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The Federal Priority in Insolvency: Proposals for Reform

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THE FEDERAL PRIORITY IN INSOLVENCY: PROPOSALS FOR REFORM

William T. Plumb, Jr.

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THE FEDERAL PRIORITY IN INSOLVENCY: PROPOSALS FOR REFORM

William T. Plumb, Jr.*

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, *the debts due to the United States shall be first satisfied . . .*¹

Sired by the ancient prerogative of the English Crown,² born in the earliest days of our Republic,³ and still commonly referred to by its designation (as Section 3466) in the Revised Statutes of 1875, the virtually absolute statutory priority of the federal government in insolvent decedents' estates and in certain other insolvency proceedings has gone too long without significant amendment or reconsideration by Congress.⁴ The legislative neglect of this provision is in marked contrast to the frequent congressional re-examinations of the priorities established in bankruptcy; indeed the respective prior-

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1. REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1964) (emphasis added). The provision continues:

and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

A companion provision prescribes:

Every executor, administrator or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts, before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

REV. STAT. § 3467 (1875), as amended, 31 U.S.C. § 192 (1964).

2. See *United States v. Key*, 397 U.S. 322, 324 (1970). The sovereign prerogative, while affording the precedent, is not, however, the legal basis for the federal priority, which rests entirely on statute. *Price v. United States*, 269 U.S. 492, 499-500 (1926); *United States v. State Bank of North Carolina*, 31 U.S. (6 Pet.) 29, 34 (1832).

3. The provision can be traced back to the Act of July 31, 1789, ch. 5, § 21, 1 Stat. 42, the fifth statute enacted by the first Congress. It has been in substantially its present form, since the Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515. The provision now found in REV. STAT. § 3467 (1875), 31 U.S.C. § 192 (1964), set out in note 1 *supra*, originated in the Act of March 2, 1799, ch. 22, § 65, 1 Stat. 676.

4. See Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954); Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 233-61 (1967). The present paper, while necessarily reiterating some of the background discussion contained in those articles, is directed to consideration of a specific proposal for amendment approved by the American Bar Association in 1970.

ity provisions have been characterized as "virtually independent statutory provisions enacted with little or no thought to comparison."⁵

The insolvency priority statute "on its face permits no exception whatsoever,"⁶ although the lower courts and the Internal Revenue Service have interpolated exceptions for administration expenses,⁷ funeral expenses,⁸ certain widows' allowances,⁹ and prior mortgages,¹⁰ pledges¹¹ and "choate" liens.¹² The Supreme Court, however, has persistently and pointedly reserved opinion whether a "choate" lien,¹³ or even a mortgage,¹⁴ would prevail over the federal priority, and has imposed a test of "choateness" so stringent that it is a rare competing lien, unless previously enforced by taking title or possession, that could satisfy the requirements.¹⁵ Security assignments,¹⁶

5. Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships*, 43 HARV. L. REV. 251, 252 (1929).

6. See *United States v. Vermont*, 377 U.S. 351, 357 (1964). However, the Government's further argument that, through application of some "federal law of property rights," the priority even reaches property not owned by the debtor has been rejected. *Ideco Div. of Dresser Indus., Inc. v. Chance Drilling Co.*, 422 F.2d 165, 168-69 (5th Cir. 1970).

7. *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960); *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925).

8. S.M. 5032, V-1 CUM. BULL. 109 (1926).

9. *Postmaster Gen. v. Robbins*, 19 F. Cas. 1126 (No. 11,314) (D. Me. 1829); *Jessie Smith*, 24 B.T.A. 807, 811 (1931); I.T. 2712, XII-2 CUM. BULL. 138 (1933). *But cf.* *Federal Reserve Bank v. Smylie*, 134 S.W.2d 838, 842 (Tex. Civ. App. 1939); *In re Estate of Ballard*, 57-2 U.S. Tax Cas. ¶ 9777 (Mich. P. Ct. 1944).

10. *Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141, 143 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957); *United States v. Guaranty Trust Co.*, 33 F.2d 533 (8th Cir. 1929), *affd. on other grounds*, 280 U.S. 478 (1930).

11. *In re Decker's Estate*, 355 Pa. 331, 340-41, 49 A.2d 714, 719-20 (1946).

12. *United States v. Atlantic Municipal Corp.*, 212 F.2d 709 (5th Cir. 1954); *United States v. South Carolina*, 227 S.C. 187, 87 S.E.2d 577 (1955).

13. See, e.g., *United States v. Key*, 397 U.S. 322, 332 n.11 (1970); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361, 365-66 (1953); *United States v. Texas*, 314 U.S. 480, 484-85 (1941).

14. See *New York v. Maclay*, 288 U.S. 290, 294 (1933).

15. It is not only necessary that, before the event of insolvency, the identity of the lienor, the amount of the lien, and the property to which it attaches be fixed beyond possibility of change or dispute (*Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946)) but, at least in the case of personalty, the debtor must have been divested of either title or possession, if not both. *United States v. Gilbert Associates, Inc.*, 345 U.S. 361, 366 (1953).

16. *In re Gruner*, 295 N.Y. 510, 68 N.E.2d 514 (1946). *Contra*, *Creditors Exch. Serv., Inc. v. United States*, 277 F. Supp. 885 (S.D. Tex. 1967). Those mortgages and security interests that were held "inchoate" under the somewhat less stringent test formerly applicable as against federal tax liens (see note 45 *infra* and accompanying text), because they secured future obligations, including those arising from later obligatory payments by the creditor and foreclosure expenses (*United States v. Pioneer Am. Life Ins. Co.*, 374 U.S. 84 (1963); *United States v. R.F. Ball Constr. Co.*, 355 U.S. 587 (1958)), would surely fail the test of § 3466. *Cf.* *United States v. Menier Hardware No. 1, Inc.*, 219 F. Supp. 448, 454 (W.D. Tex. 1963).

mechanics' liens,¹⁷ landlords' liens,¹⁸ general judgment liens,¹⁹ and state and local tax liens²⁰ (except possibly for real estate taxes),²¹ although perfected as against everyone else, yield to the federal priority when insolvency supervenes, as does an attorney's claim for his fee.²²

The supremacy for federal claims provided by the abortive federal bankruptcy acts of the early and middle nineteenth century,²³ on the other hand, has progressively given way to a "reasonable classification of claims as entitled to priority because of superior equities."²⁴ Federal claims *other than tax claims* were reduced to parity with the claims of general creditors in bankruptcy by the Act of 1898.²⁵ However, the change may have been the result of a drafting inadvertence since Congress in 1926, soon after the Supreme Court so construed the law, restored such claims to priority although subordinating them to administration and other expenses, certain wage claims, and state, local, and federal taxes, and placing them on a parity with claims enjoying priority under state law.²⁶

17. *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963). *Cf.* *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956).

18. *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945); *United States v. Saidman*, 231 F.2d 503 (D.C. Cir. 1956).

19. *Thelusson v. Smith*, 15 U.S. (2 Wheat.) 396 (1817). *See* *New York v. Maclay*, 288 U.S. 290, 293 (1933). *But cf.* *Muniz v. United States*, 129 Ind. App. 433, 155 N.E.2d 140 (1958); *In re Meyer's Estate*, 159 Pa. Super. 296, 48 A.2d 210 (1946). *See* *Kennedy, supra* note 4, at 908-09.

20. *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946); *United States v. Texas*, 314 U.S. 480 (1941).

21. *See* *United States v. Atlantic Municipal Corp.*, 212 F.2d 709 (5th Cir. 1954); *United States v. South Carolina*, 227 S.C. 187, 87 S.E.2d 577 (1955).

22. *In re Holly Knitwear, Inc. v. Solomon*, 71-2 U.S. Tax Cas. ¶ 9654 (N.J. P. Ct. 1971).

23. Act of April 4, 1800, ch. 19, § 62, 2 Stat. 36 (repealed by Act of Dec. 19, 1803, ch. 6, 2 Stat. 248); Act of Aug. 19, 1841, ch. 9, § 5, 5 Stat. 444 (repealed by Act of March 3, 1843, ch. 82, 5 Stat. 614); Act of March 2, 1867, ch. 176, § 28, 14 Stat. 531 (repealed by Act of June 7, 1878, ch. 170, 20 Stat. 99). The pertinent provisions of the old bankruptcy acts are quoted in *United States v. Anderson*, 334 F.2d 111, 114-15 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964).

24. *Carpenter v. Wabash Ry.*, 309 U.S. 23, 28 (1940). *Accord*, *United States v. Randall*, 401 U.S. 513, 516 (1971).

25. Section 64b(5) of the National Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 563, embraced "debts owing to any person who by the laws of the States or the United States is entitled to priority," and ranked such debts behind taxes and certain wage claims but ahead of general creditors. *See* *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152 (1912). In *Davis v. Pringle*, 268 U.S. 315, 318-19 (1925), a unanimous Court held that federal nontax claims were not even qualified for that level of priority but ranked with the claims of general creditors since the United States was not a "person" within the meaning of § 64b(5).

26. Act of May 27, 1926, ch. 406, § 15, 44 Stat. 667. The Chandler Act of June 22, 1938, ch. 575, 52 Stat. 874, amending § 64a(5) of the Bankruptcy Act, eliminated

Federal *tax* claims were placed on a parity with state and local tax claims by the 1898 Act,²⁷ but continued to outrank all other claims²⁸ until 1926 when taxes were demoted below certain wage claims.²⁹ The Chandler Act of 1938 introduced the concept of postponing perfected federal and other statutory liens on personalty in favor of administration expenses and wage claims if such liens were not accompanied by possession and had not been enforced by sale prior to bankruptcy.³⁰ And, in 1966, Congress not only confirmed the previously debated point that a tax lien not perfected by filing of notice was invalid in bankruptcy³¹ but also reduced to general creditor status, with some exceptions, federal, state, and local tax claims that were more than three years old if not secured by perfected liens.³²

With exceptions designed to exclude preferential transfers and disguised rules of priority, prior mortgages and liens have, for more than a century, been recognized under the federal bankruptcy acts,³³ since "[p]roperty interests in a fund not owned by a bankrupt at

priorities granted by state law, other than those for landlords, from their previous parity with federal nontax claims.

27. Act of July 1, 1898, ch. 541, § 64a, 30 Stat. 544. See *Missouri v. Ross*, 299 U.S. 72, 74-75 (1936); *New Jersey v. Anderson*, 203 U.S. 483, 489 (1906).

28. *Oliver v. United States*, 268 U.S. 1 (1925) (wages held subordinate to taxes). In *United States v. Randall*, 401 U.S. 513, 516 (1971), it is stated categorically that "[u]ntil 1926 claims for administration expenses were subordinate to tax claims," although, in fact, the contemporary decisions were in conflict. See 3A W. COLLIER, *BANKRUPTCY* ¶¶ 64.01, 402 (14th ed. rev. 1969); Colin, *The Priority of the United States in the Payment of Its Claims Against a Bankrupt*, 24 COLUM. L. REV. 360 (1924).

29. Act of May 27, 1926, ch. 406, § 15, 44 Stat. 666.

30. Act of June 22, 1938, ch. 575, 52 Stat. 877, amending § 67c of the Bankruptcy Act (now, as further amended, 11 U.S.C. § 107(c)(3) (Supp. V, 1965-1969)).

31. Act of July 5, 1966, Pub. L. No. 89-495, § 5, 80 Stat. 269, amending § 70c of the Bankruptcy Act, 11 U.S.C. § 110(c) (Supp. V, 1965-1969). While the bill was pending, the Supreme Court decided that the law had been the same all along. *United States v. Speers*, 382 U.S. 266 (1965).

32. Act of July 5, 1966, Pub. L. No. 89-496, 80 Stat. 270-71, amending §§ 17a and 64a(4) of the Bankruptcy Act, 11 U.S.C. §§ 35(a) and 104(a)(4) (Supp. V, 1965-1969); *In re Autorama Tool & Die Co.*, 412 F.2d 369, 373 (6th Cir. 1969), *cert. denied*, 397 U.S. 1043 (1970). See Marsh, *Triumph or Tragedy? The Bankruptcy Amendments of 1966*, 42 WASH. L. REV. 681, 682-97 (1967); notes 299-302 *infra* and accompanying text.

33. Although the Act of April 4, 1800, ch. 19, § 31, 2 Stat. 30, prescribed paying nonfederal creditors proportionately, without regard to their liens (*Harrison v. Sterry*, 9 U.S. (5 Cranch) 289, 301 (1809)), subsequent acts have, with the exceptions indicated, recognized perfected liens. Act of Aug. 19, 1841, ch. 9, § 2, 5 Stat. 442 (*Peck v. Jenness*, 48 U.S. (7 How.) 612 (1849)); Act of March 2, 1867, ch. 176, §§ 14, 20, 14 Stat. 523, 526 (*Doe v. Childress*, 88 U.S. (21 Wall.) 642 (1875)); Act of July 1, 1898, ch. 541, § 67(d), 30 Stat. 564; Act of June 22, 1938, ch. 575, § 67b, 52 Stat. 876 (now, as further amended, 11 U.S.C. § 107(b) (Supp. V, 1965-1969)). "[T]he Bankruptcy Act has traditionally recognized that a lien is a valid property right which must be satisfied out of the assets to which it attaches before any part of those assets becomes available for distribution to unsecured creditors." H.R. REP. NO. 686, 89th Cong., 1st Sess. 2 (1965).

the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights, are . . . not a part of the bankrupt's property and do not vest in the trustee."³⁴ Rights of a mortgagee (*e.g.*, to be reimbursed for foreclosure expenses) that would be "inchoate" by the standards of Section 3466 if bankruptcy had not supervened prevail against the trustee,³⁵ and statutory liens and four-month-old attachment liens that would be "inchoate" by Section 3466 standards may be perfected against the trustee even after bankruptcy.³⁶ In both cases such claims gain a preference over the taxes and other federal claims unsecured by recognized liens but entitled to priority in the bankrupt estate.³⁷

Under still another system of priorities, which operates without regard to the solvency of the debtor, unpaid federal tax assessments have, for more than a century, been made liens on "all property and rights to property . . . belonging to" the taxpayer.³⁸ Originally this secret tax lien prevailed even over a bona fide purchaser³⁹ but Congress has shown an ever-increasing awareness of the public importance of title security and of the need of certain creditors to be able to rely upon the taxpayer's apparently unencumbered ownership of his property. Thus in 1913, Congress protected purchasers, mortgagees, and judgment creditors⁴⁰ and, in 1939, pledgees,⁴¹ against federal tax liens of which notice had not been filed in a duly designated office. Nevertheless, in a series of court decisions beginning in 1950, creditors with valid and perfected liens under state law,⁴² and finally even

34. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135 (1962).

35. *Compare* *Security Mortgage Co. v. Powers*, 278 U.S. 149, 155-56 (1928) (recognizing in bankruptcy such a contingent right of a mortgagee), *with* *United States v. Pioneer Am. Life Ins. Co.*, 374 U.S. 84, 91 (1963) (holding such right "inchoate" as against a federal tax lien, even under standards that were less strict (*see* note 45 *infra* and accompanying text) than those applied under Section 3466).

36. Concerning statutory liens, *compare* Bankruptcy Act § 67c(1)(B), 11 U.S.C. § 107(c)(1)(B) (Supp. V, 1965-1969), *with* *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881, 886-88 (4th Cir. 1963). Concerning attachments, *compare* *In re Consolidated Container Carriers, Inc.*, 254 F. Supp. 605 (E.D. Pa. 1966), *aff'd.*, 385 F.2d 362 (3d Cir. 1967), *and* *Doe v. Childress*, 88 U.S. (21 Wall.) 642 (1875), *with* *United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 51 (1950).

37. *In re Knox-Powell-Stockton Co.*, 100 F.2d 979 (9th Cir. 1939). *Cf.* *City of Richmond v. Bird*, 249 U.S. 174 (1919).

38. Act of July 13, 1866, ch. 184, § 9, 14 Stat. 107, from which INT. REV. CODE of 1954, § 6321 is derived. *See also* Act of March 3, 1865, ch. 78, 13 Stat. 470.

39. *United States v. Snyder*, 149 U.S. 210 (1893).

40. Act of March 4, 1913, ch. 166, 37 Stat. 1016.

41. Revenue Act of 1939, § 401, 53 Stat. 882, now, with further amendments, INT. REV. CODE of 1954, § 6323. The same provision protected purchasers of "securities" and those who lent on the security of securities from tax liens not actually known to them, whether or not notice had been filed.

42. Victims included holders of mechanics' liens for work already completed (*United*

persons protected by federal law,⁴³ were subjected, as against subsequently attaching federal tax liens, to a test of "choateness" derived from,⁴⁴ but ultimately held to be somewhat less stringent than,⁴⁵ that which had been applied in insolvency under Section 3466.

In 1959, reacting to those decisions, the American Bar Association (ABA) proposed a comprehensive revision of the law of federal liens and priorities. The proposal ultimately led to the enactment of the Federal Tax Lien Act of 1966, a major objective of which was to restrict, on a selective basis, the unwarranted preference enjoyed by the federal tax lien over many otherwise perfected security interests and liens under the "choateness" rule.⁴⁶ The ABA recommendation had also included a proposed amendment to Section 3466 designed to coordinate the federal priority in insolvency both with the general priority policies developed in the Bankruptcy Act and with the relief against the federal tax lien proposed for certain liens and security interests.⁴⁷ Since the latter proposal, which affected many federal claims in addition to tax claims, fell outside the jurisdiction of the congressional committees that considered the tax lien legislation, it had to be put aside for another day. Therefore, as a result of the continuing discrepancies between the bankruptcy and insolvency rules, some creditors have had a distinct incentive to throw

States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *rev'd*, 227 F.2d 359 (7th Cir. 1955)); attorneys' liens (*United States v. Goldstein*, 256 F.2d 581 (2d Cir.), *cert. denied*, 358 U.S. 830 (1958), *aff'd*, *United States v. Pay-O-Matic Corp.*, 162 F. Supp. 154 (S.D.N.Y. 1958)); landlords' liens perfected by distraint (*United States v. Scovil*, 348 U.S. 218 (1955)); and attachment and garnishment liens before judgment (*United States v. Acri*, 348 U.S. 211 (1955); *United States v. Liverpool & London Ins. Co.*, 348 U.S. 215 (1955)).

43. *United States v. Pioneer Am. Life Ins. Co.*, 374 U.S. 84 (1963) (mortgagee's right to recover foreclosure expenses); *United States v. R.F. Ball Constr. Co.*, 355 U.S. 587 (1958) (surety's security for indemnity against losses not yet incurred); *Leipert v. R.C. Williams & Co.*, 161 F. Supp. 355 (S.D.N.Y. 1957) (contract purchasers who had made payments but had not taken title).

44. *See United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 51 (1950).

45. *United States v. Vermont*, 377 U.S. 351 (1964). The competing lien was required to meet the tests of certainty of the lienor, the property, and the amount, but divestment of title or possession was not required, as it was under Section 3466. *See* note 15 *supra*. Hence, a state tax lien attaching to "all" the debtor's property (like the federal tax lien itself) and enforceable without suit was deemed "choate" for this purpose. 377 U.S. at 357-59.

46. INT. REV. CODE OF 1954, § 6323, as amended by PUB. L. No. 89-719, 80 Stat. 1125 (1966). In varying degrees and subject to specified conditions, protection was extended to holders of mechanics' liens, attorneys' liens, certain possessory liens, and real property tax liens; to commercial and construction lenders and sureties; to all otherwise prior lenders and lienors with respect to recovery of their expenses; and to contract purchasers, retail purchasers, and certain "casual" purchasers. *See* W. PLUMB & L. WRIGHT, *FEDERAL TAX LIENS* (3d ed., tent. publication 1971).

47. *Report of the Special Committee on Federal Liens*, in 84 ABA ANNUAL REPORT 645, 731-36 (1959) [hereinafter 1959 REPORT].

into bankruptcy a debtor whose case might have been handled, with less expense and less burden on the federal courts, in another form of proceeding.⁴⁸ In those circumstances in which bankruptcy is not an available alternative, unjust discrimination against creditors results from the more stringent priority rule of Section 3466.⁴⁹ And, when federal tax claims are involved, the hard-won and much-needed protections provided for secured creditors and certain lienors by the Federal Tax Lien Act may be nullified if the debtor becomes insolvent but bankruptcy does not ensue—the very circumstance in which those protections would become of crucial importance.⁵⁰

The readiness of Congress in 1966 to accept equitable limitations on the priority of federal tax liens, as well as to restrict further the favored position of federal taxes in bankruptcy,⁵¹ encourages the hope that Congress may now be receptive to review of the third great branch of federal priorities. Perhaps the dictum of Justice Holmes, that “[p]ublic opinion as to the peculiar rights and preferences due to the sovereign has changed,” may at last be confirmed.⁵²

In 1970, the ABA approved a revised version of its insolvency priority recommendation which is now before the Senate Judiciary

48. The relative advantages and disadvantages to creditors are detailed in W. PLUMB & L. WRIGHT, *supra* note 46, at ch. 6.

49. A decedent's estate cannot become bankrupt (*In re Fackelman*, 248 Fed. 565 (S.D. Cal. 1918)) although bankruptcy proceedings do not abate if commenced before death. Bankruptcy Act § 8, 11 U.S.C. § 26 (1964). See text accompanying notes 334-40 *infra*. Insolvencies of banks, building and loan associations, and insurance companies are administered under other state or federal laws rather than in bankruptcy (Bankruptcy Act § 4, 11 U.S.C. § 22 (1964)) and, except in the case of national banks (12 U.S.C. § 194 (1964); *Cook County Natl. Bank v. United States*, 107 U.S. 445 (1883)), are subject to the priority rule of § 3466. *United States v. Knott*, 298 U.S. 544 (1936); *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483 (1926). Railroads may not become bankrupt (Bankruptcy Act § 4, 11 U.S.C. § 22 (1964)), although they may be reorganized under § 77 of the Bankruptcy Act, 11 U.S.C. § 205, (1964), which makes applicable, with respect to unsecured claims, the rules of priority pertaining to equity receiverships—which include § 3466. Bankruptcy Act § 77(b), 11 U.S.C. § 205(b) (1964). See note 82 *infra*. Involuntary bankruptcy may not be instituted by creditors of wage earners, farmers, persons owing less than \$1,000 (Bankruptcy Act § 4b, 11 U.S.C. § 22(b) (1964)) or of persons whose act of bankruptcy occurred more than four months previously (Bankruptcy Act § 3b, 11 U.S.C. § 21(b) (1964)) nor by less than three creditors holding net unsecured claims aggregating at least \$500 if the debtor has twelve or more creditors. Bankruptcy Act § 59b, 11 U.S.C. § 95(b) (1964). See *International Shoe Co. v. Pinkus*, 278 U.S. 261, 266 (1929).

50. See *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 161 (4th Cir. 1967) (concurring opinion), *cert. denied*, 390 U.S. 1025 (1968).

51. See text accompanying notes 31-32 *supra* and note 46 *supra* and accompanying text.

52. *Davis v. Pringle*, 268 U.S. 315, 318 (1925). The statement was quoted with approval in *National City Bank v. Republic of China*, 348 U.S. 356, 359 (1955), in support of the view that the sovereign's immunity from suit had not been “favored by the test of time,” but had “increasingly been found to be in conflict with the growing subjection of governmental action to moral judgment.”

Committee as S. 2197, having been introduced by Senator Quentin N. Burdick "by request," for the purpose of inviting public comment.⁵³ The suggestions and criticisms made in the following analysis of the proposal are meant to detract nothing from the great desirability of the reform, for which I have worked for many years, but are intended to facilitate the kind of accommodation to the legitimate interests of the Government that ultimately paved the way for the adoption of the Federal Tax Lien Act of 1966 and which may prove even more essential in this instance when there are not one, but many federal financial agencies with the power, and perhaps the will, to impede enactment.

I. FEDERAL CLAIMS ENTITLED TO PRIORITY

The federal priority under Section 3466 is not limited to tax claims but applies to debts of every kind, including those arising under government contracts and the vast federal programs of loan insurance, guaranties, and direct loans.⁵⁴ Since the Government is able to choose its nontax debtors, it is free to exact such security as the circumstances require and the policy of the particular program

53. The proposal is set out and explained in Report of Comm. on Relative Priority of Government and Private Liens, *Proposed Legislation and Recent Developments on Lien Priorities*, 4 REAL PROP., PROB. & TR. J. 413 (1969), which was approved by the ABA in 1970 [hereinafter 1970 REPORT]. The proposed provisions hereafter quoted are from S. 2197, 92d Cong., 1st Sess. (1971), which differs from the ABA draft in minor respects, generally not affecting the substance. The resolutions of approval, set out in 56 A.B.A.J. 991 (1970), stated the objectives:

(1) to bring the priority provisions in line with the policies expressed in the National Bankruptcy Act;
 (2) to provide (and partly to clarify) that the priority conferred is inapplicable against competing liens; and
 (3) to limit the priority conferred to tax claims of the United States, thereby providing greater equity for other creditors of the insolvent.

The proposal was endorsed by the National Bankruptcy Conference. NATIONAL BANKRUPTCY CONFERENCE, ANNUAL MEETING PROCEEDINGS, Resolution No. 27, at 11 (1970). Although this paper is in the nature of a belated minority report on the draft legislation by one who participated in the deliberations (1970 REPORT, *supra* at 415), the suggestions herein conform to the letter as well as the substance of the principles stated in the resolutions, and differ only in the implementation.

54. Although Congress relinquished the benefit of the insolvency priority in the case of the "normal lending operations," but not the "wartime activities," of the Reconstruction Finance Corporation (*In re Temple*, 174 F.2d 145 (7th Cir. 1949); Act of May 25, 1948, ch. 334, § 3, 62 Stat. 261-62, repealed by § 8(a) of Pub. L. No. 89-554, 80 Stat. 654 (1966)), it expressly extended the priority to Commodity Credit Corporation loans (15 U.S.C. § 714b(e) (1964)). The Supreme Court has refused, in the silence of Congress, to imply an intent to relinquish the priority for such unincorporated financing agencies as the Small Business Administration, the Farm Credit Administration, and the Federal Housing Administration. *Small Bus. Admin. v. McClellan*, 364 U.S. 446, 450 (1960); *Dept. of Agriculture v. Redmund*, 330 U.S. 539, 544-45 (1947); *United States v. Emory*, 314 U.S. 423, 433 (1941).

permits;⁵⁵ such security will appear of record for the protection of others dealing with the debtor.⁵⁶ If the federal government does not take security, it is ordinarily because the purpose of the program would be defeated if a recorded encumbrance discouraged the extension of credit by others; yet, if insolvency ensues, the Government puts in an appearance as a priority creditor. The Government, deriving its revenue from the entire population, is better able to self-insure such risks than are private parties, for many of whom the failure of even a single major debtor may be ruinous. As the Fourth Circuit said many years ago in holding that Congress in the Bankruptcy Act of 1898 had relinquished the priority of federal nontax claims in bankruptcy:

No sound principle of public policy can be invoked in support of preference to the federal government . . . over citizens in the collection of ordinary debts. On the contrary, the contractual operations of the federal government . . . have become so extensive and so involved with the business of private citizens that priority to the federal government . . . , except for taxes, would operate as an oppressive hardship on other creditors of bankrupts.⁵⁷

The tremendous expansion of federal-financing programs since the priority of nontax claims in bankruptcy was restored by Congress in 1926⁵⁸ compels reconsideration of whether it is sound government policy to attempt to bolster the economy by federal loans and guaranties, frequently involving marginal debtors, and at the same time to discourage uninsured credit by making it more hazardous.⁵⁹ The 1970 ABA proposal—making a bold but justifiable step

55. See Recent Development, 64 MICH. L. REV. 944, 948-49 (1965).

56. For the proposition that the Government must comply with state recording laws, see *United States v. Union Livestock Sales Co.*, 298 F.2d 755 (4th Cir. 1962). The record of a mortgage may not, however, disclose that the United States is a *guarantor*, and thus may entrap those who, under state law, would be superior to a private mortgage. See *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963), discussed in Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of the Federal Preference?*, 64 MICH. L. REV. 1107, 1120-22, 1133-34 (1966).

