disagreed about the priority to be given tax penalties. The Bankruptcy Court determined that the penalties (like the taxes and interest) were administrative expenses under § 503(b) but held them to be subject to equitable subordination under § 510(c). 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).

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

> "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.

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 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 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. See, e.g., Burden, supra, at 120; Schultz, supra, at 234; In re Virtual Network, supra, at 1250.

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.

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 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 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 before 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.

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.

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, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Notes and Comments

1. As previously set forth, postpetition taxes, interest and penalties enjoy an administrative expense priority. These taxes, interest and penalties were the subject of Noland. BC § 510(c) allows the bankruptcy court to subordinate one claim to another under principles of equitable subordination. A line of Court of Appeals decisions had held that tax penalties should be subject to this reclassification – if the penalty did not compensate the taxing authority for out of pocket costs, it was unfair to reduce the recoveries of general unsecured creditors. The Noland court held that this was an impermissible rewriting of the statute as it eviscerated the priority given to penalties. If equitable subordination was to be applied, it must be based on fact specific findings, such as inequitable conduct by the tax authority.
2. In *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996) the debtor corporation incurred an "exaction" (Supreme Court's word) equal to 10% of a required contribution to a pension plan that it failed to make. The debtor then instituted bankruptcy proceedings. The IRS filed a claim for the 10% charge in the bankruptcy. The lower courts found that the charge was a penalty and not a tax, that the penalty did not compensate the government for pecuniary loss and therefore was a nonpriority claim. Using a broad view of principles of equitable subordination, those courts subordinated the penalty to the claims of unsecured creditors. The bulk of the Supreme Court's opinion was devoted to the question of whether in essence the exaction was a tax or a penalty. After determining that it was a penalty, the court determined that the claim was a general unsecured claim not subject to equitable subordination for the reasons set forth in Noland. The standards for equitable subordination are the same for prepetition penalties and postpetition penalties.

PROBLEM SET

1. Where in the Bankruptcy Code does it say that prepetition penalties on unsecured tax claims are allowed?
2. Does interest continue to accrue beyond the petition date?
3. Should X pay the tax, interest and penalties that it owes?
4. 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?
5. What about postpetition interest?
6. Should X pay the tax, interest and penalties that it owes?

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

8. Do penalties run up to the petition date?

9. Do penalties on secured tax claims continue to run after the petition?

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

11. What is the priority of a claim for prepetition interest?

12. What about prepetition penalties?