57. *Davis v. Pringle*, 1 F.2d 860, 864 (4th Cir. 1924), *affd.*, 268 U.S. 315 (1925). See note 25 *supra*. Although the priority of the English Crown had extended to contract claims, it is reported that since 1947 England has limited the priority to obligations arising from "public acts." Salter, *Priority Accorded the Sovereign in Bankruptcy: The American and British Views*, 63 COM. L.J. 354 (1958). The majority of the states, which inherited the priority rule as part of the common law, rejected its application to contract claims as inappropriate to our society. See *United States Fidelity & Guar. Co. v. Carter*, 161 Va. 381, 403, 170 S.E. 764, 772 (1933).

58. See note 26 *supra* and accompanying text.

59. See *United States v. Guaranty Trust Co.*, 280 U.S. 478, 485 (1930). See also

forward from its 1959 recommendation—would accordingly limit the federal priority in insolvency and bankruptcy to tax claims.⁶⁰

II. PROCEEDINGS IN WHICH PRIORITY IS APPLICABLE

A. Collective Proceedings Only

Although the first clause of Section 3466 appears to give the Government priority "[w]hensoever any person indebted to the United

MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND. & COM. L. REV. 73, 74-76 (1959); Comment, *supra* note 56.

60. 1970 REPORT, *supra* note 53, at 414-15. The proposal, in S. 2197, 92d Cong., 1st Sess. (1971), reads:

[Sec. 3466] (c) OTHER CLAIMS.—Except as provided in subsection (d) [relating to penalties and forfeitures], all claims of the United States other than those referred to in paragraph (4) of subsection (b) [relating to taxes] shall be paid without priority along with all claims not otherwise entitled to priority under subsection (b).

(Bracketed explanations added.) Although only § 3466 would be so amended, the effect would be also to demote federal nontax claims from fifth priority to parity with general creditors in bankruptcy since § 64a(5) of the Bankruptcy Act incorporates the insolvency priority. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 244-46 (1967), for a further development of the argument for the proposal.

If Congress should reject this limitation, consideration should be given to bringing about some consistency and uniformity in the application of the priority to federal nontax claims. As the law stands, if a government agency insures or guarantees a loan and the obligation on default is assigned to the United States before a bankruptcy or insolvency proceeding is instituted, the federal priority is given effect. *United States v. Emory*, 314 U.S. 423 (1941). But if the assignment of the defaulted claim is delayed until after proceedings have begun, the priority does not apply. *United States v. Marxen*, 307 U.S. 200 (1939) (bankruptcy); *Engleman v. Commodity Credit Corp.*, 107 F. Supp. 930 (S.D. Cal. 1952) (assignment for creditors). Cf. *In re Miller*, 105 F.2d 926, 929 (2d Cir. 1939) (Government may not prove a priority claim under the debtor's agreement to indemnify it on the guaranty). In a Chapter X reorganization, however, by virtue of Bankruptcy Act § 201, 11 U.S.C. § 601 (1964), the Government has until the qualification of a receiver or trustee (or the order approving the petition and continuing the debtor in possession), rather than until the filing of the petition, to obtain an assignment and qualify the obligation for priority. *United States v. Anderson*, 334 F.2d 111, 117-18 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964). Concerning the situation when the Government's protection of the lender takes the form of a percentage "participation" in the loan, see *Small Bus. Admin. v. McClellan*, 364 U.S. 446 (1960); Comment, *supra* note 56, at 1133. The ABA proposal approves the *Marxen* rule, *supra* (see 1970 REPORT, *supra* note 53, at 422), and thus, if the denial of priority of federal nontax claims is not accepted, would serve to perpetuate those irrational distinctions. See S. 2197, 92d Cong., 1st Sess. (1971), which provides:

[Sec. 3466] (g) DEFINITIONS.—For the purposes of this section and section 3467—

....

(2) "claims" means claims found to be legally due and owing by the debtor as of the date of the divestment of his property in the manner prescribed in subsection (a) [see note 74 *infra*] (or as of the date of death in the case of an insolvent estate)

Since the Government's exposure to loss is the same in either case, whether it stands as the legal or beneficial owner of the claim or is still merely an insurer or guarantor at the moment of bankruptcy or insolvency, its priority (or lack thereof) should be the same. For further development of this and related suggested amendments for con-

States is insolvent," the Supreme Court, viewing the provision as a whole,⁶¹ has determined that, except in the case of a decedent's estate, something more than insolvency is required. The insolvency of a living debtor must have been manifested by (1) a "voluntary assignment" made by one not having sufficient property to pay his debts, (2) the attachment of the estate and effects of an absconding, concealed, or absent debtor, or (3) the commission of an act of bankruptcy (even though not followed by a bankruptcy proceeding).⁶² These acts, in general, involve a divestment of the debtor's property for the benefit of his creditors; the Supreme Court has therefore generalized in repeated dicta that the "priority does not attach while the debtor continues the owner and in possession of the property,"⁶³ but applies only "when the possession and control of the estate of the insolvent is given to any person charged with the duty of applying it to the payment of the debts of the insolvent, as the rights and priorities of creditors may be made to appear."⁶⁴ Hence, outside of bankruptcy,⁶⁵ the federal insolvency priority has been applied almost exclusively to insolvent decedents' estates, general assignments for creditors, general receiverships,⁶⁶ liquidations of insolvent corporations,⁶⁷ and compar-

sideration in the event the priority of federal nontax claims is continued, see Plumb, *supra* at 246-48.

61. Section 3466, 31 U.S.C. § 191 (1964), provides in full:

Priority established.

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

62. *United States v. Oklahoma*, 261 U.S. 253, 262 (1923).

63. *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 488 (1926).

64. *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 490 (1926). *See also* *King v. United States*, 379 U.S. 329, 336 (1964); *United States v. Knott*, 298 U.S. 544, 552 (1936); *United States v. Oklahoma*, 261 U.S. 253, 260 (1923).

65. For a discussion of proceedings under the Bankruptcy Act, see pt. II, B. *infra*.

66. Although the Supreme Court views the question as an open one (*Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 368-69 (1946)), it is generally considered that only a general receivership of all the debtor's property within the jurisdiction for the benefit of all his creditors will constitute an act of bankruptcy (*see* 1 W. COLLIER, *BANKRUPTCY* ¶ 3.502 (14th ed. rev. 1971)) that will make the Section 3466 priority applicable. A receivership in aid of foreclosure of a mortgage or lien, or other limited receiverships, ordinarily would not have that effect (*Elfast v. Lamb*, 111 F.2d 434 (2d Cir. 1940); *In re Clement-Rowe Press, Inc.*, 42 F. Supp. 209 (S.D.N.Y. 1941); *contra*, *In re 211 East Delaware Place Bldg. Corp.*, 14 F. Supp. 96 (N.D. Ill. 1936)) unless extended generally to all creditors. *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946); *United States v. Clover Spinning Mills Co.*, 373 F.2d 274 (4th Cir. 1966).

67. Such liquidations include not only state-supervised liquidations of banks and insurance companies (*Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483,

able collective proceedings for the administration of the assets of an insolvent.

Nevertheless, some lower courts have applied the insolvency priority to situations in which acts of bankruptcy⁶⁸ have been committed that did not involve or lead to collective proceedings of any kind—*e.g.*, a debtor making a fraudulent conveyance⁶⁹ or a preferential transfer,⁷⁰ or the Government⁷¹ or another creditor⁷² obtaining a lien through legal proceedings or distraint that has not been duly vacated or discharged. Since a statutory rule of priority that creates no lien⁷³ but simply provides the order of distribution of the debtor's assets is appropriately applicable only in collective proceedings involving administration of all or substantially all of a debtor's assets, the ABA proposal would make clear that it is so confined.⁷⁴

B. *Proceedings Under Bankruptcy Act*

The proposed amendment would make the insolvency priority rules applicable to administrations "otherwise than in bankruptcy."⁷⁵ The exclusion is desirable in order to avoid conflict between the proposed system of priorities in insolvency and the system established by the Bankruptcy Act, to the extent that it is not deemed feasible to eliminate the differences.⁷⁶ Nevertheless, the areas in which Section 3466 has heretofore been applied in bankruptcy should be ex-

489-90 (1926); *United States v. Knott*, 298 U.S. 544 (1936)), but also the winding up of any insolvent corporation by its directors or others as trustees in liquidation. *In re Bonnie Classics, Inc.*, 116 F. Supp. 646 (S.D.N.Y. 1953).

68. See Bankruptcy Act § 3a, 11 U.S.C. § 21(a) (1964), which defines acts of bankruptcy.

69. *United States v. Mr. Hamburg Bronx Corp.*, 228 F. Supp. 115 (S.D.N.Y. 1964).

70. *Lakeshore Apartments, Inc. v. United States*, 351 F.2d 349, 353 (9th Cir. 1965).

71. *United States v. Menier Hardware No. 1, Inc.*, 219 F. Supp. 448 (W.D. Tex. 1963).

72. *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881, 885-86 (4th Cir. 1963).

73. See *United States v. Oklahoma*, 261 U.S. 253, 259-60 (1923).

74. See 1970 REPORT, *supra* note 53, at 419. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (a) APPLICABILITY.—This section shall apply (1) whenever any person indebted to the United States is divested of the title or right to possession, or both title and right to possession, of all or substantially all of his property for the purpose of effecting a general administration for the benefit of creditors otherwise than in bankruptcy if, at the time of such divestment, such property is insufficient to pay his debts, or (2) whenever the estate of a deceased debtor of the United States is at the time of death insufficient to pay the debts of that estate.

Consideration might be given, however, to whether the scope of Section 3466 ought to be broadened to embrace administrations of "all or a greater portion of the property," rather than "substantially all." Cf. Bankruptcy Act § 131, 11 U.S.C. § 531 (1964).

75. See proposed § 3466(a)(1), set out in note 74 *supra*.

76. See pt. IV. B. *infra*.

plored to determine whether the exclusion should be qualified in any way.⁷⁷

Section 3466 does at present serve an essential function in conventional bankruptcies in that Section 64a(5) of the Bankruptcy Act⁷⁸ incorporates it by reference by providing fifth priority for "debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority."⁷⁹ If, as proposed, "debts other than for taxes" owing to the United States are to be excluded from the priority, there will be no further need for reference to Section 3466 in conventional bankruptcies since the Bankruptcy Act contains its own provisions for the priority status of federal taxes.⁸⁰

In railroad reorganizations under Section 77 and in other corporate reorganizations under Chapter X of the Bankruptcy Act, priorities are not governed by Section 64 of the Act, which applies in conventional bankruptcies;⁸¹ instead, the rules of priority in equity

77. The frequent judicial statements that Section 3466 "does not apply in bankruptcy" are misleading and should be read in light of the issue decided. Most of the cases involved the priority of nonfederal statutory liens which, under Bankruptcy Act § 67b & c, 11 U.S.C. § 107(b) & (c) (Supp. V, 1965-1969), are valid or perfectible against the trustee and hence against the Government if it claims through the trustee rather than under an antecedent lien of its own and which cannot be displaced by the super-priority which federal taxes would enjoy under Section 3466, and in the absence of bankruptcy. *United States v. First Natl. Bank & Trust Co. of Fargo*, 386 F.2d 646, 648 (8th Cir. 1967); *Adams v. O'Malley*, 182 F.2d 925, 927 (8th Cir. 1950); *In re Taylorcraft Aviation Corp.*, 168 F.2d 808, 810 (6th Cir. 1948); *United States v. Sampson*, 153 F.2d 731, 734 (9th Cir. 1946); *In re Knox-Powell-Stockton Co.*, 100 F.2d 979, 982 (9th Cir. 1939).

78. 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969).

79. It was with reference to the demotion of federal taxes to fourth and of other federal claims to fifth priority, if bankruptcy ensues, that the court in *United States v. Gargill*, 218 F.2d 556, 559 (1st Cir. 1955), declared that Section 3466 "is not applicable in proceedings in bankruptcy." But it was only the incorporation of Section 3466 by § 64a(5) of the Bankruptcy Act that assured federal nontax claims even fifth priority. *Cf. Davis v. Pringle*, 268 U.S. 315 (1925), discussed in note 25 *supra*.

80. The 1959 ABA proposal, which did not undertake to exclude nontax claims from priority, would have qualified the exclusion of bankruptcy proceedings from Section 3466 by providing:

[Sec. 3466(c)] (6) RULE IN BANKRUPTCY.—This section is a law of the United States entitling the United States to priority within the meaning of the Bankruptcy Act, and in proceedings under that Act the claims of the United States shall have the degree of priority therein specified. 1959 REPORT, *supra* note 47, at 735. If Congress declines to relinquish the priority of federal nontax claims, such language might be adopted, although a more direct approach would be to amend the first part of § 64a(5) of the Bankruptcy Act itself, 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969), to read, "debts other than for taxes owing to the United States," since apparently nothing else is in fact embraced by the present more general terms thereof. *In re Chicago Express, Inc.*, 222 F. Supp. 566, 571 (S.D.N.Y. 1963), *affd.*, 332 F.2d 276 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964).

81. Bankruptcy Act § 102, 11 U.S.C. § 502 (1964), expressly excludes the application of § 64 of the Act, 11 U.S.C. § 104 (Supp. V, 1965-1969), in corporate reorganizations under Chapter X unless the reorganization fails and liquidation follows. Section 77

receiverships, which include the rule of Section 3466 if the debtor is insolvent, are controlling.⁸² Since the Bankruptcy Act itself pre-

contains no comparable provision and it has often been said that "Section 64 . . . is applicable to a proceeding under Section 77" (*In re New York, O. & W. Ry.*, 25 F. Supp. 709, 713 (S.D.N.Y. 1937)) or that the question is an open one (*Gardner v. New Jersey*, 329 U.S. 565, 578 n.7 (1947)); however, the cases involved not the priority scheme of § 64 but a misplaced proviso, since transferred to the jurisdictional section where it belongs (Bankruptcy Act § 2a(2A), 11 U.S.C. § 11a(2A) (Supp. V, 1965-1969)), giving the court power to hear and determine any question concerning the amount or legality of any unpaid tax. *See Lyford v. City of New York*, 137 F.2d 782, 785 (2d Cir. 1943). Such a jurisdictional provision may well be incorporated under Section 77 by Bankruptcy Act § 77(l), 11 U.S.C. § 205(l) (1964), but the priority system of § 64 seems clearly inconsistent with that of § 77(b), 11 U.S.C. § 205(b) (1964) [discussed in note 82 *infra*], and has been said to be incompatible with a proceeding that deals with secured debts. *United States v. Anderson*, 334 F.2d 111, 115-16 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964); *In re New York, O. & W. Ry.*, 59 F. Supp. 865, 868-69 (S.D.N.Y. 1943), *modified sub nom. Lyford v. New York*, 140 F.2d 840, 845 (2d Cir.), *cert. denied*, 323 U.S. 714 (1944). *See T. FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION* 344 (1939). It may also be significant that Bankruptcy Act § 67c, 11 U.S.C. § 107(c) (1964), which makes the priorities of § 64 predominant over certain invalidated or postponed liens, is expressly made inapplicable not only under Chapter X but in railroad reorganizations as well. *Cf. 5 W. COLLIER, BANKRUPTCY* ¶ 77.21, at 569 (14th ed. rev. 1970); T. FINLETTER, *supra* at 359-60.

On the other hand, the special proceedings under Chapters XI and XIII do, in general, incorporate the priorities of § 64. Bankruptcy Act §§ 302, 659(6), 11 U.S.C. §§ 702, 1059(6) (1964); and Bankruptcy Act § 337(2), 11 U.S.C. § 737(2) (Supp. V, 1965-1969); *In re Belkin*, 358 F.2d 378 (6th Cir. 1966); *In re Chicago Express, Inc.*, 332 F.2d 276 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964). Whether § 64 is incorporated in Chapter XII is unclear from the language of § 402 of the Bankruptcy Act, 11 U.S.C. § 802 (1964). *See T. FINLETTER, supra* at 345-46.

82. The applicability of Section 3466 to insolvent Chapter X reorganizations is settled by *United States v. Key*, 397 U.S. 322 (1970); *United States v. Anderson*, 334 F.2d 111 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964). The Court in *Key*, in referring to the railroad reorganization law that was the precursor of the general corporate reorganization provisions, stated that "[n]othing in § 77 casts any doubt upon the continued priority of the United States under § 3466." 397 U.S. at 330. One court, however, has dismissed that statement as "clearly dictum" (which it was) and has refused to apply Section 3466 in an insolvent railroad reorganization, at least in the case of secured federal claim. *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103 (M.D. Tenn. 1970), *appeal docketed*, No. 71-1228, 6th Cir., 1971. The court, in so holding, referred to Bankruptcy Act § 77(b), 11 U.S.C. § 205(b) (1964), which prescribes that "unsecured claims, which would have been entitled to priority if a receiver in equity . . . had been appointed by a Federal court . . . shall be entitled to such priority . . ." (emphasis added) as evidence that, if applicable at all, Section 3466 did not apply to secured federal claims in such a proceeding. Section 77(b), however, was not designed, except perhaps incidentally, either to incorporate or to limit the application of Section 3466. In its original form, in § 77(c) (as added by the Act of March 3, 1933, ch. 204, § 1, 47 Stat. 1467), it related only to "unsecured claims, which would have had priority over existing mortgages . . ." (emphasis added) and was plainly designed to incorporate the equitable priority of certain operating expenses incurred within six months before a railroad receivership (*see notes 238-41 infra* and accompanying text). In that form, § 77 probably did not, in itself, incorporate Section 3466 at all. *See Rodgers & Groom, Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 COLUM. L. REV. 571 (1933). The provision was broadened in 1935 by deletion of the words, "over existing mortgages," so that it incorporated the whole spectrum of priorities of unsecured claims in equity receiverships to the exclusion of the rules of Bankruptcy Act § 64, 11 U.S.C. § 104 (1964) (*see note 81 supra*) and incidentally embraced Section 3466 with respect to unsecured federal claims. But no

cludes approval of any reorganization plan that does not provide for *full payment* of federal taxes and customs duties (unless the Government agrees to a compromise),⁸³ the principal function of Section 3466 in such reorganizations, as in the case of conventional bankruptcies, relates to federal nontax claims which, if the proposal is adopted in this respect, would no longer be within the priority at all. However, the Supreme Court has recently relied upon Section 3466 to supplement the specific provisions of the Bankruptcy Act with respect to full payment of *taxes* in reorganizations by requiring that federal taxes be paid not only fully but also *first in time*.⁸⁴ Perhaps the ABA proposal to exclude proceedings "in bankruptcy" from the scope of Section 3466 would not have the effect of precluding its application in such reorganizations, since a "proceeding to reorganize is not a bankruptcy, though an amendment to the bankruptcy act creates and regulates the remedy."⁸⁵ But, assuming the desirability in reorganization plans of requiring payment of federal taxes first in time (even if assets suffice to assure ultimate full payment),⁸⁶

express reference thereto was necessary, any more than in Chapter X, to make Section 3466 apply to all federal claims whether secured or not (*see* text accompanying note 395 *infra*) since the appointment of a trustee to take charge of the railroad's property supplies the act of bankruptcy requisite to the application of Section 3466 (assuming insolvency also exists). It is immaterial for this purpose that the railroad was ineligible to become bankrupt. *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 489-90 (1926). It must be admitted, however, that there is contrary legislative history in connection with a further amendment by the Act of June 26, 1936, ch. 833, 49 Stat. 1969, which added to Bankruptcy Act § 77(e), 11 U.S.C. § 205(e) (1964), the prescription, next discussed in the text, that no railroad reorganization plan could be approved unless it provided for either the full payment or compromise of federal taxes and customs duties. The reports declared that the section as amended would be "much more flexible and less drastic than . . . section 3466" because "[t]he bill entitles the Government to preferred treatment only as to claims for taxes and customs duties. Such treatment is not accorded other debts due the United States, in spite of the fact that Congress' continued policy would so warrant." S. REP. NO. 1985, 74th Cong., 2d Sess. 3 (1936); H.R. REP. NO. 2926, 74th Cong., 2d Sess. 6 (1936). Although the Court in *Key* (397 U.S. at 327-29, 331-32) concluded that the comparable provision of Chapter X, Bankruptcy Act § 199, 11 U.S.C. § 599 (1964), supplemented rather than excluded the application of Section 3466, there were not the same contrary indications in the legislative history in that instance.

83. Bankruptcy Act §§ 77(e), 199; 11 U.S.C. §§ 205(e), 599 (1964). *See also* Bankruptcy Act § 455, 11 U.S.C. § 855 (1964), regarding real property arrangements under Chapter XII.

84. *United States v. Key*, 397 U.S. 322 (1970).

85. *See Lowden v. Northwestern Natl. Bank & Trust Co.*, 298 U.S. 160, 163 (1936).

86. Since interest ceases to run on the federal claims at the commencement of the proceeding (*United States v. Edens*, 189 F.2d 876 (4th Cir. 1951), *affd.*, 342 U.S. 912 (1952)), deferral of payment of the Government's claim while other claimants are paid deprives the federal claim of part of its value even though ultimate full payment is assured. In conventional bankruptcies, in which liquidation is the objective, payment of priority debts "in advance of the payment of dividends to creditors" is required by Bankruptcy Act § 64a, 11 U.S.C. § 104(a) (Supp. V, 1965-1969), and Bankruptcy Act § 65b, 11 U.S.C. 105(b) (1964). The ABA did not consider the merit of the "first in

the matter should be dealt with directly and not left to construction.⁸⁷

The ABA proposal would not alter the above-mentioned mandate that no plan of reorganization shall be confirmed by the court unless it provides for "payment" of federal taxes and customs duties or unless the Government is willing to accept "a lesser amount." On the face of it, the Government now has, and would continue to have, the power to circumvent the purposes of the proposal in this major area of insolvency administration by exacting full payment of federal taxes as a condition to its acquiescence in any plan, even if the amount of senior mortgages and of the liens and priorities that would be recognized by the proposed legislation exhausts the value of the debtor's property.⁸⁸ In practice, the exercise of such power may be restrained by the Government's realization that it will be subordinated to those mortgages, liens, and priorities if obstruction of the confirmation of a plan forces an adjudication of bankruptcy,⁸⁹ and perhaps also by its recognition of "the objective of Congress . . . to enable enterprises which are in trouble to get back onto their feet."⁹⁰ It seems desirable, however, to provide a statutory guideline

time" rule as applied to reorganizations since the committee reported before *Key* was decided.

87. The National Bankruptcy Conference in 1964 (after the decision in *United States v. Anderson*, 334 F.2d 111 (5th Cir.), cert. denied, 379 U.S. 879 (1964), discussed in note 82 *supra*), resolved that Section 3466 should be made entirely inapplicable in Chapter X proceedings. NATIONAL BANKRUPTCY CONFERENCE, ANNUAL MEETING PROCEEDINGS, Resolution No. 7 at 11 (1964). The main objectives of that proposal may be achieved by the ABA proposal's exclusion of federal nontax claims from priority and its placing of state and local taxes on a parity with federal taxes even in cases governed by Section 3466.

88. "The priority thus conferred [by the full payment requirement] is superior to all other claims against the estate, even to existing and perfected liens which might otherwise be prior." 6A W. COLLIER, BANKRUPTCY ¶ 9.17, at 269-70 (14th ed. rev. 1969). "Indeed, the preference over secured claims provided by Section 199 [11 U.S.C. § 599] exceeds the general preference given by Section 3466." Brief for United States at 26, *United States v. Key*, 397 U.S. 322 (1970).

89. Bankruptcy Act § 236, 11 U.S.C. § 636 (1964). See text accompanying notes 23-37 *supra*, concerning liens and priorities in a liquidating bankruptcy. The possibility of conversion to a straight bankruptcy proceeding is not open, however, in the case of a railroad reorganization that fails to result in an acceptable plan (Bankruptcy Act § 4, 11 U.S.C. § 22 (1964); see Fooshee & Billyou, *Amendments to Federal Railroad Reorganization Statutes Proposed by the American Bar Association*, 16 BUS. LAW. 543, 547 (1961)), although theoretically the proceeding may be dismissed and followed by foreclosure of the prior liens (see *In re New York, O. & W. Ry.*, 59 F. Supp. 865, 871 (S.D.N.Y. 1943), *affd. sub nom. Lyford v. New York*, 140 F.2d 840 (2d Cir.), cert. denied, 323 U.S. 714 (1944)) or by an equity receivership in which Section 3466 would apply. Bankruptcy Act § 77(i), 11 U.S.C. § 205(i) (1964).

90. *Hearings on the Revision of the Bankruptcy Act Before the House Comm. on the Judiciary*, 75th Cong., 1st Sess. 350-51 (1937) [hereinafter *Hearings*]. It was represented to Congress at that time, after two years' experience with the predecessor of Bankruptcy Act § 199, 11 U.S.C. § 599 (1964), that "there is not a single case in which a reorga-

for the "lesser amount," which the Government may be expected, or preferably required by the court, to accept. This amount should be equal to the value of the Government's interest, if any, in the debtor's property (measured by the standards of the "full priority" rule applicable in receiverships and reorganizations)⁹¹ after deducting all liens and claims having priority over the taxes under the proposed revision of Section 3466.⁹²

Finally, the application of existing Section 3466 to proceedings under the Bankruptcy Act has the effect of subjecting trustees, receivers, and distributing agents operating under the Act to Section 3467,⁹³ the "policeman" of Section 3466, which imposes personal liability for knowingly⁹⁴ making payments in disregard of the Government's priority.⁹⁵ The ABA proposal to confine Section 3466 to administrations "otherwise than in bankruptcy," and Section 3467 to payments of other claims before federal claims "which *under the preceding section* are entitled to priority over the claims so paid,"⁹⁶ would preclude the use of this remedy for mispayments at least in conventional bankruptcy cases,⁹⁷ if not in special proceedings under

nizing debtor has been forced into liquidation because of inability to arrive at a fair and proper settlement of the governmental tax claim with the officials of the Treasury Department." The hearings indicated, however, that any concessions made by the Government were guided by its judgment of whether full payment could be exacted without stripping the business of working capital or unduly jeopardizing its future success, rather than by recognition of the priority rights of the mortgagees. See text accompanying notes 6-10 *supra*.

91. See *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Kyser v. MacAdam*, 117 F.2d 232, 237 (2d Cir. 1941). It may be appropriate to require that the amount so determined be paid to the Government in cash rather than in securities of a business corporation.

92. See *Hearings*, *supra* note 90, at 44 (Assn. of the Bar of the City of N.Y., opposing enactment of Bankruptcy Act § 199: "If the property is found by the court to be worth more than the liens, senior to that of the Government, the Government should not be entitled to more than the amount of the excess . . ."). Cf. INT. REV. CODE of 1954, § 6325(b)(2), which provides for discharge of tax liens on mortgaged property upon payment of the value of the Government's interest or for no payment if there is no equity for the Government. Although such discharges are discretionary (Treas. Reg. § 301.6325-1(b)(2) and (3) (1964)), the judicial supervision of the reorganization would seem to make it appropriate here to require acceptance of an amount determined by the court in conjunction with the valuations it must make in ascertaining that the plan is "fair and equitable" to all. Of course, if old stockholders receive anything in the reorganization, other than for new capital, the taxes should be paid in full. Cf. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939).

93. REV. STAT. § 3467 (1875), as amended, 31 U.S.C. § 192 (1964), set out in note 1 *supra*.

94. See text accompanying notes 430-38 *infra*.

95. See text accompanying notes 138-62 *infra*.

96. 1970 REPORT, *supra* note 53, at 416, 418 (emphasis added). See proposed § 3467, set out in note 427 *infra*.

97. If this is a "booboo," the writer, as draftsman of the 1959 ABA recommendation that contained substantially the same language, must accept the responsibility.

the Act.⁹⁸ However, under the present Bankruptcy Act, it is difficult to conceive of circumstances in which mispayments made with knowledge of a federal claim would occur without subjecting the trustee to a surcharge—with an effect similar to that of Section 3467 although administered by the bankruptcy court.⁹⁹ The trustee who prematurely pays claims of lower priority without the protection of a court order, with the result that a federal claim remains unsatisfied, would surely be surcharged,¹⁰⁰ even if he subsequently obtained the referee's approval.¹⁰¹ Likewise, although a dividend to creditors has been duly ordered, a trustee's nondisclosure of a known federal claim or his disregard of instructions to provide for it would vitiate the protection of the order.¹⁰² In the unlikely event that after "candid disclosure to creditors [and] to the court," the court nevertheless erroneously gives instructions that would protect the trustee from surcharge,¹⁰³ the same court order would also protect him from

98. See *Lowden v. Northwestern Natl. Bank & Trust Co.*, 298 U.S. 160 (1936).

99. Of the four reported cases in the last century in which Section 3467 liability was imposed on a trustee or other officer in bankruptcy, three involved conventional bankruptcies in which the United States had filed no proof of its claim but distribution was made with knowledge of the claim and without obtaining a bar order. *Lewis v. United States*, 92 U.S. 618 (1876); *United States v. Kaplan*, 74 F.2d 664 (2d Cir. 1935); *United States v. Barnes*, 31 F. 705 (C.C.S.D.N.Y. 1887). The possibility of such a situation arising was minimized by the Chandler Act of 1938 which subjected the United States to the general requirement that claims be filed within a prescribed time if they are to be allowed for payment (Bankruptcy Act § 57n, 11 U.S.C. § 93n (1964)), although conceivably a dividend depleting the fund available for a federal claim (known to the trustee) might be declared and paid before the time for filing claims expires (Bankruptcy Act § 65b, 11 U.S.C. § 105(b) (1964)) or the trustee might fail to provide, from the proceeds of property, for a perfected federal lien for which no proof of claim need be filed. *DeLaney v. City and County of Denver*, 185 F.2d 246 (10th Cir. 1950). The fourth and most recent reported instance of the application of Section 3467 in bankruptcy involved an arrangement under Chapter XI in which a plan had been confirmed on the condition that funds be reserved for a known but unliquidated federal claim. The available funds instead were dissipated in payments to general creditors, pursuant to specific court orders and with the countersignature of the referee, before the expiration of the time set by the court for filing proof of the federal claim. Although the bankruptcy court approved the distributing agent's account and discharged him, Section 3467 liability was thereafter imposed in a separate suit on the ground that it was the agent's responsibility to object to payments of deposited funds, pursuant to the plan, before the federal claim was definitely provided for. *King v. United States*, 379 U.S. 329 (1964). For additional facts, see the decision below at 322 F.2d 317 (3d Cir. 1963), and the prior proceeding, *In re Seeley Tube & Box Co.*, 120 F. Supp. 269 (D.N.J. 1954), *revd.*, 219 F.2d 389 (3d Cir.), *cert. denied*, 350 U.S. 821 (1955).

100. *In re Lambertville Rubber Co.*, 111 F.2d 45 (3d Cir. 1940).

101. Distributions to creditors are the responsibility of the referee, not the trustee, but the referee's adoption of the trustee's act as his own does not relieve the trustee. *In re Prindible*, 115 F.2d 21 (3d Cir. 1940).

102. *In re B.A. Montgomery & Sons*, 17 F.2d 404 (N.D. Ohio 1927). Cf. *King v. United States*, 379 U.S. 329 (1964), discussed in note 99 *supra*, to the same effect under Section 3467.

103. See *Mosser v. Darrow*, 341 U.S. 267, 274 (1951). Cf. *In re Mississippi Valley*

liability under Section 3467, at least if the United States had subjected itself to the court's jurisdiction by proving its claim.¹⁰⁴

When available, the remedy of surcharging the trustee would seem more in keeping with the purpose of vesting in the bankruptcy court exclusive jurisdiction of "the supervision and control of the trustees and others who are employed to assist them."¹⁰⁵ If situations, within the reach of Section 3467, are anticipated in which the surcharge would not be an available remedy, specific amendment of the Bankruptcy Act might be more appropriate than continuing the application of the independent remedy to bankruptcy cases.

C. *Insolvency Arising During Proceeding*

The federal priority under the present Section 3466 applies (in the prescribed forms of proceedings) "whenever" a living debtor "is insolvent" or the estate of a deceased debtor "is insufficient to pay all the debts due from the deceased."¹⁰⁶ Insolvency in the bankruptcy sense of having debts in excess of assets, rather than in the equity sense of inability to pay debts as they mature, is prerequisite.¹⁰⁷ Except as may be inferred from the use of the word "whenever" and of the present tense ("is"), the law gives no clue to whether the condition of insolvency or insufficiency must exist at the commencement of the proceeding or only at distribution. The 1959 ABA proposal sought to establish a point of reference for the determination of such insolvency or insufficiency of assets by defining a debtor or estate as insolvent if the "property which is subject to general ad-

Iron Co., 58 F. Supp. 222, 228 (E.D. Mo. 1944), which held that an act of the trustee pursuant to court order, even though initiated by him, is the act of the court and cannot subject the trustee to liability to parties injured thereby.

104. Cf. *United States v. Pate*, 47 F. Supp. 965, 968 (W.D. Ark. 1942). See *King v. United States*, 379 U.S. 329, 338-39 (1964), which stated that if the court had ordered the improper payment in the face of objection, "a very different case" would have been presented under Section 3467.

105. See *United States Fidelity & Guar. Co. v. Bray*, 225 U.S. 205, 217 (1912). In some cases, the surcharge remedy may be more effective than that under Section 3467. A trustee may be surcharged for failure to seek out prior liens of record (*In re Prather*, 138 F. Supp. 433 (S.D. Ill. 1956); see *In re Woodmar Realty Corp.*, 294 F.2d 785, 793 (7th Cir. 1961)), whereas constructive notice of filed liens has not been charged to fiduciaries under Section 3467. *Livingston v. Becker*, 40 F.2d 673 (E.D. Mo. 1929).

106. 31 U.S.C. § 191 (1964).

107. *United States v. Oklahoma*, 261 U.S. 253, 259-60 (1923). The ABA proposal would reaffirm this rule. See S. 2197, 92d Cong., 1st Sess. (1971), which reads:

[Sec. 3466] (g) DEFINITIONS.—For the purposes of this section and section 3467

...

(4) "insolvent" refers to a condition in which the debtor's property which is subject to general administration for the benefit of creditors, or the property of the estate of a decedent is insufficient to pay all the debts of that debtor or estate

ministration . . . is insufficient, *either at the commencement of the proceedings or during pendency thereof*, to pay all his debts."¹⁰⁸ The 1970 version takes the opposite tack and proposes that the priority apply only if, *at the time of divestment of the property of a living debtor or at the time of death*, the property of the debtor or decedent was insufficient to pay all his debts;¹⁰⁹ the report states that this position "is believed [to be] a codification of existing law."¹¹⁰

The report cites as its authority for the "existing law" a 1933 Recent Case note¹¹¹ that was critical of a Second Circuit decision that reached the *opposite* result and which, to this day, stands as the only federal court authority squarely in point. That case, *Hatch v. Morosco Holding Co.*,¹¹² involved a consent receivership, based upon an allegation of "solvency but temporary financial embarrassment,"¹¹³ for the purpose of conserving the assets of the debtor corporation. Although insolvency was not shown to have existed at the inception, it did exist when distribution was ordered six years later.¹¹⁴ The court unanimously held that the Section 3466 priority applied "to debts owed the government by a debtor in receivership who becomes insolvent after the receiver is appointed if the statute would have been applicable had the debtor been insolvent at the time the receiver was appointed."¹¹⁵ Certain superficially contrary statements of the Supreme Court, to the effect that the priority attaches at the time the receiver or other person takes over the property,¹¹⁶ were explained as referring to situations in which insolvency *did* then exist,¹¹⁷ but not as excluding the possibility of its later attachment.¹¹⁸ On the other hand, the Second Circuit found

108. 1959 REPORT, *supra* note 47, at 732, 734 (emphasis added).

109. See proposed § 3466(a), set out in note 74 *supra*.

110. 1970 REPORT, *supra* note 53, at 419-20.

111. 46 HARV. L. REV. 1342 (1933).

112. 61 F.2d 944 (2d Cir. 1932), *cert. denied*, 288 U.S. 613 (1933).

113. 61 F.2d at 945.

114. 61 F.2d at 945. In *Hofmann v. United Welding & Mfg. Co.*, 140 Conn. 597, 602, 102 A.2d 878, 881 (1954), the opinion incorrectly states that in *Morosco* "the receiver conceded that on the date of his appointment the corporate estate was insolvent." The concession in fact related to the distribution date.

115. 61 F.2d at 946.

116. *E.g.*, in *County of Spokane v. United States*, 279 U.S. 80 (1929), the debtor was insolvent from the inception, and the Court was saying that no then inchoate lien could defeat the priority. The same may be said of the later similar declarations in *Massachusetts v. United States*, 333 U.S. 611, 617 n.8, 626 (1948).

117. 61 F.2d at 946.

118. In *United States v. Oklahoma*, 261 U.S. 253, 260 (1923), the Court said that "If priority in favor of the United States attaches at all, it takes effect immediately

inferential Supreme Court support for its position in *Price v. United States*,¹¹⁹ in which a consent receivership had been commenced upon an allegation of solvency although in fact the debtor "was in a failing condition" and "was found to be insolvent *within a short time after* the appointment of the receiver"; the Supreme Court had declared that "[w]hen the assets *turned out* to be less than the debts, the creditors were entitled to have them dealt with as a trust fund and distributed among them according to their rights and priorities," with the United States coming first.¹²⁰

The Recent Case note, which is cited as indicating "existing law" to the contrary, actually directed its criticism of *Morosco* to a point that has been irrelevant for the past third of a century. We have seen that, in the case of a living debtor, the present Section 3466 priority is conditioned not only upon the existence of insolvency (at some time not clearly specified) but also upon the occurrence of certain events of which the pertinent ones are a "voluntary assignment" by a debtor "not having sufficient property to pay all his debts," and the commission of "an act of bankruptcy."¹²¹ Insolvency at the time of the triggering event is plainly an integral part of such an assignment but is not in all cases a necessary incident of an act of bankruptcy, the meaning of which has varied through the years with amendments of the bankruptcy laws.¹²² At

upon the taking over of the bank." (Emphasis added.) In that case the state asserted a lien in favor of its depositors' guaranty fund. The Court said that the lien could not exist before the taking of possession by the bank commissioner at which time, according to the Court, the Government's priority must have attached if it attached at all. Therefore, the lien did not antedate the Government's priority, if any. The Court then found that insolvency in the sense required by Section 3466 had not been a prerequisite to the takeover of the bank and that its existence had not been shown. As the Government brought the suit, apparently early in the proceeding, to obtain an order for payment of the federal claim in advance of the making of any other distribution, the question of insolvency in the prescribed sense "subsequently arising" was not presented.

119. 269 U.S. 492 (1926).

120. 269 U.S. at 502 (emphasis added). The *Morosco* court felt that if insolvency need not exist at the very inception of the receivership it can make no difference whether insolvency follows "within a short time" or after a period of years. The court granted that the Supreme Court's language could be construed to mean merely that insolvency found to exist shortly after the receiver was appointed had "some evidential force to show actual insolvency" from the *inception*. 61 F.2d at 947. But if that hiatus weakens the *Price* case as precedent, it takes nothing from the authority of the *Morosco* decision itself, in which the estate was solvent at the outset and the issue was squarely presented and decided.

121. See text accompanying notes 61-62 *supra*.

122. Although there was no federal bankruptcy law when the predecessor of Section 3466 was enacted in 1797, or for much of the century that followed, the reference therein was to acts of bankruptcy under the applicable state laws, or under any future bankruptcy laws that might be passed by Congress. See *Conard v. Nicoll*, 29 U.S. (4

the time of the *Morosco* case, and until 1938, the appointment of a receiver, as such, was an act of bankruptcy only if the debtor, "being insolvent, applied for a receiver" or if "because of insolvency a receiver . . . [had] been put in charge of his property."¹²³ Solvency having been found at the time of appointment of the receiver,¹²⁴ that test for an act of bankruptcy was not met.¹²⁵ However, the law defined another act of bankruptcy as the debtor's making of "a general assignment for the benefit of his creditors,"¹²⁶ regardless of whether he was solvent or insolvent at the time thereof.¹²⁷ The argument had been frequently advanced that a debtor's participation in a consent receivership—by which friendly creditors, with the concurrence of the debtor, enabled him to hold off all creditors while attempting rehabilitation—was an act of bankruptcy equivalent to a general assignment for the benefit of creditors. Although the lower courts were divided, the prevailing view was that a consent receivership was not an act of bankruptcy.¹²⁸ If *Morosco* was in error, therefore, it was only because the court slighted the threshold question in applying Section 3466 to a case in which there was neither a "voluntary assignment" while insolvent nor, in the absence of insolvency at the time, any occurrence which was then regarded as an act of bankruptcy.

One state court decision, *Hofmann v. United Welding & Manufacturing Co.*,¹²⁹ has also been cited, although not in the ABA report, as authority for the assertion that the Section 3466 priority can apply only if insolvency exists at the time of divestment.¹³⁰ But the case

Pet.) 291, 307-08 (1830). In *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 368 (1946), for example, the Court cited a 1938 amendment to the Bankruptcy Act as identifying the act of bankruptcy that made the ancient priority applicable.

123. Act of Feb. 5, 1903, ch. 487, § 2, 32 Stat. 797, amending Bankruptcy Act of 1898, § 3 (emphasis added). There was some authority that, even if insolvency in the bankruptcy sense in fact existed, a receivership did not constitute this act of bankruptcy if such insolvency was not alleged in the petition or relied upon by the court in appointing the receiver. *In re Valentine Bohl Co.*, 224 F. 685 (2d Cir. 1915); *In re Wm. S. Butler & Co.*, 207 F. 705 (1st Cir. 1913). But see *Davis v. Michigan Trust Co.*, 2 F.2d 194, 196 (6th Cir. 1924).

124. 61 F.2d at 945.

125. See *Nolte v. Hudson Navigation Co.*, 8 F.2d 859 (2d Cir. 1925).

126. Bankruptcy Act of 1898, ch. 541, § 3a(4), 30 Stat. 546, as amended, 11 U.S.C. § 21(a)(4) (1964).

127. *West Co. v. Lea*, 174 U.S. 590 (1899).

128. *United States v. Middle States Oil Corp.*, 18 F.2d 231 (8th Cir. 1927); *Vaccaro v. Security Bank of Memphis*, 103 F. 436 (6th Cir. 1900). But cf. *Davis v. Miller-Link Lumber Co.*, 296 F. 649 (5th Cir. 1924).

129. 140 Conn. 597, 102 A.2d 878 (1954).

130. See Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 906 n.8 (1954).

does not so hold. *Hofmann* involved a receiver appointed in a stockholder's suit to dissolve a solvent corporation whose assets were alleged to be in danger of being wasted. The Government based its priority claim on the fifth act of bankruptcy, which had been expanded by the Chandler Act of 1938 to include a receivership "procured, permitted, or suffered voluntarily or involuntarily" by the debtor "while insolvent or unable to pay his debts as they mature."¹³¹ Although the funds available at the time of distribution were inadequate to pay debts, there was no finding that *either* insolvency or inability to pay maturing debts had existed when the receiver was appointed six years earlier. The court remanded the case for findings thereon, declaring that "[o]nly if the court finds that the company was insolvent under the Bankruptcy Act, or was unable to pay its maturing debts can the court conclude that an act of bankruptcy was committed, and only upon that conclusion may priority attach to the federal claims."¹³²

In the case of a decedent's estate, the sole statutory prerequisite for federal priority is insufficiency of assets to pay debts; the courts have held that the priority applies to an estate that was solvent at the time of death but subsequently became insolvent.¹³³

"Existing law," therefore, may fairly be stated as follows: Insolvency, in the sense of insufficiency of assets to pay debts, must exist at the time of divestment only if the Government relies upon the "voluntary assignment" clause of Section 3466,¹³⁴ or if the particular act of bankruptcy relied upon embraces a requirement of insolvency. But a general assignment for the benefit of creditors, even by a debtor who at the time is solvent in every sense, a general receivership or proceeding for reorganization of a solvent debtor who is merely unable to meet his debts as they mature, or the administration of the estate of a solvent decedent will also be subject to the federal priority, provided only that insolvency in the bankruptcy sense exists by the time of distribution. The 1959 ABA proposal, although shifting the focus from the technical acts of bankruptcy to any divestment of title or possession for the purpose of effecting a

131. Act of June 22, 1938, ch. 575, § 3a(5), 52 Stat. 844, 11 U.S.C. § 21(a)(5) (1964) (emphasis added).

132. 140 Conn. at 604, 102 A.2d at 882 (emphasis added).

133. *In re Williams' Estate*, 189 Misc. 210, 68 N.Y.S.2d 840 (Surr. Ct. 1947). Cf. *Bowes v. United States*, 127 N.J. Eq. 132, 11 A.2d 720 (1940). See also *Viles v. Commissioner*, 233 F.2d 376 (6th Cir. 1956); *Leroy K. New*, 48 T.C. 671 (1967) (applying the companion provision, Section 3467).

134. In view of the expansion of the acts of bankruptcy, this clause of Section 3466 probably serves little, if any, purpose today.

general administration for the benefit of creditors, would have confirmed existing law in this respect. The 1970 ABA proposal, in denying priority in all cases unless assets at the time of divestment or at the time of death were insufficient to pay debts, would have changed existing law, despite protestation to the contrary.

This criticism, however, is by no means a conclusive objection to the revised proposal. Since the whole objective of the legislative proposal is to change and improve existing law, we may take a pragmatic approach, with the precedents serving only to illuminate the problems to be considered. Important as "a page of history" may be, it might well be overcome in this situation by "a volume of logic."¹³⁵ Is there, then, some logical reason to deny the federal priority if, at the time of divestment or death, the debtor had \$101,000 in assets and \$100,000 in debts, and to apply the priority where he had \$99,000 in assets and \$100,000 in debts—if in either case there is \$50,000 left for distribution to creditors at termination? The system of priorities in proceedings under the Bankruptcy Act applies whether the estate was solvent or insolvent in its inception and whether or not there is first an attempt, through one of the special proceedings (analogous to equity receiverships), to rehabilitate the debtor.¹³⁶ Since one of the announced objectives of the reform is "to bring the priority provisions in line with the policies expressed in the National Bankruptcy Act,"¹³⁷ the burden is on the proponents to justify such a departure from bankruptcy principles in the final distribution of an initially solvent, but terminally insolvent, decedent's estate, receivership, liquidation, or assignment for creditors.

The one persuasive reason suggested for the proposed change is that the application of Section 3466 carries with it the personal liability that Section 3467, the "policeman" of the priority, imposes upon the fiduciary,¹³⁸ a risk which may, in some circumstances, impose

135. See *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921) (Holmes, J.).

136. Voluntary bankruptcies, involuntary bankruptcies based on certain acts of bankruptcy (*West Co. v. Lea*, 174 U.S. 590 (1899)), and proceedings for reorganization or relief of debtors may be commenced when the debtor is not insolvent in the bankruptcy sense. Bankruptcy Act §§ 3, 77(a), 130, 323, 423 & 623, 11 U.S.C. §§ 21, 205(a), 530, 723, 823 & 1023 (1964). The rules for priority of distribution under § 64 of the Act, 11 U.S.C. § 104 (Supp. V, 1965-1969), make no distinction based on whether the debtor was solvent at the inception. If a proceeding under Chapters X-XIII fails, it is displaced by a liquidating bankruptcy in which the same rules of priority apply. Bankruptcy Act §§ 236, 376, 481 & 666, 11 U.S.C. §§ 636, 776, 881 & 1066 (1964).

137. 56 A.B.A.J. 991 (1970).

138. See text accompanying notes 93-105 *supra*. A receiver, although an officer of the court, is subject to such liability. See *King v. United States*, 379 U.S. 329, 334-36 (1964), approving *United States v. Crocker*, 313 F.2d 946 (9th Cir. 1963).

an unwarranted impediment to the continuation and rehabilitation of an apparently solvent enterprise.¹³⁹ It is no doubt advisable, and consistent with the Bankruptcy Act,¹⁴⁰ to apply different operating rules to proceedings whose object is the rehabilitation of the debtor's business than to those directed solely to the liquidation and distribution of his assets. But I submit that the proposed rule goes too far. Section 3466 embraces liquidation proceedings, such as assignments for the benefit of creditors, corporate liquidations, and many administrations of decedents' estates, as well as proceedings designed to continue and restore a business, yet all would be relieved of the operation of the priority rule if the proceeding happens to have *commenced* with the estate in a solvent condition. It imposes no undue burden on the liquidating fiduciary, even when the estate is honestly thought to be solvent, to require that he pay known claims in their proper order of priority, or at least that he set aside sufficient funds to provide for known but unliquidated priority claims before paying other claims.¹⁴¹

Even in the case of an operating receivership or reorganization proceeding, or of an estate continuing to conduct a decedent's business, the impediment to operations attributed to the liability imposed by Section 3467 may not be as great as is imagined. The fiduciary in such cases is at liberty, within the limits of his authority, to incur and pay obligations for expenses of operation,¹⁴² unimpeded by the federal priority, since such expenses are preferred over pre-administration claims of the United States.¹⁴³

139. 1970 REPORT, *supra* note 53, at 420. The potential impediment to the operation of a solvent receivership is illustrated in *United States v. Middle States Oil Corp.*, 18 F.2d 231, 239 (8th Cir. 1927), in which the Government sought to prevent any payments to creditors until the amount of federal taxes could be ascertained, even though assets of the receivership far exceeded its debts (including the maximum federal claim) and a heavy burden of interest was accumulating. Finding the federal priority inapplicable for want of an act of bankruptcy (*see* note 122 *supra*), the court said, "To withhold payment further of claims established with no resulting benefit to the government would be an act of gross injustice, which no government should desire." *Cf. United States v. Lutz*, 295 F.2d 736, 742 (5th Cir. 1961).

140. *See In re Yale Express Sys., Inc.*, 362 F.2d 111, 116 (2d Cir. 1966).

141. Both ABA proposals (*see* note 151 *infra* and accompanying text) would relieve even the liquidating fiduciary of liability if he proved actual solvency of the estate at the time a nonpriority claim was paid; but there is no reason to make his proof easier by excusing him on grounds of ignorance of insolvency (*see* text following note 152 *infra*) in the case of a liquidating proceeding. Other creditors cannot demand a dividend when a priority federal claim, even if unliquidated in amount, remains unpaid. *Pennsylvania Cement Co. v. Bradley Contracting Co.*, 274 F. 1003 (S.D.N.Y. 1920).

142. *Cake v. Mohun*, 164 U.S. 311, 315-16 (1896); *Chicago Deposit Vault Co. v. McNulta*, 153 U.S. 554 (1894); *Thompson v. Phenix Ins. Co.*, 136 U.S. 287 (1890); *Kennebec Box Co. v. O.S. Richards Corp.*, 7 F.2d 290 (2d Cir. 1925).

143. *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960); *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925). Concerning the priority of such ex-

However, in order to maintain relations with suppliers and employees or to prevent accumulation of interest, the operating fiduciary may also desire to avoid prolonged delay in the payment of certain obligations that antedate the administration.¹⁴⁴ Were it not for the effect, if any, of the federal priority statute, the fiduciary might be free to pay such claims in the normal course of business, without need for simultaneous proportionate (or priority) payments to other creditors, so long as he believes in good faith that all will be paid from assets on hand.¹⁴⁵ But, even under general law, his freedom is not unlimited, and such out-of-order payments may not be made after the solvency of the estate is in jeopardy¹⁴⁶ and certainly not after the operation has been discontinued and liquidation has commenced.¹⁴⁷ No reason is apparent why the initially solvent estate should be freed of application of the federal priority, or the fiduciary of the obligation to respect it, in any circumstances in which general law would require the fiduciary to treat other creditors equally or in strict accordance with their priorities.

I submit that, to the extent that relief may be necessary or desirable, the appropriate remedy is to amend Section 3467 to untie the hands of the operating fiduciary of a solvent estate during the interval before operations cease or the situation becomes hopeless, rather than to make the relative rights of creditors in the ultimate distribution depend upon the historical accident of whether administration commenced before or after that event. Section 3467, as now written, literally imposes liability irrespective of insolvency upon any "person who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts, before he satisfies and pays the debts due to the United States from such person or estate."¹⁴⁸

penses under the ABA proposal, see text accompanying notes 199-216 *infra*. The fiduciary incurs no liability under Section 3467 for paying expenses having priority over the federal claim. *United States v. Wisconsin Valley Trust Co.*, 233 F. Supp. 73 (W.D. Wis. 1964); *Jessie Smith*, 24 B.T.A. 807 (1931).

144. *United States v. Middle States Oil Corp.*, 18 F.2d 231, 239 (8th Cir. 1927), discussed in note 139 *supra*. In limited circumstances, in which the business might be unable to continue operating if the pre-administration obligation went unpaid, the payment may enjoy the priority of an administration expense. See text accompanying notes 251-62 *infra*.

145. *Standard Oil Co. v. Grand Rapids Trust Co.*, 98 F.2d 207, 209-10 (6th Cir. 1938).

146. *Gutterson & Gould v. Lebanon Iron & Steel Co.*, 151 F. 72, 75-77 (M.D. Pa. 1907).

147. *Standard Oil Co. v. Grand Rapids Trust Co.*, 98 F.2d 207, 210 (6th Cir. 1938) ("when operations are discontinued, the doctrine that equality is equity must govern the receiver—and no liens or preferences should be recognized unless satisfactorily established").

148. REV. STAT. § 3467, as amended, 31 U.S.C. § 192 (1964).

Only the historic link between that provision and Section 3466¹⁴⁹ has caused judicial rejection of the Government's contention that even the officers of a *solvent* corporation, not under administration, may incur personal liability if they pay any other obligations while the corporation is indebted to the Government and if the corporation thereafter becomes unable to pay the federal claim.¹⁵⁰ Both versions of the ABA proposal would make clear that only the payment of claims against a *then insolvent* debtor or estate can subject the fiduciary to liability for neglecting to satisfy first the federal claims entitled to priority.¹⁵¹ The 1970 proposal would also expressly provide—what has heretofore been implicit—that a fiduciary will not incur personal liability with respect to federal claims the existence of which was unknown to him when he paid other claims.¹⁵² A comparable requirement that the fiduciary have knowledge that the estate has become insolvent, or at least that he have such information as would put a reasonably prudent fiduciary upon inquiry, ought to be imposed as a condition to the personal liability of the operating fiduciary of an initially solvent administration who pays nonpriority claims in the normal course of business.

Such protection may be inadequate, however, to remove the impediment to business operation and rehabilitation. The precise point in time when an operating estate becomes insolvent may be less obvious to the fiduciary and his supervising court than it appears, with the benefit of hindsight, to another court in a later suit to impose personal liability. Apparently, under present law, not even prior court approval of payment of debts in the face of a known federal claim would protect the fiduciary from liability if, as is sometimes the case,¹⁵³ the Government refrained from submitting to the

149. Before codification in the Revised Statutes of 1875, both provisions were part of a single sentence. The division into two sections "did not work any change in the purpose or meaning." *King v. United States*, 379 U.S. 329, 336 (1964).

150. *United States v. Lutz*, 295 F.2d 736 (5th Cir. 1961).

151. 1959 REPORT, *supra* note 47, at 733, 735; S. 2197, 92d Cong., 1st Sess. (1971), amending REV. STAT. § 3467. Each proposal would substitute the words, "any claim against an insolvent debtor or estate" for the present words "any debt due by the person or estate." The text of the latter proposal is set out in full in note 427 *infra*.

152. S. 2197, 92d Cong., 1st Sess. (1971), amending REV. STAT. § 3467. See text accompanying notes 430-38 *infra*.

153. Except in proceedings under federal law, the Government need not file its claim within the prescribed time limits (*United States v. Summerlin*, 310 U.S. 414 (1940)), but may elect simply to advise the fiduciary of its claim at any time before distribution and rely upon his personal liability under Section 3467 (*United States v. Luce*, 78 F. Supp. 241 (D. Minn. 1948)); or it may decide to bring a separate action against the debtor or estate in the federal court and then belatedly file the judgment as an adjudicated claim. *Hart v. United States*, 207 F.2d 813 (8th Cir. 1953), *cert. denied*, 347 U.S. 919 (1954); *United States v. Peoples Trust & Sav. Co.*, 97 F.2d 771 (7th Cir.

jurisdiction of the court supervising the administration.¹⁵⁴ It may be preferable, therefore, in lieu of an uncertain test of *scienter*, to prescribe a more objective standard of liability under Section 3467. To be consistent with the purpose of Section 3466, any such standard should require some "notorious manifestation" of insolvency in order to provide certainty for those who must observe the priority.¹⁵⁵ In general, personal liability should be imposed upon an operating fiduciary of an initially solvent estate, whether or not the United States was a party to the proceeding and bound by the court's orders, only if (1) before the payment of a nonpriority claim the estate had been found by the supervising court to be insolvent or had been ordered into liquidation,¹⁵⁶ or (2) the payment was made in such circumstances that, under the law governing the proceeding, the fiduciary was obligated to make provision for the priorities or equal rights of other creditors.¹⁵⁷

When an initially solvent operating receivership or other estate under administration reaches the point of liquidation and distribution, there is no more reason to depart from the normally prescribed order of distribution than in a reorganization proceeding under the Bankruptcy Act that failed and was converted into a liquidating bankruptcy.¹⁵⁸ The fact that the receivership or estate was solvent

1938); G.C.M. 9991, XI-1 CUM. BULL. 135 (1932). *But cf.* Treas. Reg. § 301.6871(a)-2(b) (1957), directing the filing of claims in receiverships.

154. The Government is bound by a court's orders approving payment of claims if it participated in the proceeding. *United States v. Muntzing*, 69 F. Supp. 503 (N.D. W.Va. 1946); *United States v. Pate*, 47 F. Supp. 965, 968 (W.D. Ark. 1942). But the fiduciary is not protected if the court's approval is merely *ex parte* (*Gutterson & Gould v. Lebanon Iron & Steel Co.*, 151 F. 72, 75 (M.D. Pa. 1907)), or if the Government is not a party to the proceeding. *Field v. United States*, 34 U.S. (9 Pet.) 182, 201 (1835); *Viles v. Commissioner*, 233 F.2d 376, 380 (6th Cir. 1956); *John H. Beasley*, 42 B.T.A. 275 (1940).

155. *Cf.* *Prince v. Bartlett*, 12 U.S. (8 Cranch) 431, 434 (1814), which explained the need for some overt act of insolvency to make the priority applicable by saying, "Insolvency must be understood to mean a legal and known insolvency manifested by some notorious act of the debtor pursuant to law: not a vague allegation, which, in adjusting conflicting claims of the United States and individuals, against debtors it would be difficult to ascertain."

156. *See Blair, The Priority of the United States in Equity Receiverships*, 39 HARV. L. REV. 1, 17 (1925).

157. *See* text accompanying notes 146-47 *supra*.

158. *See* note 136 *supra*. The practical effect of this position (which was the position of the ABA in 1959 (*see* text accompanying note 108 *supra*)) is to eliminate proof of insolvency as a prerequisite to the right to priority of distribution. If assets are sufficient at termination of the proceeding, no question of priority will arise (*see Davis v. Pullen*, 277 F. 650, 654 (1st Cir. 1922)); if insufficient, insolvency at that time is ipso facto established. The reference to insolvency, however, serves a purpose in untying the hands of an operating fiduciary until insolvency appears. *See* text accompanying notes 138-57 *supra*.

at the outset is irrelevant to the *raison d'être* of the federal priority, which—aside from the naked exercise of sovereign power that it sometimes appears to be¹⁵⁹—is that the pendency of the proceedings, usually under the protection of judicial custody, ties the hands of the tax collector by precluding his availing of the summary collection remedies of lien¹⁶⁰ and levy¹⁶¹ while the fiduciary vainly seeks to preserve the business values for other creditors, stockholders, or legatees.¹⁶²

D. Administrations Not "For the Benefit of Creditors"

It has been held that the present Section 3466 is inapplicable if a financially embarrassed debtor gives a mortgage, as distinguished from an assignment, to a trustee for creditors, provided that there is a realistic equity of redemption and the purpose of the mortgage is rehabilitation rather than liquidation.¹⁶³ There is no substantive difference, however, between such an arrangement and the rehabilitative receivership which, at least since 1938, has been an act of bankruptcy making applicable the federal priority if the proceeding terminates in insolvency. The ABA 1959 proposal, therefore, prescribed that a mortgage or pledge, as well as an assignment, of all or substantially all of a debtor's property for the purpose of general

159. See dissenting opinion in *Massachusetts v. United States*, 333 U.S. 611, 635 (1948) ("The statute by which the Federal Government gives its own claims against an insolvent priority over claims in favor of a state government must be applied by courts, not because federal claims are more meritorious or equitable, but only because that Government has more power.")

160. *Byers v. McAuley*, 149 U.S. 608, 615-16 (1893). Cf. *Lazarus v. Prentice*, 234 U.S. 263 (1914). Concerning reorganization proceedings under the Bankruptcy Act, see §§ 77(j) & 116(4) thereof, 11 U.S.C. §§ 205(j) & 516(4) (1964).

161. *In re Tyler*, 149 U.S. 164, 181 (1893); Treas. Reg. §§ 301.6331(a)-1(a)(3), 301.6871(a)-2 (1957); G.C.M. 9991, XI-1 CUM. BULL. 135 (1932). Cf. *Youngstown Sheet & Tube Co. v. Patterson-Emerson Comstock of Indiana*, 227 F. Supp. 208, 215-17 (N.D. Ind. 1963). Although an assignment for the benefit of creditors may involve no judicial custody, the passage of title from the debtor nevertheless may preclude levy on the property. *Boese v. King*, 108 U.S. 379 (1883).

162. See *Dickinson v. Saunders*, 129 F. 16, 19 (1st Cir. 1904). Cf. *Bowen v. Hockley*, 71 F.2d 781, 784 (4th Cir. 1934); *Piedmont Corp. v. Gainesville & N.W.R.R.*, 30 F.2d 525, 529 (N.D. Ga. 1929).

163. *United States v. Gargill*, 218 F.2d 556, 560 (1st Cir. 1955); *Intermountain Assn. of Credit Men v. United States*, 14 Utah 2d 389, 384 P.2d 808 (1963). A trust mortgage has been held to invoke the priority if its purpose is liquidation rather than rehabilitation (*United States v. Davis*, 247 F. Supp. 84 (E.D. Mich. 1965), *affd. sub nom. United States v. County of Wayne*, 378 F.2d 671 (6th Cir.), *cert. denied*, 389 U.S. 972 (1967)), or if the reversion provided for the debtor is a sham. *Wing v. United States*, 208 F. Supp. 5 (D. Mass. 1962). It is immaterial whether the trust mortgage is ineffective under state law (e.g., MICH. STAT. ANN. § 27A.5201 (1962)) for failure of the trustee to file prescribed information with the court. *Maguire v. United States*, 71-2 U.S. Tax Cas. ¶ 9590 (E.D. Mich. 1971).

administration for the benefit of creditors should be deemed a "divestment."¹⁶⁴ The federal priority would then be applicable whether or not a reversion was provided. This change was carried forward by the ABA in its 1970 proposal,¹⁶⁵ although perhaps uncritically, since it seems out of harmony with the principle of that draft that only an administration of an estate that is insolvent from the outset will be subject to the federal priority rules.

On the other hand, if as herein proposed the premise of the ABA 1959 proposal—that the prescribed priorities shall apply in any case in which an administration terminates in insolvency—is adopted, some of the language common to each proposal may be narrower than it should be to carry out that purpose. Both proposals prescribe that the divestment of the debtor's title or possession (or the trust mortgage or pledge) must be "for the purpose of effecting a general administration for the benefit of creditors."¹⁶⁶ The element of "benefit of creditors" may be deemed lacking, for example, in a receivership in a stockholders' suit,¹⁶⁷ or perhaps even in an initially solvent consent receivership¹⁶⁸ or voluntary reorganization proceeding; yet, in such cases as well as in creditor-oriented administrations, the custody of the court may stay the use of the usual tax collection weapons as the proceeding degenerates into insolvency with no protection for the Government.¹⁶⁹ It ought to be made clear that any general administration divesting title or possession of the debtor's assets (as well as a trust mortgage or pledge) is one "for the benefit of creditors" from the time the assets become insufficient to pay debts.

III. RECOGNITION OF ANTECEDENT LIENS UNDER STATE LAW

The ancient sovereign priority of the English Crown applied only to the unencumbered assets of the debtor and was subject to specific

164. 1959 REPORT, *supra* note 47, at 732.

165. See 1970 REPORT, *supra* note 53, at 422. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (g) DEFINITIONS.—For the purposes of this section and section 3467—

(1) "divestment" includes an assignment, mortgage, or pledge of all or substantially all of the property of a debtor for the purpose of effecting a general administration for the benefit of creditors, whether or not provision is made for a revision [*sic*: should read "reversion"] to the debtor

166. 1959 REPORT, *supra* note 47, at 731; S. 2197, 92d Cong., 1st Sess. (1971), *amending* REV. STAT. § 3466(a). The latter proposal is set out in note 74 *supra*.

167. See, e.g., *Hofmann v. United Welding & Mfg. Co.*, 140 Conn. 597, 102 A.2d 878 (1954), discussed in text accompanying notes 129-32 *supra*.

168. The court so held in *United States v. Middle States Oil Corp.*, 18 F.2d 231, 237 (8th Cir. 1927), distinguishing a voluntary assignment from a consent receivership, the purpose of which is not to benefit creditors by a distribution of the property, but to deter them and enable the corporation to carry on its business.

169. Cf. *Harkin v. Brundage*, 276 U.S. 36, 43-45 (1928). *But cf.* *Bank of Andrews v. Gudger*, 212 F. 49, 54 (4th Cir. 1914) (involving conflict with the bankruptcy power).

liens and encumbrances that existed before the sovereign sought to enforce his right.¹⁷⁰ In this country, the statutory counterpart of the sovereign priority has been construed to be all but absolute and operates to deprive, among others, the mechanic's lienor, the landlord, and possibly even the mortgage lender of the security relied upon in extending credit, as well as to pre-empt the liens of rival taxing authorities.¹⁷¹

The ABA 1970 proposal would provide relief from this harsh rule.¹⁷² It would preserve, as against unsecured federal claims, any mortgage or other contractual security,¹⁷³ any statutory, common-law or equitable lien, or any lien obtained by judgment, levy, or other judicial proceeding or distraint. Although such relief for lien claimants has sound precedent in both the Bankruptcy Act and the Federal Tax Lien Act, the 1970 proposal lacks some of the limitations and safeguards that Congress built into those enactments. Only two limitations on the recognition of antecedent liens in insolvency administrations are proposed. The first, which may in fact be more effective than its counterpart in the Bankruptcy Act, would deny

170. See *Marshall v. New York*, 254 U.S. 380, 382 (1920); *In re Gruner*, 295 N.Y. 510, 68 N.E.2d 514, 522 (1946).

171. See text accompanying notes 6-21 *supra*.

172. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (e) CERTAIN LIENS PRESERVED.—Nothing in this section shall—

“
 (2) entitle an unsecured claim of the United States to priority over a competing claim secured by a lien existing at the time of divestment (or at the time of death in the case of an insolvent estate) if such lien would be entitled under other applicable law to priority over the claim of a general unsecured creditor.

“
 (g) DEFINITIONS.—For the purposes of this section and section 3467—

“
 (3) a “general unsecured creditor” means a creditor with a claim that is neither secured by a lien nor entitled to priority;

“
 (5) the term “lien” means an interest in real or personal property which secures payment or performance of an obligation, whether arising by agreement, statute or other rule of law, application of principles of equity, judgment, levy, or other judicial proceedings or distraint, but such term does not include any lien which first becomes effective upon or after an assignment by the debtor for the benefit of creditors, the commencement of any other proceeding intended to rehabilitate the debtor or liquidate his property, or upon insolvency of the debtor, or execution against his property levied at the instance of one other than the lienor, and the holder thereof shall be treated under this section as an unsecured claimant; and

(6) “other applicable law” means the law applicable to the proceeding or procedure in which the debtor's property is undergoing a general administration for the benefit of creditors or the estate is being administered.

173. Contractual security is included in the term “lien,” as defined in proposed § 3466(g)(5), set out in note 172 *supra*. The definition, however, is more narrowly worded than the corresponding definition of a “security interest” in the Federal Tax Lien Act of 1966, INT. REV. CODE of 1954, § 6323(h)(1), in that the proposal refers only to security for the payment or performance of an obligation and omits reference to security for the purpose of “indemnifying against loss or liability.” This apparent oversight should be corrected.

lien status to any purported lien, whether created by statute, agreement, or judicial doctrine, if the lien "first becomes effective upon or after an assignment by the debtor for the benefit of creditors, the commencement of any other proceeding intended to rehabilitate the debtor or liquidate his property, or upon insolvency of the debtor, or execution against his property levied at the instance of one other than the lienor."¹⁷⁴ Such purported liens are viewed as disguised rules of priority in distribution since the debtor remains free to dispose of his property until the crucial event occurs.¹⁷⁵ The second limitation created by the 1970 proposal, which is really no limitation at all, is that an otherwise qualified lien would prevail over unsecured federal claims in insolvency proceedings only if it would be entitled to priority *over a general unsecured creditor* under the law governing the administration of the debtor's or decedent's property.¹⁷⁶

Instead of bringing the insolvency priorities "in line with the policies expressed in the National Bankruptcy Act," as contemplated by the ABA resolution,¹⁷⁷ the provisions of the 1970 proposal granting recognition to antecedent liens depart from those policies in at least three significant respects:

1. In bankruptcy, statutory liens for rent and liens of distress for rent (whether statutory or not) are invalidated against the trustee and are reduced to the status of priorities junior to unsecured but nondischargeable tax claims¹⁷⁸ and on a parity (to the extent of three months' rent) with other unsecured federal claims.¹⁷⁹ In proceedings governed by the proposed Section 3466, the landlord who enjoys a lien under state law would ordinarily be preferred over unsecured federal claims for taxes or otherwise,¹⁸⁰ although nondis-

174. The omission of prepositions ("upon" or "upon or after") with respect to two of the proscribed categories gives rise to ambiguities that should be clarified.

175. See proposed § 3466(g)(5), set out in note 172 *supra*. Cf. Bankruptcy Act § 67c(1)(A), 11 U.S.C. § 107(c)(1)(A) (Supp. V, 1965-1969); H.R. REP. NO. 686, 89th Cong., 1st Sess. 5-6 (1965). The cited provision of the Bankruptcy Act invalidates only *statutory* purported liens of this nature, not those based upon common law, equity, or agreement; it refers only to those which first become "effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor."

176. Proposed § 3466(e)(2) & (g)(6), set out in note 172 *supra*.

177. See note 53 *supra*.

178. See notes 299-302 *infra* and accompanying text.

179. Bankruptcy Act §§ 64a(5), 67c(1)(C) & 67c(2), 11 U.S.C. §§ 104(a)(5), 107(c)(1)(C) & 107(c)(2) (Supp. V, 1965-1969).

180. On the other hand, if the federal tax claim had become a lien before the proceeding, even though after the landlord's lien attached, the federal lien would prevail since the Federal Tax Lien Act of 1966, amending INT. REV. CODE of 1954, § 6323, did nothing to relieve landlords of the effect of decisions holding their liens inchoate as

chargeable federal tax claims would prevail over the landlord who has only a priority (including a priority disguised as a lien).¹⁸¹

2. In bankruptcy, a lien obtained by attachment, judgment, levy, or other legal or equitable process or proceeding while the debtor was insolvent (or one which was sought and permitted in fraud of the Bankruptcy Act) is nullified if a petition under the Act is filed within four months.¹⁸² Such preferences are valid at common law, however,¹⁸³ and in the absence of an applicable local statute to the contrary¹⁸⁴ would prevail, under the proposal, over federal taxes that had not become liens.¹⁸⁵ It is questionable whether the Government should be called upon to yield its insolvency priority to such preferential judicial liens.¹⁸⁶

3. Perhaps most significantly, a lien is not recognized against a trustee in bankruptcy (and hence against unsecured federal claims) unless the lien has been so perfected that it would be valid against judgment and execution creditors and those obtaining liens by legal or equitable proceedings upon simple contracts¹⁸⁷ and, even if so perfected, a statutory lien will not be recognized against the trustee unless it is also perfectible and is in fact perfected against a bona fide

against a federal tax lien. *United States v. Scovil*, 348 U.S. 218 (1955). The ABA proposal, like the Bankruptcy Act (*United States v. First Natl. Bank & Trust Co. of Fargo*, 386 F.2d 646 (8th Cir. 1967)), would not alter the relative standing of liens antedating the proceeding.

181. See note 268 *infra*.

182. Bankruptcy Act § 67a(1), 11 U.S.C. § 107(a)(1) (1964). Since proceedings "under this Act" include reorganizations and arrangements under Chapters X-XIII, such preferential liens would be invalidated in those cases as well as in conventional bankruptcies. 4 W. COLLIER, *BANKRUPTCY* ¶ 67.03[4], at 85 (14th ed rev. 1969).

183. See *Grandison v. Robertson*, 231 F. 785, 788 (2d Cir. 1916).

184. *E.g.*, 39 PA. STAT. ANN. §§ 151-52 (1954); WASH. REV. CODE §§ 23.72.010 & .030 (1959). *Cf. Tua v. Carriere*, 117 U.S. 201 (1886).

185. An attachment or judgment lien arising before the proceeding but after the debtor is insolvent would not be one that first becomes effective "upon" insolvency and none of the other proposed restrictions (see text accompanying notes 174-76 *supra*) would affect it unless a state statute avoiding preferences makes the lien one which is not entitled to priority over unsecured creditors in the ensuing proceeding.

186. Attachment liens and general judgment liens, of whatever age, are not now valid against the federal insolvency priority (see notes 19 & 36 *supra* and accompanying text), and it is doubtful that relief should be extended to those that are preferential by bankruptcy standards. *Cf. Lakeshore Apartments, Inc. v. United States*, 351 F.2d 349 (9th Cir. 1965). See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 256-57 (1967). It may be argued that, in bankruptcy, preferences are avoided for the benefit of all creditors and that it is inappropriate to avoid them for one favored creditor. But, even in bankruptcy, it is the priority creditors, including the United States, who first benefit from the avoidance. If other creditors are to enjoy a similar benefit in proceedings governed by state law, it is for the states to make appropriate provisions.

187. Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (Supp. V, 1965-1969).

purchaser, either by the date of bankruptcy or timely thereafter.¹⁸⁸ This standard of perfection contrasts sharply with the proposed insolvency standard, which would be satisfied if the lien were valid against general *unsecured* creditors under the law applicable to the proceeding.

The contrast is even more marked when the proposal is compared with the standards which Congress adopted in dealing not, as in bankruptcy, with the relative priorities between liens and a mass of creditors that includes the United States, but with the priority between liens and federal taxes specifically. In the Federal Tax Lien Act of 1966,¹⁸⁹ Congress carefully circumscribed the recognition of security interests, as against federal tax liens, not only by requiring that the security interests be perfected against judgment creditors but also by limiting the circumstances in which the priority of a security interest might relate to property acquired and advances made after the filing of the tax lien.¹⁹⁰ Congress also declined to recognize the priority of a mechanic's lien unless, in addition to satisfying local law requirements for perfection against bona fide purchasers (not merely judgment creditors), the lien claimant himself had actually begun to furnish services, labor, or materials before the tax lien was filed.¹⁹¹ With respect to landlords' liens, state and local tax liens (other than for real property taxes and the like), and a variety of other liens, Congress was unwilling to relax the judicially developed standard of "choateness" which denied their priority unless there was certainty of the lienor, the property, and the amount of the lien before the federal tax lien arose.¹⁹² In each instance, the requirements actually imposed by Congress were stricter than those the ABA had previously urged.¹⁹³ However, in its 1959 proposal the ABA realistically recognized the improbability that Congress would go further in derogating from the heretofore absolute federal priority in insolvency than it was willing to go in simple contests between liens. It recommended, therefore, that existing liens be recognized against the federal insolvency priority only if the liens

188. Bankruptcy Act § 67c(1)(B), 11 U.S.C. § 107(c)(1)(B) (Supp. V, 1965-1969). See Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 158-60, 41 REF. J. 5, 8-9 (1967).

189. Pub. L. No. 89-719, 80 Stat. 1125 (1966).

190. INT. REV. CODE of 1954, § 6323(c), (d) & (h)(1). See W. PLUMB & L. WRIGHT, *supra* note 46, ch. 3, § 2.

191. INT. REV. CODE of 1954, § 6323(h)(2).

192. H.R. REP. NO. 1884, 89th Cong., 2d Sess. 35 (1966). See notes 42 & 45 *supra* and accompanying text.

193. See 1959 REPORT, *supra* note 47, at 684-87.

would have been entitled to priority *over the federal claim*—not merely over any unsecured creditor,¹⁹⁴ as proposed in 1970—immediately before the divestment of the debtor's property.

It would be a tenable intermediate position, consistent with the general purpose of the proposal to place the Government, in other insolvencies, in the position it would occupy in bankruptcy, to urge that *unsecured* federal taxes be subordinate to any lien that would have been recognized if bankruptcy had ensued, notwithstanding that the Government might have prevailed over such lien if the federal claim had itself achieved *lien* status before the proceeding.¹⁹⁵ To ask for a still more liberal standard is to invite rebuff.

IV. PRIORITIES AMONG UNSECURED CLAIMS

A. *Expenses and Claims That May Be Paid Prior to Federal Claims*

In addition to recognizing antecedent liens, the ABA proposal would relax the federal priority rule by prescribing that specified expenses and unsecured claims be paid prior to, or on a parity with, unsecured federal claims.¹⁹⁶ The order of payment of such priority items among themselves, however, would be left for determination by other governing law. For example, if state law makes certain wage claims superior to administration expenses,¹⁹⁷ that ranking would not be disturbed although the proposal lists wages third and administration expenses first among the items that "shall be paid prior to claims of the United States." Similarly, it would be of no concern whether an expense that is to be paid "prior to the claims of the United States" is paid before or after a senior mortgage. But circuitry problems will arise when items not preferred over federal

194. *See id.* at 732, proposing to provide:

(b) CERTAIN LIENS PRESERVED. Notwithstanding subsection (a) [establishing the federal priority], nothing herein shall impair . . . any other valid lien or security interest which would have been entitled to priority over the claim of the United States immediately preceding such divestment.

(Bracketed explanation added.) The provision seems ineptly worded (*see* note 97 *supra*); it fails to make clear the evident intention that the test is to be whether the competing lien would have prevailed over the federal tax *if it had become a lien* immediately preceding the divestment—a test that would incorporate the standards of perfection made applicable against federal tax liens.

195. The federal insolvency priority does not have the effect of a lien. *United States v. Oklahoma*, 261 U.S. 253, 259 (1923).

196. Proposed § 3466(b), in S. 2197, 92d Cong., 1st Sess. (1971).

197. *See, e.g., Division of Labor Law Enforcement v. Stanley Restaurants, Inc.*, 228 F.2d 420 (9th Cir. 1955), involving administration expenses of an assignee for the benefit of creditors.

claims enjoy a higher priority under state law than those that are so preferred.¹⁹⁸

1. *Administration Expenses*

The first mentioned, and ordinarily the first paid, of the proposed priority items would be "[e]xpenses of collecting, preserving, and distributing the property of the debtor or estate, including federal, state, and local taxes incurred during administration."¹⁹⁹ In this respect, the proposal is consistent with existing decisions which have read into the seemingly absolute terms of Section 3466 a preference for administration expenses over the federal priority.²⁰⁰ Once the terms of the preference are specifically set out in the statute, however, the courts will be limited by the language used, as they are under Section 64 of the Bankruptcy Act, and will have no "blanket authorization for the importation of general equitable doctrines."²⁰¹ This commendable effort to express in twenty-two words a concept that is defined with great specificity in several hundred words in the Bankruptcy Act raises the question whether the extent of the preference may prove to be not only narrower than under that Act but also narrower than the courts have heretofore implied in insolvency cases.²⁰² In addition, the failure to use, except in the caption of the paragraph,²⁰³ the familiar term "administration ex-

198. See pt. IV. B. *infra*.

199. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (b) PRIORITY CLAIMS.—The following claims shall be entitled to the priority specified:

(1) ADMINISTRATIVE EXPENSES.—Expenses of collecting, preserving, and distributing the property of the debtor or estate, including Federal, State, and local taxes incurred during administration, shall be paid (ratably if the property is insufficient to pay all such expenses) prior to the claims of the United States.

200. *Abrams v. United States*, 274 F.2d 8 (8th Cir. 1960); *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925).

201. See *In re Chicago Express, Inc.*, 222 F. Supp. 566, 570 (S.D.N.Y. 1963), *affd.*, 332 F.2d 276 (2d Cir.), *cert denied*, 379 U.S. 879 (1964). *Accord*, *Guerin v. Weil, Gotshal & Manges*, 205 F.2d 302, 304 (2d Cir. 1953); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941). *But cf.* *Bank of Marin v. England*, 385 U.S. 99, 103 (1966).

202. For example, the Section 3466 priority has been judicially subordinated to the legal expense incurred by a debtor in the preparation of an assignment for the benefit of creditors, although the expense antedates the administration. *Abrams v. United States*, 274 F.2d 8 (8th Cir. 1960). The comparable expense in bankruptcy is the expense of preparing and filing a voluntary petition, which the majority of courts allowed only as a provable claim, *without priority*, before it was expressly included in the administration expense priority in 1898. *In re Gies*, 10 F. Cas. 339 (No. 5407) (E.D. Mich. 1875); *In re Jaycox*, 13 F. Cas. 398 (No. 7239) (N.D.N.Y. 1873); *In re Evans*, 8 F. Cas. 835 (No. 4552) (W.D. Tex. 1869); *In re Hirschberg*, 12 F. Cas. 212 (No. 6530) (S.D.N.Y. 1868). *Contra*, *In re Kennedy*, 14 F. Cas. 309 (No. 7700) (W.D. Pa. 1873).

203. See note 199 *supra*. While the caption might be referred to in order to resolve

penses"²⁰⁴—which has become the generic designation for the items allowed first priority in bankruptcy²⁰⁵—may raise a question whether the operating expenses and liabilities incurred by a nonbankruptcy fiduciary in continuing a debtor's or decedent's business would enjoy preference over the federal priority. The courts have heretofore allowed this preference²⁰⁶ but, under the proposal, it would be conditioned upon the expenses having been incurred in "preserving . . . the property of the debtor or estate."²⁰⁷ For another purpose, courts in receivership cases have drawn a distinction between the expenses of "preservation" of the property or business for the benefit of all parties in interest and the expenses merely of continued operation of a private business in the hope of rehabilitation for the benefit of junior creditors and stockholders.²⁰⁸ When that distinction is drawn,²⁰⁹ the term "preservation" embraces such things as insuring

an ambiguity, it could not control "the plain meaning of the text." *Maguire v. Commissioner*, 313 U.S. 1, 9 (1941).

204. For some reason (*see note 97 supra*), even the caption uses the term "administrative expenses" rather than the more common term "administration expenses."

205. Formerly, the bankruptcy law listed as separate categories "the actual and necessary cost of preserving the estate subsequent to filing the petition" and "the cost of administration." Act of July 1, 1898, ch. 541, § 64b(1) & (3), 30 Stat. 563. Although both categories occupied the same level of priority after 1938 (Act of June 22, 1938, ch. 575, § 1, 52 Stat. 874, amending § 64a(1) of the Bankruptcy Act), ambiguities resulted which were ultimately resolved by revising the provision to read, "the costs and expenses of administration, *including* the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition." Pub. L. No. 87-681, § 8, 76 Stat. 570-71 (1962), 11 U.S.C. § 104(a)(1) (Supp. V, 1965-1969) (*emphasis added*). *See H.R. REP. NO. 1208*, 87th Cong., 1st Sess. 6-7 (1961).

206. *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925) (the nature of the expenses is indicated in the report of the companion case of the same name in 7 F.2d 290 (2d Cir. 1925)); *In re Holmes Mfg. Co.*, 19 F.2d 239 (D. Conn. 1927). Although the cases do not appear to have directly considered the priority of liabilities for torts arising during the receivership, in cases in which the federal insolvency priority was in issue, it has been held that such tort liabilities rank generally as operating expenses of the receiver. *Bereth v. Sparks*, 51 F.2d 441 (7th Cir. 1931); *Anderson v. Conduct*, 93 F. 349 (7th Cir. 1899).

207. *See note 199 supra*.

208. *American Engr. Co. v. Metropolitan By-Products Co.*, 275 F. 34, 38 (2d Cir.), *cert. denied*, 257 U.S. 653 (1921); *Woodbury v. Pickering Lumber Co.*, 1 F. Supp. 92 (W.D. Mo. 1932); *Cody Trust Co. v. Hotel Clayton Co.*, 293 Ill. App. 1, 16-17, 12 N.E.2d 32, 38-39 (1937); *Cox v. Snow*, 47 Idaho 229, 273 P. 933 (1929); *Montgomery Coal Corp. v. Allais*, 223 Ky. 107, 3 S.W.2d 180 (Ky. Ct. App. 1928); *U.S. Inv. Corp. v. Portland Hosp.*, 40 Ore. 523, 67 P. 194 (1901). It was held in these cases that the expenses of operation of a private corporation, unless involving "preservation," could not be given priority over an unconsenting senior lienor.

209. It was recognized in *Cox v. Snow*, 47 Idaho 229, 234-35, 273 P. 933, 934-35 (1929), that in a broad sense everything the receiver does involves "preservation" but that *when a distinction is drawn* between "preservation" and "operation" the former is used in a narrow sense. The Government argued in *In re Holmes Mfg. Co.*, 19 F.2d 239, 240-41 (D. Conn. 1927), that the federal priority could not be subordinated to operating expenses not involving "preservation." The court held, 19 F.2d at 242, however (in the absence of the statutory guidance which the ABA proposal would provide), that

or preventing destruction of the property²¹⁰ or restoring it to salable condition;²¹¹ the term generally extends to the operation of the business only when necessary to preserve a public service franchise.²¹² On the other hand, a recent Supreme Court case indicates that, in bankruptcy, operating expenses fall in that category of administration expenses having to do with "preserving the estate," a category that was said to "include the larger objective . . . of operating the debtor's business with a view to rehabilitating it."²¹³ The statement seems something less than dictum, however, for the Court was merely reciting a premise upon which the parties were "agreed." The actual holding was that tort liabilities qualified for priority as "actual and necessary" costs of operating the debtor's business.

Actually, it is far from clear that Congress would or should agree to subordinate the priority of antecedent federal tax claims to the ordinary expenses and risks of prolonged operation.²¹⁴ To do so would permit the Government's margin of safety to be dissipated in a losing effort to preserve and restore the business while the Government is precluded from pursuing its normal collection remedies.²¹⁵ At least in administrations for the primary benefit of junior creditors,

the Government, despite its right of priority (which is not a lien but a rule of distribution—see *United States v. Oklahoma*, 261 U.S. 253, 259 (1923)), was not in the position of a senior lienor (see note 208 *supra*).

210. *American Engr. Co. v. Metropolitan By-Products Co.*, 275 F. 34, 38 (2d Cir.), *cert. denied*, 257 U.S. 653 (1921); *Cox v. Snow*, 47 Idaho 229, 231, 273 P. 933, 935 (1929).

211. *Karn & Hickson v. Rorer Iron Co.*, 86 Va. 754, 11 S.E. 431 (1890).

212. *Union Trust Co. v. Illinois Midland Ry.*, 117 U.S. 434, 455-56 (1886); *Wallace v. Loomis*, 97 U.S. 146, 162 (1878); *Jerome v. McCarter*, 94 U.S. 734, 738 (1877).

213. *Reading Co. v. Brown*, 391 U.S. 471 (1968). The Court also quoted 3A W. COLLIER, *BANKRUPTCY* ¶ 62.15, at 1537 (now 14th ed. rev. 1969) that "continued operation of a business is in substance a means of preservation, namely as a going concern, sometimes with a view to rehabilitation."

214. Under the proposed provision for the postponement of tax liens on personalty to administration expenses in insolvency, even tax claims secured by antecedent liens would be so exposed, except as against realty. See note 404 *infra*. Since many operating administrations are conducted under the Bankruptcy Act, any effective limitation on the priority of operating expenses over federal claims would have to be embodied in amendments to §§ 64a(1), 77(e), 216(3) & 461(8) of that Act, 11 U.S.C. § 104(a)(1) (Supp. V, 1965-1969), 11 U.S.C. §§ 205(e), 616 (3) & 861(8) (1964), as well as to REV. STAT. § 3466.

215. See text accompanying notes 160-62 *supra*. The Government's brief in *Reading Co. v. Brown*, 391 U.S. 471 (1968), discussed in text accompanying note 213 *supra*, asserted that the forbearance of priority creditors, in the case of an attempted rehabilitation of a debtor under Chapter XI of the Bankruptcy Act, is "premised on the predictability of the nature and extent of the administrative expenses that will be incurred and attain first priority," and that they would be more likely to force the debtor into bankruptcy if they were exposed to the risk of uncontrollable items of expense (*i.e.*, tort claims). Brief for United States at 29-30 n.14. See also Recent Case, 81 HARV. L. REV. 887, 889 (1968).

stockholders, or legatees, it may be appropriate to impose some limitation or condition upon the priority of operating expenses over antecedent claims covered by the federal insolvency priority.²¹⁶

Some clarification also seems desirable with respect to the priority proposed to be provided for "Federal, State, and local taxes *incurred* during administration."²¹⁷ Courts in receivership cases have commonly viewed taxes as expenses of the administration if they fell due after its commencement, even if the taxable period had ended before that time.²¹⁸ On the other hand, under the Bankruptcy Act a tax

216. Even when the administration is for the benefit of a senior creditor, who is, therefore, subordinated to operating expenses (*Kneeland v. American Loan & Trust Co.*, 136 U.S. 89, 100 (1890)), the first assets dissipated in the rehabilitation effort will be the unmortgaged assets to which the federal priority attaches (*cf. Pennsylvania Steel Co. v. New York City Ry.*, 216 F. 458, 471 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915)), and it might be appropriate to condition the federal subordination to operating expenses, except when an overriding public interest in the operation (*see In re New York, N.H. & H.R.R.*, 304 F. Supp. 1121, 1134 (D. Conn. 1969)) makes it inappropriate to do so. A clearer case for imposing a limitation can be made when the United States is senior to the creditors for whose benefit the administration is conducted, since generally the interests of senior creditors who do not invoke the administration are not subject to the expenses thereof. *Kneeland v. American Loan & Trust Co.*, 136 U.S. 89, 96 (1890). *See also* note 208 *supra*. If the insolvent business is to continue, it should not be at the risk of a senior creditor who has nothing to gain from the operation (*see In re Prima Co.*, 88 F.2d 785, 790 (7th Cir. 1937)) but should be at the expense and risk of those who, in their own interests, thought it wise to continue and who should themselves advance the necessary funds if the operation cannot be otherwise financed without priority over senior creditors. *American Engr. Co. v. Metropolitan By-Products Co.*, 275 F. 34, 39 (2d Cir.), *cert. denied*, 257 U.S. 653 (1921); *Hanna v. State Trust Co.*, 70 F. 2, 8-9 (8th Cir. 1895); *Cody Trust Co. v. Hotel Clayton Co.*, 293 Ill. App. 1, 17-18, 12 N.E.2d 32, 39 (1937). Although senior lienors were affected in those cases and we are here dealing with the Government as an unsecured priority creditor (*In re Holmes Mfg. Co.*, 19 F.2d 239, 241 (D. Conn. 1927), discussed in note 209 *supra*), the principle is similar (*Spackman v. Swan Creek Orchard Co.*, 274 F. 107 (D. Del. 1921)). Congress in legislating on the matter may properly consider whether the Government should bear the risks of operation for the benefit of junior, or even senior, interests or whether its claims should first be paid or securely provided for as a condition to continued operation, unless the Government approves the operation in the hope of greater recovery for all. *Cf. INT. REV. CODE* of 1954, § 6325(d)(2), which permits subordination of a federal tax lien by agreement where it appears that the chance of ultimate recovery will be thereby improved; Bankruptcy Act § 199, 11 U.S.C. § 599 (1964), which in effect gives absolute priority to federal taxes in a Chapter X reorganization unless, in order to enable the reorganization to succeed (*see* note 90 *supra*), the Government accepts "a lesser amount." It should be borne in mind, however, that the practical effect of subordinating operating expenses to federal claims may in fact be to impose the risk and burden of operation on antecedent wage claimants, whom the proposed law is designed to favor, rather than on the junior creditors, whose claims presumably will have been wiped out before the question of priority between federal claims and operating expenses becomes a material issue. The operating expenses, even if advanced by the junior creditors for their own benefit, will ordinarily be preferred by state law at least over all unsecured creditors, including wage claimants (*but see Division of Labor Law Enforcement v. Stanley Restaurants, Inc.*, 228 F.2d 420 (9th Cir. 1955)), and, under the circular priority rule (*see* pt. IV. B. *infra*), would pre-empt the position of the wage claimants preferred by federal law if denied priority in their own right.

217. *See* proposed § 3466(b)(1), set out in note 199 *supra*.

218. *Michigan v. Michigan Trust Co.*, 286 U.S. 334 (1932); *Reconstruction Fin.*

falling due after bankruptcy is not considered an expense of administration if the liability to pay the tax had accrued—in the sense that all the facts necessary to determine the tax liability were then known or knowable—before the filing of the petition. In some instances (*e.g.*, taxes measured by net income) the taxable period must have closed but in others it is enough that the triggering event (*e.g.*, doing business on the first day of the year) has occurred, while in still others (*e.g.*, employment and other excise taxes) the tax for the then current taxable period may be apportioned.²¹⁰ It would seem that the bankruptcy rule ought to be applied since taxes based upon transactions and periods antedating the insolvency administration ordinarily have nothing to do with the collection, preservation, or distribution of the estate²²⁰ and should enjoy only the priority allowed for taxes, regardless of their due date.²²¹

The ABA proposal specifies that, if the property of the estate proves insufficient to pay all administration expenses, all such expenses shall be paid ratably.²²² This provision conforms to the rule under Section 64 of the Bankruptcy Act that ranks taxes incurred during administration no higher than expenses of operation and no lower than the trustee's own compensation.²²³ Although in some circumstances a similar result has been reached in receivership cases,²²⁴ the courts in such cases more often subdivide the administration expense category and allow first priority to "judicial costs," which include expenses of sales and the compensation of the receiver and his attorney and auditor, second priority to federal taxes incurred by the receivership, and third rank to state tax liabilities.²²⁵ After pro-

Corp. v. Missouri-Kansas-Texas R.R., 122 F.2d 326, 332-33 (8th Cir. 1941); *Wiswall v. Kunz*, 173 Ill. 110, 50 N.E. 184 (1898).

219. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 272-79 (1967).

220. An exception might be allowed when payment of past taxes by the fiduciary is essential to avoid loss of the privilege to engage in business. See text accompanying notes 251-62 *infra*. Cf. *Michigan v. Michigan Trust Co.*, 286 U.S. 334, 344-45 (1932); *United States v. California*, 281 F.2d 726 (9th Cir. 1960).

221. See *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 100 (3d Cir. 1964).

222. See proposed § 3466(b)(1), set out in note 199 *supra*.

223. Bankruptcy Act § 64a(1), 11 U.S.C. § 104(a)(1) (Supp. V, 1965-1969); *United States v. Killoren*, 119 F.2d 364 (8th Cir. 1941); *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941). See *Nicholas v. United States*, 384 U.S. 678, 691 (1966).

224. *Southern Ry. v. United States*, 306 F.2d 119, 126-28 (5th Cir. 1962). Cf. Annot., 24 A.L.R. 1174 (1923).

225. *Union Trust Co. v. Illinois Midland Ry.*, 117 U.S. 434, 481 (1886); *Reconstruction Fin. Corp. v. Missouri-Kansas-Texas R.R.*, 122 F.2d 326 (8th Cir. 1941); *Wire Wheel Corp. v. Fayette Bank & Trust Co.*, 30 F.2d 318 (7th Cir. 1928), *cert. denied*, 279 U.S. 873 (1929); *Coy v. Title Guar. & Trust Co.*, 220 F. 90, 92 (9th Cir. 1915); *Piedmont Corp. v. Gainesville & N.W.R.R.*, 30 F.2d 525, 528-29 (N.D. Ga. 1929); *Parks v. Central Door &*

viding for these prerogative rights, the courts follow no inflexible rules²²⁶ but maintain their freedom to adjust priorities among operating liabilities²²⁷ in order not only to avoid prejudicing future operations²²⁸ but also to recognize superior equities.²²⁹ Congress, in connection with the federal-statutory variants of the equity receivership, railroad and other corporate reorganizations under the Bankruptcy Act, has recognized the inappropriateness of applying the rigid priority framework of that Act²³⁰ and has provided for much the same flexibility in setting the priorities of trustees' certificates for operating expenses that would prevail in equity.²³¹ It is unclear whether the proposed rule of proportionate distribution is intended wholly to pre-empt state law and judicial discretion in this regard²³² or whether it would be permissible, after setting aside the prescribed proportionate share of the available funds for partial satisfaction of the fiduciary's federal taxes, to apply the balance toward full payment of judicial costs and state taxes, and such other expenses as the court may choose to favor, at the expense of lesser grades of the fiduciary's operating liabilities.²³³ In this respect the proposal should

Lumber Co., 164 Ore. 363, 102 P. 706 (1940); *Bauer v. Wilkes-Barre Light Co.*, 274 Pa. 165, 117 A. 920 (1922). See Annot., 27 A.L.R.2d 720, 723-24 (1953); 1 R. CLARK, A TREATISE ON THE LAW AND PRACTICE OF RECEIVERS § 646(a) (2d ed. 1929).

226. See *American Trust Co. v. Metropolitan S.S. Co.*, 190 F. 113, 114 (1st Cir.), *cert. denied*, 223 U.S. 727 (1911).

227. Receivers' certificates, issued to finance operations, enjoy such priority, with respect to operating expenses and other issues of certificates, as the order authorizing them may provide. *Ball v. Improved Property Holding Co.*, 247 F. 645, 650 (2d Cir. 1917); *Central Trust Co. v. H.B. Mehring Co.*, 154 Md. 477, 141 A. 111 (1927).

228. *Central Trust Co. v. Pittsburgh, Shawmut & N.R.R.*, 176 F.2d 937, 938 (3d Cir. 1949), *cert. denied*, 339 U.S. 903 (1950); *Reconstruction Fin. Corp. v. Missouri-Kansas-Texas R.R.*, 122 F.2d 326, 331 (8th Cir. 1941); *Anderson v. Condict*, 93 F. 349, 353 (7th Cir. 1899); *Pusey & Jones v. Pennsylvania Paper Mills*, 173 F. 634, 637 (M.D. Pa. 1909).

229. *Reconstruction Fin. Corp. v. Missouri-Kansas-Texas R.R.*, 122 F.2d 326, 335 (8th Cir. 1941) (favoring employee's injury claim over other operating expenses).

230. See *United States v. Anderson*, 334 F.2d 111, 115-16 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964); T. FINLETTER, *supra* note 81, at 344; notes 81-82 *supra*.

231. Bankruptcy Act § 77(c)(3), 11 U.S.C. § 205(c)(3) (1964), permits the court to provide that certificates shall have "such priority in payments over existing obligations, secured or unsecured, or receivership charges, as might in an equity receivership be lawful," and in connection with safety equipment, permits priority even over state and local, but not federal, taxes. Cf. *In re Long Island R.R.*, 95 F. Supp. 919 (E.D.N.Y. 1951). Under Chapter X, such priority may be granted "over existing obligations, secured or unsecured, as in the particular case may be equitable." Bankruptcy Act § 116(2), 11 U.S.C. § 516(2) (1964). Cf. *In re Prima Co.*, 88 F.2d 785 (7th Cir. 1937).

232. Concerning the power of Congress to pre-empt state law in setting priorities of nonfederal liabilities among themselves, in administrations not under the Bankruptcy Act, see text accompanying notes 323-42 *infra*.

233. For example, if the receiver's compensation and other judicial costs are \$5x, federal taxes \$10x, state taxes \$5x, and other expenses \$20x, and the fund available is \$20x, the ratable shares are 50% of each. If \$5x (50%) is then paid on the federal

be clarified to preserve desirable flexibility in the operation of businesses under administration.

There may, however, be a more fundamental objection to the proposal in this regard. Despite the precedent of Section 64, there is something to be said for prescribing a hierarchy of priorities among administration expenses if all cannot be paid. A court, outside of bankruptcy, should perhaps be permitted to preserve the integrity of its own "costs" even at the expense of federal taxes. On the other hand, placing the fiduciary's own federal taxes only on a parity with the ordinary operating expenses of the business under administration seems hardly consistent with the general principle of federal priority, which the proposal would, of course, modify, but in general would not repudiate. It may be more in harmony with the proposal as a whole to provide for prior payment of judicial costs, followed by wages (subject perhaps to some limitation of amount), after which the fiduciary's federal, state, and local taxes would be paid on a parity with each other, and then other ordinary operating expenses with such priority among themselves as the court in its discretion or the state law may determine. The ranking of administration expenses, no doubt, gives rise to problems since many will have been paid currently during the course of the operation; but so also does a provision that all shall be paid proportionately. It is, of course, important to protect the fiduciary from personal liability for payments made before he knew or should have known that funds would be insufficient.²³⁴

2. *Expenses Antecedent to Administration*

The proposed legislation would provide, for the first time,²³⁵ that wages shall enjoy the same priority over federal claims in insolvency proceedings as is now provided in conventional bankrupt-

taxes, could the court then allow full payment of the costs and of the state taxes, leaving only 5% (25%) for the other expenses? That is the solution which proposed § 3466(f)(2), set out in note 348 *infra*, would apply when state law priorities differ from those to be set out in the federal law, but that provision, read literally, applies only to the priorities among "claims" which by definition include only amounts "legally due and owing by the debtor as of the date of divestment" or death (proposed § 3466(g)(2), set out in note 60 *supra*), thus excluding administration expenses from its terms. Conceivably, therefore, the proposed provision (§ 3466(b)(1)) that administration expenses "shall be paid (ratably if the property is insufficient to pay all such expenses) prior to the claims of the United States" could be read as an inflexible mandate for proportionate satisfaction of all grades of administration expenses falling within the first priority.

234. See text accompanying notes 151-57 *supra*.

235. For the present law to the contrary, see *United States v. Emory*, 314 U.S. 423 (1941); *Plantations Indus. Supply v. Cramer Assoc.*, — R.I. —, 273 A.2d 671 (1971).

cies²³⁶—i.e., amounts earned by workmen, servants, clerks, or traveling or city salesmen within three months before the death of the debtor or the divestment of title or possession of his property may be paid, to the extent of not over \$600 for each claimant, ahead of federal claims.²³⁷

The 1970 ABA proposal is silent concerning the priority, as against federal claims, of liabilities for supplies, materials, and services incurred in operating railroads and certain other public service businesses²³⁸ within a limited period (usually six months) before the commencement of an equity receivership or of a reorganization under the Bankruptcy Act.²³⁹ Such liabilities enjoy priority over gen-

236. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466(b)] (3) WAGE CLAIMS.—Claims for wages against the debtor or estate to the extent that such claims would be entitled to priority in a bankruptcy proceeding under section 64(a)(2) of the Bankruptcy Act shall be paid prior to claims of the United States.

....

.... In applying sections 64(a)(2) . . . of the Bankruptcy Act for purposes of paragraphs (3) . . . of this subsection, the date of divestment of the debtor's title or right to possession or both title and right to possession, or the date of death in the case of an insolvent estate, shall be regarded as the date of . . . "commencement of the proceeding"

The ABA proposal referred to the wage priority under the Bankruptcy Act "as amended from time to time." 1970 REPORT, *supra* note 53, at 416. The omission of those words in S. 2197 seems unfortunate since the provision will apparently be construed to freeze the wage priority in insolvency as it now exists in bankruptcy rather than automatically adjust to keep pace with changes in the bankruptcy law. See *Hassett v. Welch*, 303 U.S. 303, 314 (1938); *United States ex rel. Kessler v. Mercur Corp.*, 83 F.2d 178, 180 (2d Cir. 1936). Concerning the rule for cases where applicable state law is more or less liberal in providing wage priorities, see text accompanying notes 347-56 *infra*.

237. Bankruptcy Act § 64a(2), 11 U.S.C. § 104(a)(2) (Supp. V, 1965-1969). The proposal does nothing to remedy the inequitable rule that, if bankruptcy supersedes a receivership or assignment for creditors, the three-month period within which wages must have been earned in order to enjoy the preference is measured from the date of the bankruptcy proceeding and thus voids the priorities to which the workers would have been entitled in the superseded proceeding. *In re Ko-Ed Tavern, Inc.*, 129 F.2d 806, 810 (3d Cir. 1942); *Strom v. Peikes*, 123 F.2d 1003 (2d Cir. 1941). *Contra*, *Manly v. Hood*, 37 F.2d 212 (4th Cir. 1930). Relief from that rule would require amendment of the Bankruptcy Act.

238. A very few courts have given the principle a broader application with respect to private businesses whose inability to operate would have caused loss to creditors but not to the public. *Dudley v. Mealey*, 147 F.2d 268 (2d Cir.), *cert. denied*, 325 U.S. 873 (1945); *L'Hote v. Boyet*, 85 Miss. 636, 38 S. 1 (1905); *Drennen v. Mercantile Trust & Deposit Co.*, 115 Ala. 592, 23 S. 164 (1897). Where the public interest is not involved, however, most courts decline to impose a preference upon senior creditors "for their own good" unless they have consented thereto. See *In re Pusey & Jones Corp.*, 192 F. Supp. 233, 235-36 (D. Del.), *affd.*, 295 F.2d 479, 480 (3d Cir. 1961).

239. Section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1964), specifies that "unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors." This provision clearly incorporates the six-month rule for purposes of railroad reorganizations. *Southern Ry. v. Flournoy*, 301 F.2d 847, 850 (4th Cir. 1962). Although former § 77B(b)

eral creditors²⁴⁰ and, in limited circumstances, even over mortgagees,²⁴¹ but their priority in relation to federal claims has never been resolved by the courts in the nearly a century since the Supreme Court gave its blessing to the so-called "six-month rule."²⁴² If the six-

(10) of the Bankruptcy Act, 48 Stat. 915 (1934), relating to reorganization of corporations other than railroads, contained similar language, which was omitted when the provision was revised and re-enacted as Chapter X of the Chandler Act of 1938, the power of the court to exercise all the powers which it would have if it had appointed a receiver in equity (Bankruptcy Act § 115, 11 U.S.C. § 515 (1964)) has been regarded as permitting application of the six-month rule in appropriate cases. *In re North Atlantic & Gulf S.S. Co.*, 200 F. Supp. 818, 821 (S.D.N.Y.), *affd. on other grounds sub nom. Schilling v. McAllister Bros., Inc.*, 310 F.2d 123 (2d Cir. 1962); *Dudley v. Mealey*, 147 F.2d 268 (2d Cir.), *cert. denied*, 325 U.S. 873 (1945). It has been suggested that Chapter X evidences congressional concern with the survival of even private businesses so that the reasons for excluding such businesses from the rule may no longer apply. T. FINLETTER, *supra* note 81, at 383-84. However, when Chapter XI is the form adopted, the strict rules of Section 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) (Supp. V, 1965-1969) preclude priority of six-month claims, which are not mentioned therein. *In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964); *In re Pusey & Jones Corp.*, 295 F.2d 479 (3d Cir. 1961).

240. *Pennsylvania Steel Co. v. New York City Ry.*, 208 F. 168, 182-84 (S.D.N.Y. 1913), *affd.*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915). But in *Whelan v. Enterprise Transp. Co.*, 175 F. 212 (C.C.D. Mass. 1909), it was held that only mortgagees, not general creditors, may be subordinated to six-month claims.

241. *Fosdick v. Schall*, 99 U.S. 235 (1879). As against the mortgagee, however, the six-month creditors are generally limited to surplus earnings during the six-month period and during the proceeding and so much of the mortgaged corpus as equals the amounts diverted from income during those periods for the benefit of the mortgagee. *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183 (1905); *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592 (D. Conn. 1967), *affd.*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969). The view of some courts that the corpus may be charged for such expenses even in the absence of a diversion of income (*Southern Ry. v. Flournoy*, 301 F.2d 847 (4th Cir. 1962); *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1110 (M.D. Tenn. 1970), *appeal docketed*, No. 77-1228, 6th Cir., 1971) results from confusion with the distinct, and narrowly limited, "necessity of payment" rule, discussed in text accompanying notes 251-62 *infra*. See *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592, 602 n.15 (D. Conn. 1967); Fitzgibbon, *The Present Status of the Six Months' Rule*, 34 COLUM. L. REV. 230 (1934).

242. Although it is stated categorically in 5 W. COLLIER, BANKRUPTCY ¶ 77.21, at 576-77 (14th ed. rev. 1970), that taxes having priority under Section 3466 are junior to six-month claims, the decision cited (*In re Missouri Pac. R.R.*, CCH BANKR. L. REP. ¶ 3780 (Ref., E.D. Mo. 1935), *affd. on another issue sub nom. J.P. Morgan & Co. v. Missouri Pac. R.R.*, 85 F.2d 351 (8th Cir.), *cert. denied*, 299 U.S. 604 (1936)) merely divided creditors into classes for purposes of Bankruptcy Act § 77(c)(7), 11 U.S.C. § 205(c)(7) (1964), but declared the ranking to be "provisional." In *United States v. Guaranty Trust Co.*, 33 F.2d 533, 539 (8th Cir. 1929), *affd. on other grounds*, 280 U.S. 478, 483 (1930), the court preferred the six-month claims but only on the ground that, since they were superior to the mortgage to which the federal claims were inferior, "it would seem illogical" that the six-month claims should be displaced by the federal priority. But we now know that problems of circuitry are not to be resolved by subordinating the Government to both the mortgage and the claims that outrank the mortgage and that, unless each *on its own merits* is superior to the federal claim, the only permissible solution is to set aside the amount of the prior mortgage and then satisfy from that fund the claims that are superior to the mortgage but inferior to the federal claim. *United States v. Buffalo Sav. Bank*, 371 U.S. 228 (1963); *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 158-59 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968). See 2 J. GERDES, CORPORATE REORGANIZATIONS UNDER

month rule is viewed as a mere equitable rule of priority among creditors of an insolvent, even though it is a rule developed and applied by the federal courts,²⁴³ it cannot prevail over the statutory priority of federal claims, either as now in force or as proposed.²⁴⁴ Even if, as has sometimes been said, the six-month creditors could be deemed to have an "equitable lien" on the income of the debtor and of the fiduciary,²⁴⁵ such a claim is the clearest kind of inchoate floating lien,²⁴⁶ which Section 3466 overrides.²⁴⁷ Although the ABA proposal would subordinate the federal priority to any lien that "would be entitled under other applicable law to priority over the claim of a general unsecured creditor," it expressly *excludes* "any lien which first becomes effective upon or after . . . the commencement of any . . . proceeding intended to rehabilitate the debtor or liquidate his

SECTION 77B OF THE BANKRUPTCY ACT § 654 (1936). Although six-month claims were preferred over a federal mortgage in *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103 (M.D. Tenn. 1970), *appeal docketed*, No. 71-1228, 6th Cir., 1971, that result was premised on the court's view that Section 3466 was inapplicable to the mortgage debt.

243. *Cf. In re Chicago Express, Inc.*, 332 F.2d 276, 279 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964), holding that the judicially developed six-month rule is not a "law of the United States" entitling such claim to parity with federal claims in proceedings to which § 64a(5) of the Bankruptcy Act, 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969), is applicable.

244. *United States v. Emory*, 314 U.S. 423, 431 (1941). Compare the rule that the precise enumeration of priorities under § 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) (Supp. V, 1965-1969), leaves no room for implying an additional priority category for six-month claims in Chapter XI proceedings, which are governed thereby. *See note 239 supra*. With respect to wages incurred within the six-month period, it would be inconsistent with the express, but more limited priority, proposed by the ABA. *See proposed § 3466(b)(3)*, set out in note 236 *supra*. *Cf. Kavanis v. Mead*, 171 F.2d 195 n.1 (4th Cir. 1948).

245. *See Southern Ry. v. Flournoy*, 301 F.2d 847, 854 (4th Cir. 1962); *United States v. Guaranty Trust Co.*, 33 F.2d 533, 539 (8th Cir. 1929), *affd. on other grounds*, 280 U.S. 478 (1930). The Supreme Court, however, while calling the six-month claims "a charge in equity on the continuing income" (*Burnham v. Bowen*, 111 U.S. 776, 782 (1884)), has declared that the claimants do not have a lien (*Fosdick v. Schall*, 99 U.S. 235, 253 (1879)) and that the rule is "not to be explained in terms of equitable lien in the technical sense, as is the case with agreements that particular property shall be applied as security for the satisfaction of particular obligations or vendors' liens and the like." *See New York Dock Co. v. S.S. Poznan*, 274 U.S. 117, 121 (1927), quoted in *In re Chicago Express, Inc.*, 332 F.2d 276, 278 (2d Cir.), *cert. denied*, 379 U.S. 879 (1964). *See also* 2 J. GERDES, *supra* note 242, § 654 (relying on decisions under state wage priority statutes).

246. *Cf. Piedmont Corp. v. Gainesville & N.W.R.R.*, 30 F.2d 525, 530 (N.D. Ga. 1929) (lien on railroad income for injury claims). While the six-month rule has been likened to "an admiralty lien on wheels" (*see Larsen v. New York Dock Co.*, 166 F.2d 687, 689 n.2 (2d Cir. 1948)) and admiralty liens are specially favored against tax liens (*United States v. Flood*, 247 F.2d 209 (1st Cir. 1957)), although perhaps not against Section 3466 (*cf. The Melissa Trask*, 285 F. 781 (D. Mass. 1923)), nevertheless, both the obligation secured and the subject matter of the "lien" are much less fixed than in the case of admiralty liens.

247. *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 357-60 (1945); *County of Spokane v. United States*, 279 U.S. 80, 93-95 (1929).

property."²⁴⁸ This exclusion accurately describes any interest or lien of the six-month claimants, who have nothing but a general claim in the absence of a receivership or its equivalent.²⁴⁹ Congress ought to declare expressly whether the public concern in facilitating the continued operation of railroads and other quasi-public enterprises warrants the creation of another "public policy" exception to the federal priority.²⁵⁰

The related, although actually distinct,²⁵¹ "necessity of payment" rule may qualify some pre-administration liabilities for priority of payment, even under the terms of the ABA proposal, as expenses of "preserving" the property in cases "where failure to make such payment would result in injury to, or would make it difficult to carry on the business of, the estate."²⁵² If the tests of this rule are met, the priority attaches whether or not the situation is one to which the six-month rule would be applicable.²⁵³ Thus, if essential workers are unwilling to serve unless paid their arrears, the payment thereof may be a necessary cost of preservation of the estate²⁵⁴ and would

248. Proposed § 3466(e)(2) & (g)(5), in S. 2197, 92d Cong., 1st Sess. (1971), discussed in text accompanying notes 174-75 *supra*.

249. On the other hand, if the six-month claims may properly be regarded as operating expenses of the fiduciary, having contributed to the production of the income subsequently earned by him (*Union Trust Co. v. Illinois Midland Ry.*, 117 U.S. 434, 464-65, 480-81 (1886); *Reconstruction Fin. Corp. v. Missouri-Kansas-Texas R.R.*, 122 F.2d 326, 332 (8th Cir. 1941); *see New York Dock Co. v. S.S. Poznan*, 274 U.S. 117, 121 (1927)), they may enjoy priority over antecedent federal claims under present law, although Section 3466 was not involved in the cases cited. But, under the language of the ABA proposal, not all such claims might qualify for priority as expenses of "preserving" the property. *See* text accompanying notes 226-32 *supra*.

250. The ABA did not consider this matter and the writer makes no recommendations on this question of policy. It has been suggested, however, that since the Interstate Commerce Act, 49 U.S.C. § 1(18) (1964), and § 77 of the Bankruptcy Act, 11 U.S.C. § 205 (1964) now assure that the railroad will continue to operate as long as public convenience and necessity require, or at least long past the institution of reorganization proceedings (*see In re New York, N.H. & H.R.R.*, 304 F. Supp. 793, 799-803 (D. Conn. 1969)), the public interest may be better served by hastening the institution of reorganization proceedings than by deferring the evil day through extensions of operating credit until all funds are exhausted. *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592, 598 n.10, 606 (D. Conn. 1967), *affd.*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969). *Cf. New Haven Inclusion Cases*, 399 U.S. 392, 490-92 (1970).

251. *See* note 241 *supra*.

252. *See Moore v. Donahoo*, 217 F. 177, 182 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915).

253. Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the *corpus* of the property, under the order of the court, with a priority of lien.

Miltenberger v. Logansport Ry., 106 U.S. 286, 311 (1882) (emphasis original).

254. *See Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 187 (1905) ("payment of the employes [*sic*] of the road is more certain to be necessary in order to keep it run-

thus have priority over federal claims²⁵⁵ even though the amounts involved or the period in which they were earned fall outside the limits of the proposed express priority for wages.²⁵⁶ If one who is in a monopoly position refuses to furnish essential supplies unless previous obligations are paid, such payment may be a necessary cost of preserving the business of the estate.²⁵⁷ But if the creditor is required by law to provide services notwithstanding past delinquencies, there may be no necessity established for payment of the arrears²⁵⁸ unless the conditions that the creditor is permitted to impose regarding cash payment for current services would make continued operation difficult or impossible.²⁵⁹ If the creditor is not obliged to provide services and occupies a sufficiently monopolistic position that payment could have been forced, but is instead content to await the termination of the proceeding, "it is absurd to contend that it is necessary for continued operation that the claims be paid."²⁶⁰

ning than the payment of any other class of previously incurred debts"); *Moore v. Donahoo*, 217 F. 177, 182-83 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915).

255. *United States v. Wisconsin Valley Trust Co.*, 233 F. Supp. 73, 79 (W.D. Wis. 1964) (accrued wages and vacation pay of union employees of truck line, operated by receiver to preserve it for sale as a going concern, preferred over Section 3466 priority; court "takes notice of the facts of business life in that these employees would not continue working had they not been paid the wages due them").

256. In *Kavanas v. Mead*, 171 F.2d 195 (4th Cir. 1948), it was held that the express provision of the Bankruptcy Act for priority of wages earned within three months precluded allowance in bankruptcy of priority for six months of wages under general equitable principles. Only the six-month principle was there involved, however; "necessity of payment," which was not discussed, was plainly negated by the fact that the back wages went unpaid during five years of bankruptcy, apparently without causing operations to cease. *See* note 260 *infra*.

257. *Miltenberger v. Logansport Ry.*, 106 U.S. 286, 311-12 (1882). *See In re New York, N.H. & H.R.R.*, 278 F. Supp. 592, 602 n.15 (D. Conn. 1967), *affd.*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969); *Moore v. Donahoo*, 217 F. 177, 182 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915).

258. The "necessity of payment" rule was applied to interline ticket and freight balances that antedated the receivership in *Miltenberger v. Logansport Ry.*, 106 U.S. 286, 311-12 (1882), on the ground that denial of connecting service would cause great detriment to the business. It has been observed, however, that the connecting railroads would now be required by the Interstate Commerce Act, 49 U.S.C. § 15 (1964) to transact business with the receiver or trustee, despite the arrears of payment for past services. This development might be "an argument that such a claim as was allowed, prior to this act, in the *Miltenberger* case, should no longer be entitled to priority." *See Carbon Fuel Co. v. Chicago C. & L.R.R.*, 202 F. 172, 174 (7th Cir. 1912).

259. *Southern Ry. v. Flournoy*, 301 F.2d 847, 853-54 (4th Cir. 1962); *In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1108-09 (M.D. Tenn. 1970), *appeal docketed*, No. 71-1228, 6th Cir., 1971.

260. *In re New York, N.H. & H.R.R.*, 278 F. Supp. 592, 603 n.15 (D. Conn. 1967), *affd.*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969). In *Miltenberger v. Logansport Ry.*, 106 U.S. 286, 308 (1882), discussed in note 258 *supra*, the Court approved orders for payment entered at the inception of the receivership, in order to preserve the business. It does not follow that the same priority of payment would have been allowed if the question had arisen only at termination of the proceedings.

The Supreme Court has said that, to enjoy priority under this rule, it must be shown that the *payment* of the arrears was necessary to the business, not merely that the supplies or services previously furnished had been necessary to its preservation;²⁶¹ but this distinction has not been uniformly observed.²⁶²

Although arrears of rent are not generally within the scope of the six-month rule,²⁶³ priority of payment for rent claims may in some cases be justified under the necessity rule if nonpayment would cause forfeiture of a valuable lease.²⁶⁴ Aside from that possibility, a landlord's claim, even though secured by a statutory lien on the tenant's property on the premises, is inferior to the federal priority²⁶⁵ in any insolvency proceeding not governed by Section 64 of the Bankruptcy Act—under which, to the extent of the preceding three months' rent, a landlord's claim that is entitled to lien or priority status under state law ranks behind taxes but on a parity with federal nontax claims.²⁶⁶ Although the ABA proposal makes no specific mention of rent claims, it would improve their position by eliminating the priority of federal nontax claims. In Section 64 cases, this change would result in landlords' priority claims (subject to the three-month limitation) being paid before federal nontax claims²⁶⁷ while in reorganizations, decedents' estates, and other insolvency proceedings, such landlord claims would be at least equal whereas today they are inferior.²⁶⁸ The landlord who has a lien, if it is effec-

See Wham, *Preference in Railroad Receiverships*, 23 ILL. L. REV. 141, 149 (1928) ("It is chiefly by 'shotgun' methods that preference as to the corpus of the road may be had.").

261. *Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 186-87 (1905).

262. See note 241 *supra*. See also T. FINLETTER, *supra* note 81, at 375-76, 382-84.

263. *In re Third Avenue Transit Corp.*, 138 F. Supp. 623, 626 (S.D.N.Y. 1955), *aff'd.*, 230 F.2d 425 (2d Cir. 1956).

264. *Ball v. Improved Property Holding Co.*, 247 F. 645, 649-50 (2d Cir. 1917).

265. See cases cited in note 18 *supra*.

266. Bankruptcy Act § 64a(5), 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969). The rules of § 64 apply in conventional bankruptcies and Chapter XI arrangements but not in railroad and other corporate reorganizations. See note 81 *supra*.

267. With the elimination of the federal nontax priority, landlords would stand alone on the fifth level of priority under Bankruptcy Act § 64a(5), 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969).

268. Proposed § 3466(c), set out in note 60 *supra*, would place federal nontax claims on a parity with "all claims not otherwise entitled to priority under subsection (b)," and thus with both landlords' claims and those of general creditors. But, under the circular priority rule (see pt. IV. B. *infra*), the landlord with a priority over general creditors might, at the expense of such creditors, obtain full payment from what remains after setting aside the Government's proportionate share of the general creditors' fund (rather than the full amount of its nontax claim as at present). If the proposal to deny priority to federal nontax claims is rejected, it would seem desirable to insert a fifth level of priority in proposed § 3666(b) placing rent claims and federal nontax claims on a parity, as they are in bankruptcy. See 1959 REPORT, *supra* note 47, at 732.

tive against general creditors and does not arise solely by reason of insolvency or the commencement of the rehabilitation or liquidation proceeding, would be elevated above unsecured federal tax claims,²⁶⁹ except in proceedings (other than reorganizations) under the Bankruptcy Act in which landlords' liens are invalidated.²⁷⁰

Liabilities for torts committed before the commencement of one of the pertinent proceedings ordinarily enjoy no priority, even under the six-month rule,²⁷¹ and none is proposed by the ABA. However in some circumstances, prior payment of such antecedent claims might be sustained under the necessity principle in order to preserve customer good will.²⁷² In addition, Congress has decreed that, in reorganizations of railroads under Section 77 of the Bankruptcy Act and in federal equity receiverships of railroads,²⁷³ claims for death or personal injury of employees occurring before the proceeding²⁷⁴ "shall be preferred and paid out of assets of such railroad corporation as operating expenses of such railroad."²⁷⁵ Since the ABA proposal subordinates the federal priority, not to "operating expenses" as such, but only to expenses of "collecting, preserving, and distributing" the property, it may be questioned whether the "prefer-

269. See text accompanying notes 178-81 *supra*.

270. Bankruptcy Act § 67c(1)(C), 11 U.S.C. § 107(c)(1)(C) (Supp. V, 1965-1969), invalidates "every statutory lien for rent and every lien of distress for rent, whether statutory or not," and reduces it to the priority status it would have under § 64a(5), 11 U.S.C. 104(a)(5) (Supp. V, 1965-1969). However, the provision is inapplicable to railroad and other corporate reorganizations. Bankruptcy Act § 67c(5), 11 U.S.C. § 107(c)(5) (Supp. V, 1965-1969).

271. *In re New York, N.H. & H.R.R.*, 92 F.2d 428 (2d Cir. 1937), *cert. denied*, 303 U.S. 650 (1938); *Pitcairn v. Fisher*, 78 F.2d 649 (8th Cir. 1935). *Contra*, *McCullough v. Union Traction Co.*, 206 Ind. 585, 186 N.E. 300 (1933). See Annot., 90 A.L.R. 648 (1934).

272. See *In re Yale Express Sys., Inc.*, 362 F.2d 111, 117 n.5 (2d Cir. 1966), reporting that an order for payment of claims for loss, damage, and delay of freight and baggage had been entered in the New Haven reorganization in order not to lose business to rival carriers. In an earlier reorganization of the New Haven, however, it had been concluded that it would be "utterly fantastic to suppose that any passenger would be deterred from traveling on a road because a judgment for any injuries he might suffer would not be a prior claim." *In re New York, N.H. & H.R.R.*, 92 F.2d 428, 430 (2d Cir. 1937), *cert. denied*, 303 U.S. 650 (1938).

273. *Carpenter v. Wabash Ry.*, 309 U.S. 23 (1940). Neither the extension of the rule to federal receiverships nor the exclusion of state court receiverships is likely to be of current concern, in view of the substantial pre-emption of the field by the Bankruptcy Act. See *New England Coal & Coke Co. v. Rutland R.R.*, 143 F.2d 179 (2d Cir. 1944). A more significant omission, however, is the reorganization under Chapter X of a rail carrier that falls outside the definition of a "railroad" in Bankruptcy Act § 77(m), 11 U.S.C. § 205(m) (1964). *Augus v. Stichman*, 273 F.2d 707 (2d Cir.), *cert. denied*, 362 U.S. 988 (1960).

274. The claim need not have arisen within the preceding six months. *Thompson v. Siratt*, 95 F.2d 214 (8th Cir. 1938).

275. Bankruptcy Act § 77(n), 11 U.S.C. § 205(n) (1964). The preference extends not only to employee injury and death claims but also to unsecured claims of sureties on supersedeas, appeal, attachment, and garnishment bonds, whether in cases of that nature or in any other. *In re Chicago, R.I. & P. Ry.*, 90 F.2d 312 (7th Cir. 1937).

ence" for such antecedent tort claims would prevail over federal claims.²⁷⁶ If such tort claims are meant to be preferred, some coordination of vocabulary seems desirable.

3. Charges Against Decedents' Estates

Because bankruptcy does not in general concern itself with decedents' estates,²⁷⁷ the ABA proposal recognizes two priorities that are foreign to the bankruptcy scheme on which it is modeled. These priorities are the expenses of the funeral and of the last illness of a deceased debtor,²⁷⁸ to the extent that they are preferred by the applicable local law over general unsecured creditors and are judicially approved.²⁷⁹ The funeral expense priority, although not heretofore expressed in the insolvency priority statute, has long been recognized by implication on the theory that such expenses are not "debts due from the deceased," within the meaning of Section 3466, but charges upon the estate, which the fiduciary of the estate is bound to discharge before any debts can be satisfied.²⁸⁰ Last illness expenses, however, are debts of the decedent and have heretofore been subordinated to the absolute federal priority.²⁸¹ Their priority, which is widely recognized under state laws,²⁸² is advocated on humanitarian grounds in that "it would be unfortunate indeed if a man in his last illness could not be attended by a physician, and in his death

276. If such claims, although superior to prior mortgages (*Carpenter v. Wabash Ry.*, 309 U.S. 23 (1940)) and equal if not superior to general expenses of administration (*cf. Reconstruction Fin. Corp. v. Missouri-Kansas-Texas R.R.*, 122 F.2d 326, 333-35 (8th Cir. 1941)), are inferior to antecedent federal claims, the same circuitry problem discussed above in connection with six-month claims (*see note 242 supra*) would arise.

277. *See* text accompanying notes 335-40 *infra*.

278. The expenses of the funeral and last illness of the debtor's spouse are not included even when they die as a result of a common disaster, although it has been suggested that it would be "wise and salutary" to cover them. *McCain v. Liberty Natl. Bank*, 54-1 U.S. Tax Cas. ¶ 9141 (N.D. Ga. 1953). Concerning the meaning of "last illness," *see* Annot., 9 A.L.R. 462 (1920).

279. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466(b)] (2) FUNERAL AND LAST ILLNESS EXPENSES.—Expenses of the funeral and claims for the last illness of a deceased debtor of the United States, to the extent that other applicable law prefers them over general unsecured creditors and they are allowed by any court having jurisdiction thereof, shall be paid prior to claims of the United States.

280. *United States v. Eggleston*, 25 F. Cas. 979, 981 (No. 15,027) (C.C.D. Ore. 1877); S.M. 5032, V-1 CUM. BULL. 109 (1926).

281. *United States v. Eggleston*, 25 F. Cas. 979, 981 (No. 15,027) (C.C.D. Ore. 1877).

282. Many state laws provide for payment of last illness expenses even ahead of debts due the United States, but such provisions are ineffective at present. *In re Estate of Shoptaw*, 54 Wash. 2d 602, 343 P.2d 740 (1959); *In re Estate of Muldoon*, 128 Cal. App. 2d 284, 275 P.2d 597 (1954). Other states have bowed to the inevitable and listed such expenses for payment after federal claims although ahead of the state's claims.

not be interred without any assurance that the doctor and the undertaker would be paid."²⁸³

The ABA proposal properly makes no provision for priority over federal claims of the allowances for the support of widows and dependents that are provided by many state laws.²⁸⁴ Consequently the proposal may be construed by implication to nullify the priority which has heretofore, although not consistently, been accorded such allowances on the same theory applied to funeral expenses, namely, that they are not debts but charges on the estate.²⁸⁵ The fact that the money or property set apart for the family is not deemed part of the assets subject to administration, however, is not a sufficient legal ground for immunizing it from application to the decedent's federal tax liabilities. The funds created by such allowances are analogous to the homestead or other exempt property set aside and excluded from a bankrupt estate, which is nevertheless subject to pursuit by the federal tax collector into the hands of those to whom it is delivered.²⁸⁶ Although family allowances are sometimes analogized to common-law dower—which ordinarily has priority over claims, including post-marital liens, for the husband's taxes²⁸⁷—they differ in the vital respect that the allowances are set aside only out of what the husband possesses at his death whereas dower ordinarily cannot be defeated by an *inter vivos* conveyance

283. *McCain v. Liberty Natl. Bank*, 54-1 U.S. Tax Cas. ¶ 9141 (N.D. Ga. 1953). The relief would not be complete, however, unless the proposal and the Bankruptcy Act were amended to provide, in cases where an insolvency or bankruptcy proceeding is commenced before death, that the debtor's last illness and funeral expenses shall be a charge upon the estate (at least to the extent that the decedent's post-divestment or post-petition accumulations are insufficient), with priority over all but administration expenses. Death does not abate bankruptcy proceedings begun during life (Bankruptcy Act § 8, 11 U.S.C. § 26 (1964)) and the applicable priority rules continue to be those of the Bankruptcy Act (*In re Devlin*, 180 F. 170, 172 (D. Kan. 1910)), which are at present ill-adapted to the situation. The recoupment of assets from the estate to meet needs resulting from the bankrupt's death has precedent in the Act of July 1, 1898, ch. 541, § 8, 30 Stat. 549, which (before the 1938 amendment that is now 11 U.S.C. § 26 (1964)) conditioned the transfer of title to the trustee upon the payment out of the estate of the statutory allowances to the widow and children if the bankrupt died during the proceeding. *Hull v. Dicks*, 235 U.S. 584 (1915), discussed in note 290 *infra*.

284. For a review of the pertinent state laws, see G. GLENN, *THE LAW GOVERNING LIQUIDATION* § 509 (1935).

285. See authorities cited in note 9 *supra*.

286. *United States v. Heffron*, 158 F.2d 657 (9th Cir.), *cert. denied*, 331 U.S. 831 (1947). Congress has determined that federal law exclusively shall determine what property is exempt from federal tax collection, whether in bankruptcy (Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (Supp. V, 1965-1969)) or otherwise (INT. REV. CODE of 1954, § 6334(c)). See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade II*, 77 YALE L.J. 605, 605-08 (1968).

287. G.C.M. 824, V-2 CUM. BULL. 54 (1926). See W. PLUMB & L. WRIGHT, *supra* note 46, ch. 5, § 4.

by the husband.²⁸⁸ The family's rights are "vested," if at all, only in the limited sense that a forced heir's right to a share in a decedent's estate is vested.²⁸⁹ In substance, provisions for such allowances are exemption laws rather than rules of property²⁹⁰ and claims created thereby are no more entitled to recognition against federal claims, particularly tax claims, than claims based on the usual homestead exemption law or statutory share in an estate.²⁹¹

4. *Taxes Antedating the Proceeding*

The 1970 ABA proposal²⁹² adopts the principle of parity among federal, state, and local taxes, which has been accepted under Section 64 of the Bankruptcy Act for seventy-three years and the denial of which in insolvency cases has been a source of friction between the governments concerned.²⁹³ However, the proposal injects an unnec-

288. Where so-called dower, under local law, could be defeated by the husband's own transfers or by his creditors, it has not been recognized against federal tax claims. *United States v. Griffin*, 164 S.2d 883 (Fla. App. 1964); *Chandler v. Pilley*, 60-1 U.S. Tax Cas. ¶ 9238 (Tenn. P. Ct. 1959); *First Natl. Bank v. White*, 58-2 U.S. Tax Cas. ¶ 9568 (Wis. Cty. Ct. 1958). See *Weitzner v. United States*, 309 F.2d 45, 48 (5th Cir. 1962), *cert. denied*, 372 U.S. 913 (1963).

289. See *United States v. First Natl. Bank & Trust Co.*, 297 F.2d 312, 315 (5th Cir. 1961). In some states, the right is not "vested" even in that sense. *Jackson v. United States*, 376 U.S. 503 (1964).

290. *Seiden v. Southland Chenilles, Inc.*, 195 F.2d 899 (5th Cir. 1952). Cf. *Bankruptcy Act* § 8, 11 U.S.C. § 26 (1964), which was amended in 1938 to overrule *Hull v. Dicks*, 235 U.S. 585 (1915), and to preclude double allowance of exemptions, both for the bankrupt himself and for his family (in the form of allowances for support), if the bankrupt died pending the proceeding. See 1A W. COLLIER, *BANKRUPTCY* ¶ 8.01 (14th ed. rev. 1971).

291. If, on the other hand, contrary to its general policy against providing exempt havens from federal tax collection, Congress should decide to relent in favor of widows and orphans, it should impose uniform federal standards on the extent of the priority that is to be allowable. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade II*, 77 YALE L.J. 605, 615-16 (1968).

292. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466(b)] (4) STATE AND LOCAL TAXES.—Taxes legally due and owing by the debtor or estate to any State or subdivision thereof which would not be dischargeable in bankruptcy under section 17(a) of the Bankruptcy Act shall be accorded equal priority with taxes legally due and owing to the United States and not so dischargeable and shall be paid before any other claims of the United States.

Such taxes legally due and owing to the United States shall be entitled to priority over all unsecured claims other than claims mentioned in paragraphs (1), (2), (3), and (4) of this subsection. In applying section . . . 17 of the Bankruptcy Act for purposes of paragraph . . . (4) of this subsection, the date of divestment of the debtor's title or right to possession or both title and right to possession, or the date of death in the case of an insolvent estate, shall be regarded as the date of "bankruptcy"

293. "The functions vested in the states by the people of the United States are of equal value and dignity with those vested in the central government, and neither is at liberty to cripple or destroy the other." *Piedmont Corp. v. Gainesville & N.W.R.R.*, 30 F.2d 525, 528 (N.D. Ga. 1929). Within three months after that nonprophetic statement was made, the Supreme Court, in *County of Spokane v. United States*, 279 U.S.

essary ambiguity by omitting to provide expressly, as the Bankruptcy Act does,²⁹⁴ that the term "State" includes the District of Columbia²⁹⁵ and the territories and possessions of the United States.²⁹⁶

Under the proposal, federal, state, and local taxes "legally due and owing" before the death of the debtor or the divestment of his property²⁹⁷ and not secured by prior liens²⁹⁸ would be junior to claims and expenses preferred under the rules above discussed but would enjoy priority over claims of general creditors, including federal nontax claims. However, again adopting a bankruptcy principle, the proposal would deny priority status to any federal, state, or local tax that would be dischargeable under the Bankruptcy Act if a petition thereunder had been filed on the date of death or divestment. Dischargeable taxes, in general, are those which fell due more than three years earlier²⁹⁹ but there are major exceptions by

80 (1929) began its long series of decisions subordinating state taxes, with or without a lien, to the federal insolvency priority. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade III*, 77 YALE L.J. 1104, 1104-10 (1968).

294. See Bankruptcy Act § 1(29), 11 U.S.C. § 1(29) (1964). The ABA 1959 proposal was in accord. 1959 REPORT, *supra* note 47, at 732-33.

295. The word "State" may or may not be construed to include the District of Columbia, depending on the court's view of the intent of Congress. Compare *Talbott v. Silver Bow County*, 139 U.S. 438, 444-45 (1891), with *United States v. Whelpley*, 125 F. 616, 619 (W.D. Va. 1903). It is provided in D.C. CODE § 47-2609 (1967) that the gross sales tax of the District shall be "a prior and preferred claim" in a receivership, "bankruptcy," or assignment for the benefit of creditors. Although that provision was construed to override the federal insolvency priority (which it could validly do, since both were enacted by Congress) (*United States v. Saidman*, 231 F.2d 503, 508-10 (D.C. Cir. 1956)), it was held (despite its language) inapplicable in cases under the Bankruptcy Act in which the rule of parity prevails. *District of Columbia v. Greenbaum*, 223 F.2d 633 (D.C. Cir. 1955). The ABA 1959 proposal, in harmony with the purpose to make the insolvency priorities consistent with those in bankruptcy, would have assured that District sales taxes would be reduced, as other District taxes (like state taxes) would have been elevated, to parity. 1959 REPORT, *supra* note 47, at 735.

296. In view of the unique status of the Commonwealth of Puerto Rico, it also seems desirable to refer to it expressly rather than leave the question of its parity to be inferred from the word "territories," which may or may not be sufficiently inclusive. See *Americana of Puerto Rico, Inc. v. Kaplus*, 368 F.2d 431 (3d Cir. 1966).

297. For a discussion of the line between taxes "legally due and owing" and those constituting administration expenses, see text accompanying notes 217-21 *supra*.

298. For a discussion of taxes for which liens had arisen, see pt. III. *supra* and pt. V. *infra*.

299. The general rule is that taxes "legally due and owing" more than three years before bankruptcy are dischargeable (Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (Supp. V, 1965-1969)), and hence are denied priority status under Bankruptcy Act § 64a(4), 11 U.S.C. § 104(a)(4) (Supp. V, 1965-1969). The identical phrase, used for the purpose of distinguishing taxes provable as fourth priority claims from those constituting administration expenses, has been construed to embrace taxes not yet due if the facts giving rise to liability have all occurred. See text accompanying note 219 *supra*. It is held, however, for the purpose of starting the three-year discharge period,

which older tax liabilities are saved from discharge and loss of priority.³⁰⁰ In conjunction with the proposal to preserve tax *liens* in insolvency whether or not the liability is dischargeable and whether or not notice of the lien has been filed,³⁰¹ the downgrading of dischargeable taxes will, at least in the case of federal taxes, be even less meaningful than it is in bankruptcy.³⁰²

The interrelationship between federal and state unemployment taxes gives rise to unique problems,³⁰³ but they can better be discussed after the following description of the circuitry rules.

that a tax is "legally due and owing" only at the date payment is due. *In re Kopf*, 299 F. Supp. 182 (E.D.N.Y. 1969). See W. PLUMB & L. WRIGHT, *supra* note 46, ch. 6, § 2.

300. In addition to the exception discussed in note 355 *infra*, there are exceptions for cases in which a false or fraudulent return, or no return, is filed, and claims for taxes withheld or collected from others (often a major factor in insolvencies) are never dischargeable. Bankruptcy Act § 17a(1)(a), (b), (d) & (e), 11 U.S.C. § 35(a)(1)(a), (b), (d) & (e) (Supp. V, 1965-1969).

301. See text accompanying notes 400-03 *infra*.

302. For example, federal income taxes, regardless of age, are nondischargeable if at the time of bankruptcy there was applicable "a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt" (Bankruptcy Act § 17a(1)(c), 11 U.S.C. 35(a)(1)(c) (Supp. V, 1965-1969)); such a "prohibition" exists from the time the liability is incurred until the taxpayer either agrees to its assessment, fails to seek review of a notice of deficiency, or exhausts his remedy through the United States Tax Court and the appellate courts. INT. REV. CODE OF 1954, § 6213(a); *In re Indian Lake Estates, Inc.*, 428 F.2d 319 (5th Cir.), *cert. denied*, 400 U.S. 964 (1970). *But cf. In re Michaud*, 317 F. Supp. 1002 (W.D. Pa. 1970), *appeal docketed*, No. 71-1165, 3rd Cir., 1971. Any of those events will be followed within a matter of days by an assessment, which gives rise to an automatic lien on all the taxpayer's property without need for filing notice thereof (INT. REV. CODE OF 1954, §§ 6321-22); so an income tax liability would be vulnerable to loss of insolvency priority, under the proposal, only during that brief period of administrative delay.

The bankruptcy provisions, although somewhat more meaningful, in that tax liens are not preserved if unfiled, have been roundly criticized. Marsh, *Triumph or Tragedy? The Bankruptcy Amendments of 1966*, 42 WASH. L. REV. 681, 682-97 (1967); Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 261-72 (1967). A substitute draft has been suggested by this writer in *Federal Tax Liens and Priorities in Bankruptcy—Recent Developments*, 43 REF. J. 37, 45-46 (1969). But consideration of the inadequacies of that legislation should not be permitted to complicate the present reform proposal, which merely incorporates by cross-reference the bankruptcy rule and thus leaves the solution of the problems—hopefully—to the Bankruptcy Study Commission assembled pursuant to Pub. L. No. 91-354, 84 Stat. 468 (1970), under the chairmanship of Professor Marsh himself. For this reason it is particularly desirable that proposed § 3466(b)(4) in S. 2197 (set out in note 292 *supra*) be modified, in conformity with the ABA proposal (see 1970 REPORT, *supra* note 53, at 416) to refer to the bankruptcy provision "as amended from time to time," so that the tax priority in insolvency will adjust automatically and not be frozen as it now exists in bankruptcy. See note 236 *supra*.

Under the circuitry principle, discussed in text accompanying notes 399-413 *infra*, state and local taxes that are denied priority under this rule but are preferred by state law may nevertheless be paid at the expense of other general creditors.

303. See pt. IV. C. *infra*.

B. Reconciliation with State Priority Laws

Many state laws establish their own hierarchies of priorities for application in administrations of insolvent decedents' estates, assignments for the benefit of creditors, and receiverships under the jurisdiction of the state. Such state laws are commonly applied in federal court proceedings, as a matter of equitable discretion³⁰⁴ if not of obligation,³⁰⁵ in the absence of a controlling federal law to the contrary. A sampling of state laws (covering more than one third of the states) relating to decedents' estates, assignments for creditors, and other insolvencies discloses that, while they have certain points in common, their details are as diverse as the collective minds of fifty state legislatures might be expected to make them. Some prescribe equal treatment for all creditors, subject to the overriding federal priority and, in many states, to a common-law priority for the state's own claims,³⁰⁶ although this latter priority sometimes does not extend to subdivisions of the state.³⁰⁷ Many states that assert such a priority, by common law or statute, extend it to nontax claims although some, as would the proposed federal law, confine it to taxes.³⁰⁸ While some of the state laws subordinate state claims to wage claims (within

304. *Dickinson v. Saunders*, 129 F. 16, 19-20 (1st Cir. 1904); *T.H. Mastin & Co. v. Pickering Lumber Co.*, 2 F. Supp. 605 (N.D. Cal. 1933); *Crampton v. Lautz Bros. & Co.*, 274 F. 743 (W.D.N.Y. 1921). Cf. *Schmidtman v. Atlantic Phosphate & Oil Corp.*, 230 F. 769 (2d Cir. 1916). In *Guaranty Trust Co. v. Galveston City Ry.*, 107 F. 311, 319-20 (5th Cir.), *cert. denied*, 181 U.S. 622 (1901), the state priority statute was not applied on the ground that the state law had been construed as intended to cover only state court receiverships.

305. *Marshall v. New York*, 254 U.S. 380, 384-85 (1920), held the priority, at least of a state's own claims, as declared by the courts of the state, to be conclusive in a federal court receivership. Since the state priority laws determine the outcome of the case, for the claimants affected, and not merely the availability of the remedy, it would seem that the "rules of decision" law, 28 U.S.C. § 1652 (1964), and the underlying principle which it embodies (*Guaranty Trust Co. v. York*, 326 U.S. 99 (1945)) would compel the federal courts to apply such laws, so far as they are not in conflict with valid federal legislation, such as the statutory federal priority in insolvency and any laws enacted under the bankruptcy power. See text accompanying notes 323-42 *infra*. See also T. FINLETTER, *supra* note 81, at 357; *Developments in the Law, Reorganizations Under the Bankruptcy Act—1934-36*, 49 HARV. L. REV. 1111, 1180 (1936).

306. E.g., *In re Carnegie Trust Co.*, 206 N.Y. 390, 99 N.E. 1096 (1912). See T. FINLETTER, *supra* note 81, at 354-55; 1 R. CLARK, *supra* note 225, § 669; 42 AM. JUR. 2d, *Insolvency* § 81 (1969). Some states deny their inheritance of the crown prerogative. 42 AM. JUR. 2d, *supra*.

307. T. FINLETTER, *supra* note 81, at 355. State laws conferring priority on state claims may also be construed to exclude their subdivisions. *Campion v. Village of Graceville*, 181 Minn. 446, 232 N.W. 917 (1930). If the subdivisions enjoy priority, it may be junior to that of the state itself.

308. *United States Fidelity & Guar. Co. v. Carter*, 161 Va. 381, 170 S.E. 764 (1933).

prescribed limits)³⁰⁹ as do the Bankruptcy Act and the ABA proposal, others place the wage priority behind the state's claims or at least behind claims for taxes.³¹⁰ The wage priorities range from a top limit of \$1,000³¹¹ down to \$100³¹² (in contrast to \$600 under the ABA proposal) but some state laws place no limit on the amount³¹³ and others fail to provide any priority for wages.³¹⁴ The period within which the wages must have been earned (three months under the ABA proposal) ranges under state law from sixty days³¹⁵ to one year³¹⁶ and may even be unlimited.³¹⁷ Some wage priorities created by state law may embrace broader classes of employees than the "workmen, servants, clerks, or traveling or city salesmen" covered by the Bankruptcy Act and the ABA proposal,³¹⁸ and some include in the wage priority the welfare and pension fund contributions that the federal law excludes.³¹⁹ All such state laws provide priority for funeral and administration expenses; but some make no

309. *E.g.*, ILL. ANN. STAT. ch. 3, § 202 (Smith-Hurd 1961) (Probate Act); MD. ANN. CODE art. 47, § 15 (1971) (assignment for creditors or receivership); R.I. GEN. LAWS ANN. § 28-14-6.1 (1968) (assignment or other insolvency); WASH. REV. CODE § 11.76.110 (1965) (decedents' estates); WIS. STAT. ANN. § 128.17 (1957) (assignments for creditors).

310. MD. ANN. CODE art. 93, § 8-105 (1969) (decedents' estates); MASS. ANN. LAWS ch. 198, § 1 (1969) (decedents' estates) and ch. 206, § 31 (1969) (receiverships); MICH. STAT. ANN. § 27A.5251 (1962) (assignments for creditors); MINN. STAT. ANN. §§ 316.05 (1969) (receiverships) and 577.08 (1947) (assignments); R.I. GEN. LAWS § 33-12-11 (1969) (decedents' estates).

311. N.Y. DEBT. & CRED. LAW § 22 (McKinney Supp. 1970) (assignments for creditors).

312. FLA. STAT. ANN. § 733.20 (1964) (decedents' estates); MASS. ANN. LAWS ch. 198, § 1 (1969) (decedents' estates) and ch. 206, § 31 (1969) (receiverships); MO. REV. STAT. § 513.055(1) (1969) (receiverships); R.I. GEN. LAWS § 33-12-11 (1969) (decedents' estates).

313. MD. ANN. CODE art. 47, § 15 (1971) and art. 93, § 8-105 (1969); MICH. STAT. ANN. § 17.308(1) (1968) (insolvency); MINN. STAT. ANN. §§ 316.05 (1969) and 577.08 (1947) (assignment for creditors and receivership); MONT. REV. CODE §§ 45-601, -603 (1961); WASH. REV. CODE § 11.76.110 (1965) (decedents' estates).

314. D.C. CODE ANN. § 20-1325 (1967); GA. CODE ANN. § 113-1508 (1935); MICH. STAT. ANN. § 27.3178(420) (1962); MINN. STAT. ANN. § 525.44 (1969); N.J. STAT. ANN. § 3A:24-2 (1953); N.Y. Surr. Ct. PROC. ACT § 1811 (McKinney 1967); VA. CODE ANN. § 64.1-157 (1968) (all relating to decedents' estates).

315. FLA. STAT. ANN. § 733.20 (1964); WASH. REV. STAT. § 11.76.110 (1965) (both relating to decedents' estates).

316. MASS. ANN. LAWS ch. 198, § 1 (1969) and ch. 206, § 31 (1969).

317. MICH. STAT. ANN. § 17.308.1 (1968) (insolvency proceedings).

318. ARK. STAT. ANN. § 36-204 (1962) (receiverships); ILL. ANN. STAT. ch. 3, § 202 (Smith-Hurd 1961) (Probate Act); MD. ANN. CODE art. 93, § 8-105 (1969) (decedents' estates). Frequently, however, when the word "employees" is used in conjunction with others such as "workmen" and "servants," it is construed *eiusdem generis* to exclude from priority those in superior positions. 42 AM. JUR. 2d, *Insolvency* § 62 (1969).

319. *See* Joint Indus. Bd. v. United States, 391 U.S. 224 (1968); United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959).

provision for the expenses of last illness³²⁰ and others impose limitations thereon.³²¹

These diversities created little problem so long as the federal priority was superimposed as the first in rank or, by implication, behind only such universally recognized priorities as funeral and administration expenses.³²² But great perplexities may result if the federal law is modified to place federal claims behind certain claims which, in the hierarchy established by state law, rank behind or on a parity with other claims which the federal law continues to subordinate to, or place on a parity with, federal taxes. There are three possible approaches to dealing with those diversities, which we may call the mandatory, the permissive, and the synthetic circuitry approach.

The mandatory approach would establish, by federal law, the complete sequence and amount of priorities to be followed in any distribution or reorganization of an insolvent estate, whether in bankruptcy, receivership, assignment for creditors, or probate, whether the proceeding is in other respects conducted under federal or state law.³²³ There is some merit in the view that the choice or availability of a particular form of proceeding for the administration of an insolvent estate should not affect the relative priority rights of any creditor, not only as against the United States,³²⁴ but as against other creditors as well.³²⁵ On at least one occasion, Congress has prescribed

320. D.C. CODE ANN. § 20-1325 (1967); N.Y. Surr. Ct. PROC. ACT § 1811 (McKinney 1967).

321. FLA. STAT. ANN. § 733.20 (1964) (last 60 days); VA. CODE § 64.1-157 (1960) (low dollar limit).

322. We have observed, however, the circuitry problem that sometimes arises when state law elevates an unsecured claim over a mortgage that is itself superior to the federal priority. See note 242 *supra*.

323. An alternative would be to prescribe by federal law the sequence of priorities down as far as the federal tax level and permit the states to prescribe additional priorities below that level—as they were permitted to do in bankruptcy before 1938. Act of May 27, 1926, ch. 406, § 15, 44 Stat. 667, amending Bankruptcy Act § 64b(7). But, if federal nontax claims are ranked with general creditors, as proposed, any additional priorities provided by state law would be at the expense of such federal claims, a result which might make this alternative unacceptable. Under the pre-1938 bankruptcy law the states could create priorities on a parity with but not above federal nontax claims; even this rule proved unacceptable to Congress in time.

324. See notes 48-49 *supra* and accompanying text.

325. Cf. *Leonard Levin Co. v. Star Jewelry Co.*, 54 R.I. 465, 175 A. 651 (1934), in which, as an equitable condition to granting a receivership, the court determined that wage creditors should be permitted the more favorable priority they would have had in bankruptcy but for the fact that their claims were too small to permit filing an involuntary petition without the cooperation of the other creditors who preferred a receivership.

the priority of nonfederal claims in equity receiverships, on the ground that there was no sound reason to discriminate between those proceedings and reorganizations carried out under the Bankruptcy Act.³²⁶ The power of Congress to so prescribe was not doubted by the Supreme Court.³²⁷ Although, on that occasion, the effect of the statute was confined by its terms to receiverships in federal courts, there is no reason to suppose that the power to establish "uniform Laws on the subject of Bankruptcies"³²⁸ is so limited. That power is not confined to regulating traditional bankruptcy proceedings in which a discharge of the debtor is provided³²⁹ but extends to making "uniform laws on the subject of any person's general inability to pay his debts."³³⁰ While Congress may, in the exercise of this power, assume complete federal jurisdiction of proceedings normally conducted under state law and in the state courts,³³¹ it may also elect to prescribe uniform rules for only certain aspects of the proceedings, leaving state laws otherwise in effect;³³² it would seem equally permissible to prescribe such rules without assuming federal jurisdiction of the proceeding at all.³³³

Such an assertion of Congressional power might be questioned in the case of insolvent decedents' estates, which constitute a significant part of the cases to which Section 3466 is applicable. The "federal courts have no probate jurisdiction and have sedulously refrained, even in diversity cases, from interfering with the operations of state tribunals invested with that jurisdiction."³³⁴ Generally, a

326. H.R. REP. NO. 1458, 76th Cong., 1st Sess. (1939), relating to an amendment of Bankruptcy Act § 77(n), 11 U.S.C. § 205(n) (1964), to extend to railroad equity receiverships in federal courts the rule that claims for injury or death of employees and certain claims of sureties, antedating the proceeding, should be preferred as operating expenses. See text accompanying notes 273-75 *supra*.

327. *Carpenter v. Wabash Ry.*, 309 U.S. 23, 28 (1940).

328. U.S. CONST. art. I, § 8, cl. 4.

329. *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502, 513-14 (1938).

330. *Continental Ill. Natl. Bank & Trust Co. v. Chicago, R.I. & P. Ry.*, 294 U.S. 648, 670 (1935); *Campbell v. Alleghany Corp.*, 75 F.2d 947, 952 (4th Cir.), *cert. denied*, 296 U.S. 581 (1935).

331. *Kalb v. Feuerstein*, 308 U.S. 433, 438-39 (1940).

332. *Stellwagen v. Clum*, 245 U.S. 605 (1918); *Hanover Natl. Bank v. Moyses*, 186 U.S. 181 (1902).

333. Cf. *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78, 83 (1942). Congress recently relied on the bankruptcy power to impose certain restrictions on garnishments in the state courts (Pub. L. No. 90-321, § 301(a), 82 Stat. 163 (1968), 15 U.S.C. § 1671(a)(3) (Supp. V, 1965-1969)), asserting that disparities in garnishment laws had destroyed the uniformity of the bankruptcy laws and frustrated their purposes. That exercise of power was upheld in *Hodgson v. Cleveland Municipal Court*, 326 F. Supp. 419, 428-29 (N.D. Ohio 1971).

334. *Harris v. Zion's Sav. Bank & Trust Co.*, 317 U.S. 447, 450 (1943).

decedent's estate cannot become bankrupt, voluntarily³³⁵ or involuntarily,³³⁶ and preferences among creditors of the estate are "not within the purview of the bankruptcy laws."³³⁷ Nevertheless, in times past, Congress has permitted the representatives of insolvent decedents' estates to file petitions in bankruptcy or to avail of provisions of the Bankruptcy Act.³³⁸ A bankruptcy proceeding commenced in the debtor's lifetime—even though process had not been served upon him—does not abate or give way to probate jurisdiction on the death of the debtor³³⁹ and the priority rules of the Bankruptcy Act are applicable rather than those of the probate law.³⁴⁰ There is no defect of power, therefore, to prevent Congress prescribing uniform rules of priorities, even for insolvent decedents' estates, without asserting federal jurisdiction over the administration itself, for the bankruptcy power over the subject matter of "any person's general inability to pay his debts"³⁴¹ is as supreme over the probate law as over other areas of state law with which it may collide.³⁴²

Nevertheless, in deference to the general reluctance of Congress, and of the bar, to interfere with state law in matters of probate and in recognition of the difficulties of applying a single, fixed system of priorities to a variety of proceedings of differing nature and pur-

335. *In re Estate of Hiller*, 240 F. Supp. 504 (N.D. Cal. 1965).

336. *In re Fackelman*, 248 F. 565, 568 (S.D. Cal. 1918).

337. *White v. Cormier*, 311 Mass. 537, 540, 42 N.E.2d 256, 258 (1942).

338. Section 1 of the abortive Bankruptcy Act of 1841 permitted voluntary petitions to be filed for decedents' estates. Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 444, repealed by Act of March 3, 1843, ch. 82, 5 Stat. 614. Former Section 74(m) of the Bankruptcy Act, 48 Stat. 922 (1934) (superseded in 1938 by Chapters XI, XII and XIII, which contain no comparable provisions) permitted representatives of decedents' estates to petition for composition or extension of debts with the permission of the probate court. Section 75 of the Bankruptcy Act, 11 U.S.C. § 203 (which by its terms expired in 1949), permitted farmers and the personal representatives of deceased farmers (*id.* § 75(r)) to petition for extension and composition of debts (*id.* § 75(c)) and, if that failed, to be adjudged bankrupt (*id.* § 75(s)), without specifying that authorization of the probate court was required. That jurisdiction was upheld where such authorization had been obtained (*In re Estate of Brusaschetto*, 38 F. Supp. 367 (N.D. Cal. 1941)) but the Supreme Court held that the jurisdiction could not be exercised without such authorization—not on the basis of lack of constitutional power but of a strong presumption against congressional intent to interfere with the jurisdiction of the probate court. *Harris v. Zion's Sav. Bank & Trust Co.*, 317 U.S. 447 (1943).

339. Bankruptcy Act § 8, 11 U.S.C. § 26 (1964); *Hull v. Dicks*, 235 U.S. 584, 588 (1915); *Shute v. Patterson*, 147 F. 509 (8th Cir. 1906).

340. *In re Devlin*, 180 F. 170, 172-73 (D. Kan. 1910).

341. *Continental Ill. Bank & Trust v. Chicago, R.I. & P. Ry.*, 294 U.S. 648, 670 (1935); *Campbell v. Alleghany Corp.*, 75 F.2d 947, 952 (4th Cir.), *cert. denied*, 296 U.S. 581 (1935).

342. *Harris v. Zion's Sav. Bank & Trust Co.*, 317 U.S. 447, 455-56 (1943) (dissenting opinion). The majority did not deny the constitutional power. See note 338 *supra*.

pose,³⁴³ the ABA did not propose to apply the mandatory approach. Rather, the 1959 version of its proposal took the permissive approach by providing that administration expenses, funeral expenses, and the prescribed amount of wages *may* be paid before claims of the United States and that state and local taxes *may* be accorded equal priority with federal taxes and *may* be paid before other federal claims, but only if and to the extent that state law provides for such priorities.³⁴⁴ If state law allowed priority for wages only to the extent of \$100 per claimant, that amount would be paid first and federal and state tax claims would be paid next, or federal taxes alone if the state had failed to provide parity for its own taxes. General creditors, who are the beneficiaries of the state's policy to limit priorities, would get just what they get today—*i.e.*, whatever is left after paying the amount of the federal claim and such priorities as the state has seen fit to allow. There would be unavoidable circuitry problems if state law makes state taxes senior to wage claims or if it provides for priorities not recognized by the federal law and makes them senior to those which are recognized. But such problems would be kept to a minimum under this approach and may be readily resolved, if funds are insufficient, at the expense of the claims less favored by state law, without altering the amount paid on the federal claims.³⁴⁵

The ABA 1970 proposal accepts the permissive approach with respect to funeral and last illness expenses, which are to be allowed priority only to the extent that they are preferred under state law and are allowed by the court.³⁴⁶ But in all other respects it adopts what I call the synthetic circuitry approach by purporting to honor the priority of certain claims in excess of the priorities recognized by state law. These excess priorities inevitably result in circuitry and, without benefit to those whom Congress seeks to prefer, cause federal taxes and other federal claims to be subordinated to claims the priority of which was never contemplated by Congress.

On their face, the proposed provisions for priority of wages and state taxes read as if the mandatory approach were to be applied: Wages *shall* be paid before federal claims, to the extent provided in the Bankruptcy Act; state and local taxes, if not dischargeable in bankruptcy, *shall* be accorded equal priority with nondischargeable federal taxes and *shall* be entitled to priority over all claims, including other federal claims, not granted priority by the federal

343. See note 81 *supra*.

344. 1959 REPORT, *supra* note 47, at 732.

345. See note 242 *supra*.

346. See proposed § 3466(b)(2), set out in note 279 *supra*.

law.³⁴⁷ But these priorities are illusory to the extent that state law gives such claims a lesser ranking, because the proposal goes on to provide, in effect, that after the amount allowable to priority claimants has been determined in accordance with the federal statute and the balance remaining for the United States has been set aside, the pot available for nonfederal creditors shall be divided in accordance with "other applicable law"³⁴⁸—i.e., generally state law.³⁴⁹

Three examples will illustrate the operation of the proposed law:

1. The law of State *M* provides the following order of priorities for claims against an insolvent decedent's estate: (1) administration and funeral expenses, (2) last illness expenses, (3) widow's allowance, (4) state and local taxes and other debts owed to the state, (5) wages not in excess of \$100 per claimant earned within three months. *A* dies, leaving gross assets of \$42,000, against which there are the following expenses, allowances and debts:

Administration and funeral expenses	\$ 8,000
Widow's allowance	5,000
Last illness expense	4,000
Federal taxes (nondischargeable)	25,000
State and local taxes (nondischargeable)	5,000
Nontax debt to state	3,000
Wages of 30 employees (each exceeding \$600 and earned within three months)	20,000
Other debts	8,000
	<hr/> \$78,000

Under the ABA 1970 proposal, it would first be determined how much the United States is entitled to under its priority, applying

347. See proposed § 3466(b)(3) & (4), set out in notes 236 & 292 *supra*.

348. 1970 REPORT, *supra* note 53, at 420-22. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (f) CIRCULAR PRIORITIES.—

"(2) The amount to which a claim of the United States is entitled shall be determined pursuant to subsections (b), (c), (d), and (e) [providing for priorities among unsecured claims, subordination of penalties, and preservation of liens] without regard to other priority or lien laws except as provided in such subsections. After the allowance to the United States has been so determined, the order of distribution to other claims shall be as prescribed by other applicable law.

(Bracketed explanation added.)

349. Presumably "other applicable law" would embrace not only statutory priorities but also the common-law sovereign priority of certain states (see note 306 *supra*) and the six-month rule if court decisions make it applicable (see notes 238-50 *supra* and accompanying text). Cf. *Erie R.R. v. Tompkins*, 304 U.S. 64, 66 (1938); *Marshall v. New York*, 254 U.S. 380, 384-85 (1920). But cf. *In re Chicago Express, Inc.*, 332 F.2d 276, 279 (2d Cir. 1964), which held that the six-month rule developed by federal court decisions was not a priority provided "by the laws of the United States," within the meaning of Bankruptcy Act § 64a(5), 11 U.S.C. § 104(a)(5) (Supp. V, 1965-1969). It is unclear whether state law would be the "other applicable law" if the proceeding is in a federal court. See notes 304-05 *supra* and accompanying text.

the federal scheme of priorities without reference to state law, by deducting from the \$42,000 of gross assets the administration and funeral expenses (\$8,000), the last illness expense (\$4,000), and \$18,000 of the wages ($30 \times \$600$), and then dividing the remaining \$12,000 in the proportion that each tax bears to the total taxes (\$30,000), that is, \$2,000 to the state and local taxes and \$10,000 to the federal taxes. After setting aside the \$10,000 for federal taxes, the remaining \$32,000 would be divided, not in accordance with the federal scheme of priorities but under the state law, as follows:

Administration and funeral expenses	\$ 8,000
Last illness expense	4,000
Widow's allowance	5,000
State and local taxes	5,000
Nontax debt to state	3,000
Wages ($30 \times \$100$)	3,000
Balance for nonpriority claims	4,000
	<hr/>
	\$32,000

The balance remaining for debts not entitled to priority status would permit a 10 per cent dividend, as follows:

Balance of federal claim (\$15,000) ³⁵⁰	\$1,500
Balance of wages (\$17,000)	1,700
Other debts (\$8,000)	800
	<hr/>
	\$4,000

Humanitarians may applaud the foregoing result, since it permits the widow to enjoy her allowance at the expense of the Government. But, if that result is acceptable to Congress, her priority—subject perhaps to some limitation—should be provided for in all cases³⁵¹ and not made dependent upon the fortuitous existence of other claims from whose recognized priority she can benefit.

If we apply the permissive approach adopted by the ABA 1959 proposal to the same facts, the federal share would be determined as before, except that the amount set aside on account of wages would be not the \$18,000 to which the Bankruptcy Act, if applicable, would have entitled the wage claimants, but the \$3,000 to which they are entitled under the applicable state priority rule. There would thus be \$27,000, not \$12,000, left for the combined federal, state, and local tax claims; proportionate division gives \$22,

350. It is only an assumption on my part that the Government would be permitted to share in this balance. On its face, proposed § 3466(f)(2) (set out in note 348 *supra*) says that "the amount to which a claim of the United States is entitled" shall be determined by deducting the federally recognized priorities and then the "other claims" shall be paid from the pot in accordance with other applicable law. Perhaps the excess portion of the federal claim would not even share with general creditors.

351. See text accompanying notes 284-91 *supra*.

500 to the federal priority, leaving \$19,500 of the \$42,000 of gross assets for expenses and other claims. Since the widow's allowance and the nontax debt to the state have a state law priority that is not recognized as against the federal claim, they would displace the entire wage claim and a part of the state and local tax claims—resulting in nonfederal distribution as follows:

Administration and funeral expenses	\$ 8,000.00
Last illness expense	4,000.00
Widow's allowance	5,000.00
State and local taxes (37 1/2% of \$5,000)	1,562.50
State nontax debt (37 1/2% of \$3,000)	937.50
	<hr/>
	\$19,500.00 ³⁵²

As this example illustrates, the permissive approach would not eliminate all circular priority, an irreducible minimum of which is inevitable in a dual system. But, given the necessary evil of circuitry, the law under this approach would not go out of its way to increase the incidence and effect thereof by synthesizing priorities that under no circumstances would be applied under the law applicable to the proceeding. The contrary approach would have no consequence except to create a fund from which *other* claimants, who enjoy no recognized priority under federal law, may nevertheless be paid at the expense of the federal priority claims. Here, the \$3,000, which the state law and the ABA 1959 proposal would allow as the wage priority, may in some cases actually reach the wage claimants if they are not supplanted by others with higher standing under state law. But the additional \$15,000 that would be set aside in their name under the 1970 ABA proposal can never in fact reach the wage claimants—except perhaps incidentally if a fund for general creditors is thereby created—but would necessarily and in every case

352. It happens that, on the particular facts assumed, the wage earners, as the least favored priority class under the hypothetical state law, would fare better under the synthetic circuitry approach. But that is not the inevitable result. If there were only 15 wage claimants with claims of \$10,000 (each claim exceeding \$600 and earned within three months) and the facts were otherwise the same, there would be nothing left for them even under the ABA 1970 proposal since the federal share would then be \$17,500 (computed by reducing \$42,000 of gross assets by the administration and funeral expenses (\$8,000), last illness expenses (\$4,000), and \$9,000 of the wages (15 × \$600), and dividing the remaining \$21,000 proportionately—\$3,500 for the state and local taxes and \$17,500 for the federal); the \$24,500 left after setting aside the federal share would be actually applied to the administration and funeral expenses (\$8,000), last illness expense (\$4,000), widow's allowance (\$5,000), state and local taxes (\$5,000), and nontax debt to the state (\$2,500), leaving nothing for the wage claimants. It was the fortuitous existence, in this example, of a sufficiently large claim for wages that *would have been* entitled to priority in bankruptcy but enjoy a much more limited priority under state law, that created the fund, at the expense of the federal claim, from which the federally unrecognized claimants benefit, with incidental partial benefit to the wage claimants themselves at the end of the line.

benefit other claims not intended by federal law to be favored over federal tax claims.

2. The law of State *N* provides that, in an assignment for the benefit of creditors, all debts shall be paid pro rata and without priorities. *B*, who has neglected his ranch for a disastrous fling in Las Vegas, makes an assignment for creditors and, after deducting expenses, the fund available for distribution is \$15,000. He owes debts as follows:

Federal taxes (nondischargeable)	\$ 25,000
State and local taxes (nondischargeable)	5,000
Wages of 20 ranch hands (each exceeding \$600 and earned within three months)	25,000
Other business debts	20,000
Gambling, booze and entertainment	27,500
	<u>\$102,500</u>

Under the ABA 1970 proposal, the amount of the federal priority would be determined by deducting from \$15,000 the first \$12,000 of wages ($20 \times \$600$) and apportioning the balance in the proportion that each tax bears to the total taxes (\$30,000), that is, \$500 to the state and local taxes and \$2,500 to the federal taxes. There being no priorities under local law, the \$12,500 remaining after deducting the amount of the federal priority would provide a 12 1/2 per cent dividend, as follows:

Balance of federal taxes (\$22,500) ³⁵³	\$ 2,812.50
State and local taxes (\$5,000)	625.00
Wages (\$25,000)	3,125.00
Other business debts (\$20,000)	2,500.00
Gambling, booze and entertainment (\$27,500)	3,437.50
	<u>\$12,500.00</u>

The Government thus recovers, at most, only \$5,312.50, but the intended beneficiaries of the demotion of the federal priority get only \$3,750 of the balance thus made available and general creditors take \$5,937.50.³⁵⁴

The permissive approach, while overcoming the above objection, works rather badly in the circumstances of this example, since the absence of a system of priorities established by state law would result in the federal claim being paid, as at present, to the exclu-

353. See note 350 *supra*.

354. In this instance the wage claimants would have had a strong incentive to add to the burdens of the bankruptcy court if the debtor were not a farmer (Bankruptcy Act § 4, 11 U.S.C. § 22 (1964)). He himself might voluntarily choose bankruptcy if he would rather have his farmhands paid but the nondischargeability of any unpaid balance of his taxes, together with a little pressure from his gambling creditors, might deter him.

sion of all the others. However, until the state responds to the permission granted, that result seems preferable to creating an artificial priority fund computed on the basis of what the priorities might have been in bankruptcy and then dividing that fund indiscriminately at the expense of the federal claim.

3. The law of State *O* provides the following order of priorities in an assignment for the benefit of creditors: (1) administration expenses, (2) wages not in excess of \$300 per claimant earned within three months, and (3) state taxes. *C* makes an assignment for creditors and, after deducting expenses, the fund available for distribution is \$3,500. He owes unsecured debts as follows:

Wages of 10 employees (each exceeding \$600 and earned within three months)	\$ 7,000
Federal withholding taxes (nondischargeable in bankruptcy, but not traceable into a trust fund)	1,000
Other federal taxes (dischargeable)	2,500
State taxes (dischargeable)	500
	<hr/> \$11,000

Of the tax claims, only the federal withholding taxes would qualify for priority under the proposed federal law. But, since it is necessary first to deduct from the available assets the \$6,000 of wages ($10 \times \600) that would enjoy priority under the scheme of the Bankruptcy Act, there is nothing left for the federal priority. The wage claimants do not take the entire fund, however, for it is to be distributed under "other applicable law," and the law of State *O* would give \$3,000 to the wage claimants ($10 \times \$300$) and \$500 to the state. Thus, standing in the shoes of the wage claimants, the state and dischargeable state tax is collectible ahead of both the dischargeable and nondischargeable federal taxes.³⁵⁵

In this example, since the *order* of priorities under state law is consistent with the federal law, there would be no circuitry if the permissive approach is applied. The wage claimants, having a \$3,000 priority over state claims and no one in a position to displace them under state law, would take that amount, just as under the ABA 1970 proposal. But the happenstance that the wage claimants *would have been* entitled to a greater priority under the Bankruptcy Act would not result in the creation of any artificial *additional* fund for the benefit of state law priorities not recognized by federal law. Consequently, the remaining \$500 of assets would be applied to the

355. Assuming the Bankruptcy Act permits (*see* note 49 *supra*), the disadvantaged creditors might alter the result by filing an involuntary petition. On the assumed facts, however, the United States has no incentive to do this since the wage claimants would then take the entire fund, and the added expenses would probably absorb any benefit the wage claimants might hope for.

nondischargeable federal withholding tax claim rather than to the state taxes, which, on these facts (being stale and dischargeable in bankruptcy), lack a federally recognized priority.³⁵⁶

Plainly, the generosity of the Government in yielding its priority would often miss the mark under either of the ABA proposals. The remedy for the inequities evident in the foregoing examples would rest in the hands of the state legislatures which may, if they choose, bring their systems of priorities more closely in line with the permitted limits and arrange them so that each creditor would enjoy his intended share, no more and no less. It is no doubt the hope of the draftsmen that, if the results of applying the circuitry rules are sufficiently bizarre, the state legislatures will be induced to conform. But it must be remembered that the state priority rules apply in many instances in which federal claims may not be significant. Furthermore, the greatest beneficiary of the above-described circuitries is very frequently the state itself, which may be reluctant to bring its law into line. This reluctance will be particularly evident if Congress adopts the 1970 proposal which, at federal expense, artificially enlarges the fund available for otherwise unrecognized state-law priority creditors whenever the state inadequately provides for wage priorities.³⁵⁷

The draftsmen of the 1970 proposal considered supplementing the carrot with a stick by framing a provision designed to "encourage" the states to conform their priority rules to the federal standard, as well as to prevent any creditor with a federally unrecognized priority from trading on the recognized priority of another. The provision would have prescribed that "in no event" shall the federal

356. In the examples heretofore stated, it has been assumed that the state laws themselves were silent on the priority ranking of federal claims. While that is frequently the case, there are numerous instances in which either "taxes" or "debts due the United States" are expressly directed to be paid before wages and state debts and taxes, and usually also before the expenses of the last illness. Although no doubt enacted in deference to the federal statutory priority, such provisions do not refer to the federal law and are not dependent upon it, so that, until such state laws are amended, the "other applicable law" to which the proposed amendment refers may simply reinstate the absolute priority. In order to obviate the need to await amendment of such state laws before the new rules become operative, the definition of "other applicable law" should be revised to exclude any provision of state law that prescribes the priority of federal claims.

357. In some states (see notes 311 & 313 *supra* and accompanying text), the provision for wage priorities is "excessive" by bankruptcy standards and would be unrecognized by either ABA draft (until the bankruptcy standard is changed to reflect inflation). If state claims are junior to wages under state law, the excess wages would be satisfied at state expense. If state claims are senior in rank under state law and hence invulnerable, the unrecognized excess wage priority would simply drop to the level next below federal taxes (although a circuitry problem may still arise if there are federal nonpriority claims which, under the proposal, must be paid on a parity with, not behind, claims not recognized as prior under the proposal).

priority be subordinated "if and to the extent that a claim not intended to be benefited" by the federally recognized priorities "would receive in a distribution of the debtor's property more than it would have received if" such provisions "had not been enacted." However, apparently having discovered, as had their predecessors in the 1959 version,³⁵⁸ that such a drastic measure cannot be confined within reasonable bounds, even by the seemingly limiting phrase, "to the extent that," the draftsmen abandoned the project. To illustrate with a simplified example, suppose that the measure of wage priorities under state law is the same as the federal standard but that state law puts state taxes above wages and draws no distinction between dischargeable and nondischargeable taxes. The fund available, after expenses, is \$10,000 and the claims are

Federal taxes (nondischargeable)	\$10,000
State taxes (over three years old and dischargeable)	500
Wages (all qualified for priority)	10,000
	<hr/>
	\$20,500

Under either of the ABA proposals, without the contemplated restriction, the amount of wages with priority would exhaust the fund and nothing would be applied on the federal claim. Under the circuit rule, the state would then take \$500 of the amount set aside for the wage priority. But, if the restriction were adopted, the Government's subordination to wages would be inapplicable "to the extent that" the state became an unintended beneficiary of the fund made available for wages. Giving the Government the first \$500 of the fund, however, would not exhaust the effect of the restriction, for the state, by force of its priority under state law, would then claim the second \$500 which, in turn, it would have to disgorge to the Government, and so on until the entire wage fund had been absorbed by the federal priority in pristine rigor. Thus, if the aforementioned provision had been adopted, the relaxation of the federal priority would, to a large extent, be a dead letter in any state until the legislature brought its system of priorities into line. No doubt this situation would provide a strong impetus to conformity, but if Congress is that convinced that uniformity of priorities in all states in all forms of proceedings is so desirable that it should be coerced, it might better act directly by adopting the mandatory approach—at least in the absence of persuasive indication that its power does not extend so far.³⁵⁹

358. Compare (the preliminary) *Report of the Special Committee on Federal Liens*, 83 ABA ANNUAL REPORT 502, 519-21 (1958), with 1959 REPORT, *supra* note 47, at 713.

359. See text accompanying notes 323-42 *supra*.

A more limited, but more workable, inducement to conformity, in the principal area in which circuitry is likely to frustrate the proposed federal policy, would be to provide that wages not in excess of the bankruptcy limitation have priority over federal claims only if—and, under the permissive approach, to the extent that—they are entitled to priority *over unsecured claims of the state* under other applicable law.³⁶⁰ This rule would penalize wage claimants in states not providing such priority, in cases involving claims exceeding the amount which the state would take from them under the circuitry rule. But, by denying the state the opportunity to profit from this circuitry, it would remove one deterrent (although it is not the only deterrent) to the states bringing their priority rules into conformity in this respect, without forcing them to abdicate their entire system of priorities. Such a rule would not, however, resolve the principal problem that will arise, under either ABA proposal, in the case of decedents' estates: the absorption of the wage fund (under the circuitry rule) by family allowances enjoying priority under state but not federal law. A more effective way to implement the limited objective of giving workmen a protective cushion against economic displacement caused by an employer's insolvency,³⁶¹ without need for state action but without unduly interfering with state priority systems, would be to adopt the mandatory approach in this special instance. A provision using this approach would specify that, notwithstanding any other applicable law, wages and commissions equal to the bankruptcy limitation *shall* have priority not only over federal taxes but also over all other expenses, claims, and allowances not embraced in the first two priorities established by any proposed federal law.

Without some such assurance that the federal largess will be enjoyed by its intended beneficiaries, I seriously doubt that Congress will be inclined to yield the traditional federal priority over unsecured claims. If uniformity of priority rules in federally and state regulated proceedings is not *bonum in se*—and the case for uniformity (the mandatory approach) must be regarded as “not proven”—we should at least strive to minimize the “intolerable inconsistencies and confusion [that] would result if [state] insolvency law

360. The ABA 1959 proposal allowed wage priorities, subject to the bankruptcy limits, “if and to the extent that they are entitled to priority under state law,” without specifying over what claims the wages must have priority. 1959 REPORT, *supra* note 47, at 732.

361. See *United States v. Embassy Restaurant, Inc.*, 359 U.S. 29, 33 (1959). Since the dependents of an insolvent decedent also suffer “economic displacement,” this approach might be combined with a carefully limited recognition of the priority of family allowances. See note 291 *supra*.

be given effect while the national Act is in force."³⁶² That result, I submit, can best be realized by adopting, with certain possible exceptions, the permissive approach of the 1959 proposal.³⁶³

C. Unemployment Taxes: The Monkey Puzzle³⁶⁴

The federal unemployment tax was enacted, not as a means of raising federal revenue, but to encourage the states to establish tax-supported unemployment compensation systems.³⁶⁵ The liability for the 3.2 per cent federal tax, therefore, may be abated, up to a maximum of 2.7 per cent of taxable wages,³⁶⁶ by a credit for payments by the employer into approved state systems. The federal government collects and uses the remaining 0.5 per cent for its own expenses of administration of the system, for assistance to the states in their administrative costs, and for advances to the states to meet unusual needs for unemployment benefits.³⁶⁷ If the employer's payment of the state tax is delayed beyond the due date of the federal return, whether through his own perversity or neglect or because of financial difficulty or insolvency, the credit for state tax payments ultimately made is reduced to 90 per cent of the amount otherwise allowable (*i.e.*, to a maximum of 2.43 per cent), thus increasing the net federal liability in general to 0.77 per cent, which, of course, is in addition to the state tax liability of 2.7 per cent or more.³⁶⁸ If

362. See *International Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929).

363. There should be added to the ABA 1959 proposal, however, a provision based on the last sentence of § 67c(2) of the Bankruptcy Act, 11 U.S.C. § 107(c)(2) (Supp. V, 1965-1969), so that, if a claim for wages or for state or local taxes is secured by a lien which first becomes effective upon insolvency, etc., and hence is denied recognition as a lien against federal claims (see note 172 *supra*), it would at least be considered to enjoy a "priority" under state law and hence would be preferred over federal claims within the limits prescribed by the proposal.

364. The phenomenon described in the text following has been named, although only by the author, for a South American tree (*araucaria araucana*) the branches of which are intricately intertwined.

365. See *Steward Mach. Co. v. Davis*, 301 U.S. 548, 585-90 (1937).

366. Initially the federal tax was 3% and the maximum credit was 90% thereof. The federal rate is now 3.2% (INT. REV. CODE of 1954, § 3301) and has been as high as 3.5% (Treas. Reg. § 31.3301-3(a) (1963)), but the maximum credit is frozen at 90% of 3%, or 2.7% (INT. REV. CODE of 1954, § 3302(c)(1) and (d)(1)). State tax rates, while frequently fixed at 2.7%, may range higher (*e.g.*, 4% in Pennsylvania, PA. STAT. ANN. tit. 43, § 781.1 (1964)), with no credit allowable for the excess. Additional credits above actual payments to the state are allowed, subject to the over-all 2.7% limitation, to employers entitled, *e.g.*, by reason of experience rating, to pay less than the highest rate under state law. INT. REV. CODE of 1954, §§ 3302(b), 3303. The maximum credit allowable may be reduced if the state is indebted to the federal fund (INT. REV. CODE of 1954, §§ 3302(c)(2) and (3)) and the additional federal collections resulting are applied in reduction of the state's obligation (42 U.S.C. § 1101(d) (1964)).

367. 42 U.S.C. §§ 1101-05, 1321 (1964).

368. INT. REV. CODE of 1954, § 3302(a)(3).

the state tax goes unpaid by reason of the employer's insolvency, the full 3.2 per cent federal tax, without offsetting credit, may be collected under the federal priority and the state may get nothing.

In the view of the Supreme Court, Section 3466, which overrides even a prior lien obtained by the state,³⁶⁹ requires that the *gross* federal unemployment tax (unreduced by any credit for state taxes yet unpaid at the date of insolvency) as well as all other federal claims, be paid out of the insolvent estate before anything is applied on the state unemployment contribution obligation. Furthermore, even if there is money left after payment of federal priority claims, and any other claims that outrank the state under local law,³⁷⁰ so that all or part of the state unemployment contributions can be paid, no credit for such payment will be allowed to reduce the federal tax. The Court declared that the credit provision must yield to the insolvency priority statute, which gives absolute, not conditional or defeasible, priority to federal claims *as they exist on the date when the priority attaches*.³⁷¹ This assertion, of course, is nonsense, because the priority statute does not make absolute an obligation that by the very terms of its creation is conditional.³⁷² Nevertheless, this is the law today and, in consequence, the state either fails to get paid from the fund that Congress in effect made available for such payment by providing the credit, or, if funds are sufficient for both, the federal government takes its 3.2 per cent of wages and the state takes up to 2.7 per cent *in addition*—a total of 5.9 per cent as against 3.2 per cent payable by a solvent non-delinquent employer; truly a "double proof" allowed at the expense of junior creditors.³⁷³

The inequity is mitigated but not adequately resolved by the rule applied in bankruptcy, which the ABA proposal may possibly extend to other insolvency administrations. Although this rule places federal and state taxes, if nondischargeable in bankruptcy, on a par-

369. *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946).

370. Relatively few state laws give top priority rating to claims for unemployment contributions. See *Massachusetts v. United States*, 333 U.S. 611, 632 n.35 (1948).

371. *Massachusetts v. United States*, 333 U.S. 611, 624-29 (1948).

372. It could as well be said that, if the Government had sold property by warranty deed to one who then becomes insolvent, the property must be paid for out of the estate although the title later fails, or that an insolvent may not carry back net operating losses against his unpaid pre-insolvency income taxes—although the carry-backs would be allowable, by way of refund to the estate, if the earlier taxes had been paid. Cf. *Segal v. Rochelle*, 382 U.S. 375 (1966) (bankruptcy). To the Government's credit, it may be noted that it tried to concede that credit would be allowable against the federal unemployment tax for whatever the state recovered but the Court rejected the concession as a matter of law.

373. See *Massachusetts v. United States*, 333 U.S. 611, 638 (1948) (dissenting opinion).

ity,³⁷⁴ they would nevertheless not be paid in proportion to their normal shares of the combined tax liability because of a remarkable feat of algebraic legerdemain that also has the blessing of the Supreme Court. Algebra must be resorted to because credit is allowable only for what the state collects on its claim. This amount can be determined only when the amount of other tax claims, including the federal unemployment tax, ranking on a parity with it are known, which, in turn, cannot be determined until the amount to be paid on the state claim is ascertained.³⁷⁵ Since the bizarre effects of this formula on the principle of parity must be seen to be believed, I have set out two examples in the footnote.³⁷⁶

374. Although generally labeled "contributions," payments into state unemployment systems are deemed taxes for priority purposes in bankruptcy. *Missouri v. Gleick*, 135 F.2d 134 (8th Cir. 1943); *In re William Akers, Jr., Co.*, 121 F.2d 846 (3d Cir. 1941). Cf. *Carmichael v. Southern Coal & Coke Co.*, 301 U.S. 495 (1937). For a discussion of dischargeable taxes, see notes 299-302 *supra* and accompanying text.

375. *United States v. New York*, 315 U.S. 510, 518 (1942). The equation was set out and explained by the trial court, *sub nom. In re Independent Auto Forwarding Corp.*, 38 F. Supp. 976, 978 (W.D.N.Y. 1940). At that time, the reduction of the allowable credit on account of late payment was not applied when timely payment was prevented by bankruptcy or receivership. Social Security Act Amendments of 1939, ch. 666, § 609, 53 Stat. 1387. Modified to reflect the present 10% reduction of the credit for late payment (INT. REV. CODE of 1954, § 3302(a)(3)) and ignoring further modifications that would be necessary, e.g., if the state tax differs from 2.7%, the equation is:

$$X = \frac{(A + B) - \sqrt{(A + B)^2 - 4(.9AT)}}{2(.9A)}$$

with A being the state unemployment tax, B being the sum of all other taxes on a parity with it (including the gross federal unemployment tax), T being the fund remaining after allowing for higher priorities, and X being the percentage of each tax claim that can be paid.

376. Assume that the gross federal tax liability, at 3.2 per cent, is \$32,000, and the unpaid state tax, at 2.7 per cent, is \$27,000, and there are no other unpaid tax liabilities. This is a situation in which a solvent employer would pay \$27,000 to the state and \$5,000 to the United States, or \$7,700 (\$32,000 less 90 per cent of \$27,000) to the United States if the payment to the state is late. It is also a situation in which, in an insolvency administration subject to Section 3466, the United States would take the first \$32,000, and the state would take \$27,000 in addition if funds were available. How would the rule of "parity" work?

1. Suppose, first, that the fund available after satisfaction of higher priorities is \$20,164. Application of the algebraic formula establishes that 41.152 per cent of each tax claim can be paid. Hence, \$11,111 can be paid to the state. The allowable credit, reduced for late payment, is \$10,000, leaving a remaining federal tax liability of \$22,000, of which 41.152 per cent, or \$9,053, can be paid, thus exhausting the fund. The government thus takes nearly twice the *dollar amount* and nearly three times the percentage of the total collections that would have been its right if the employer had been able to meet his obligations in the normal course.

2. Now suppose that the fund available is only \$4,691. By the formula, we determine that 8.230 per cent of each tax can be paid. Hence, \$2,222 can be paid to the state, resulting in a credit of 90 per cent thereof, or \$2,000. The remaining federal tax liability is \$30,000, of which 8.230 per cent, or \$2,469, can be paid. Obviously, with the fund so small, the federal government gets fewer dollars than it would from a solvent employer. But its percentage share of the available fund is 52.6 per cent, in

Those anomalies and inequities should be corrected by amending the Internal Revenue Code³⁷⁷ along with the bankruptcy and insolvency statutes.³⁷⁸ One source of the difficulty is the tax law concept that the credit is to be allowed only to the extent that the state tax is paid. That concept is designed to assure that the amounts for which credit is allowed actually reach the state fund. But when assets are insufficient, the concept has the opposite effect of depriving the state fund of its proportionate share while sometimes giving

contrast to 44.9 per cent in the example with the larger fund and 16.7 per cent in the normal case of a solvent employer. This is parity?

In the foregoing, I have assumed that, since the ABA proposal places state and federal taxes on the same level, as does the Bankruptcy Act, the bankruptcy formula—which, in its distorted way, allows reduction of the federal claim by the credit subsequently earned—would be applied. But nothing in the draft proposal would preclude the courts from construing proposed Section 3466 as the present statute has been construed, save only that the federal claim that becomes fixed and immutable at the date of death or divestment (beyond possibility of further reduction by credit) would rank equally with the state claim rather than ahead of it. In *Massachusetts v. United States*, 333 U.S. 611, 624-29 (1948), discussed in text accompanying note 371 *supra*, the “debts due to the United States,” which Section 3466 requires to be “first satisfied,” were those existing at divestment, with no later reduction permitted. In bankruptcy the “taxes which became legally due and owing” to the United States and which enjoy fourth priority under Section 64a(4) of the Bankruptcy Act, 11 U.S.C. § 104(a)(4) (1964) were not thus viewed as unchangeable. *United States v. New York*, 315 U.S. 510, 518 (1942), discussed in note 375 *supra* and accompanying text. The ABA 1970 proposal, however, defines “claims” as those “legally due and owing by the debtor as of the date of the divestment of his property [or his death]” (see proposed § 3466(g), set out in note 60 *supra* (emphasis added)), and thus could readily be construed, as is present Section 3466, to freeze the amount of a federal claim as of that date. In that event, the Government would take 54.24 per cent (32/59) of the available fund in each example and the state would take 45.76 per cent (27/59) and, if the fund remaining after higher priorities was between \$32,000 and \$59,000, the two claims would absorb it all—at the expense of lower grades of claims.

Even if that forbidding prospect is foreclosed by appropriate revision of the draft, the ABA proposal involves complications ordinarily not present in bankruptcy, in which federal law controls the priorities. Whether the synthetic circuitry approach of the 1970 proposal or the permissive approach of the 1959 proposal is followed, the state claim may not in fact be paid from funds made available by the federal law for the tax level of priority since it is state law that determines the distribution of the portion of the fund not set aside for the federal share. See pt. IV. B. *supra*. If state law places claims for state unemployment contributions behind other state taxes or behind such federally unrecognized items as widows' allowances or wages in excess of the bankruptcy limitations, so that the state claim is supplanted under the circular priority principle described in the preceding section, the allowable credit will be further reduced to the extent that the state claim consequently goes unpaid. The federal claim will be enlarged thereby, to the further detriment of the subordinate state claim as well as of other creditors. A similar situation may arise, in bankruptcy as well as in other insolvencies, if the federal government first obtains a perfected lien, which thereby reduces the amount which the state may collect and for which credit may be allowed. Perhaps Einstein could have devised equations for dividing the fund in such cases, but I shall not attempt it.

377. INT. REV. CODE of 1954, § 3302.

378. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade III*, 77 YALE L.J. 1104, 1114 (1968).

the federal government more dollars (and always giving it a greater percentage) than it would have if assets were sufficient—thereby penalizing the state fund for the employer's inability to pay.³⁷⁹ The Government should be satisfied, under the principle of parity in bankruptcy (and, as proposed, in insolvency), to divide the available fund in the proportion that the net amount of federal tax, after full credit, bears to the state tax.

The other source of this problem is the fact that, outside of bankruptcy (and in any case where liens have arisen), these closely integrated federal and state taxes may occupy different priority levels. I suggest that provision be made for the United States to make a claim in bankruptcy or insolvency, as it does now, for the gross federal tax, reduced only by credits earned before the proceeding by earlier partial payments of state or federal tax or by virtue of experience ratings, etc., that reduce the state tax payable. Any amount so collected by the United States should be held for the account of, and divided between, both governments concerned in the proportion that the state tax (not to exceed 2.7 per cent) bears to the *net* federal tax after deduction of the credit that would be allowable if the state tax were fully paid.³⁸⁰ If the state tax exceeds 2.7 per cent, the state would make claim for the excess. In dividing the fund, due

379. It may be responded that the discriminatory effect is neutralized since the federal government guarantees the solvency of the state funds by making advances under certain circumstances (42 U.S.C. § 1321 (1964)). See *Massachusetts v. United States*, 333 U.S. 611, 632 (1948). But the burden of repaying any such advances, and thus of bearing the cost of abnormal unemployment in a particular state, falls ultimately on that state's employers through reduction of the credit against the federal tax (thereby increasing their aggregate tax) so long as the advances remain outstanding. See note 366 *supra*. See also 42 U.S.C. §§ 1101(d)(1), 1103(b)(2), 1322 (1964). That federal guaranty, therefore, hardly justifies further depleting the state fund through a discriminatory priority rule that is out of harmony with the general principle of parity between state and federal imposts.

380. In *Illinois ex rel. Gordon v. United States*, 328 U.S. 8, 11 (1946), the Court rejected under present law the argument that the credit provision makes the state claim "tantamount to a claim of the United States." But if Congress provides expressly for collection by the United States on behalf of both, in insolvency or bankruptcy, with the benefit of the federal priority, there seems no defect of power to do so (*Small Business Admin. v. McClellan*, 364 U.S. 446, 451-53 (1960); *Bramwell v. United States Fidelity & Guar. Co.*, 299 F. 705, 706 (9th Cir. 1924), *affd.*, 269 U.S. 483, 487 (1926)); nor should it involve any practical difficulty since collections of state unemployment contributions are in any event initially deposited by the states in an Unemployment Trust Fund in the United States Treasury (42 U.S.C. § 1104 (1964)) and credits to and from the states' accounts therein are now provided for in certain circumstances. This procedure seems preferable to having the Government claim and collect only the net tax after deducting the full credit and regarding the rest as a claim to be made by the state since there would be no assurance, in the latter case, that the amount for which credit was allowed would actually reach the state if state law ranked some other item not enjoying priority under federal law above state unemployment contributions. See *Massachusetts v. United States*, 333 U.S. 611, 632-33 (1948).

allowance should; of course, be made for collections by either government antecedent to the proceeding.³⁸¹

However, the circuitry effect may sometimes enhance rather than reduce the amount the state may collect from the insolvent estate. If, for example, state unemployment contributions outrank wage claims under the state insolvency law the state may collect, in the shoes of the wage claimants, a larger proportion of its claim than it would in bankruptcy (assuming that the mandatory approach is not applied to wage priorities, as heretofore suggested). A similar consequence may follow if the state first obtains a lien which, under the Bankruptcy Act or under the ABA insolvency proposal, would be recognized as superior to the federal claim. Given the general policies of the ABA proposal to recognize prior liens and to permit state legislative policies favoring certain unsecured claims—within the limitations of the circular priority rules—to pre-empt the position of nonfederal claimants favored by the federal law, there appears to be no reason in this particular situation not to let the state unemployment fund avail itself of any greater sum it may be able to collect in this manner. Therefore, if it appears advantageous for the state to claim in its own right, it may be permitted to do so. In this event, the amount allowed on the federal claim should be reduced by a credit for whatever the state thus collects independently and the division of the amount collected on the federal claim should be adjusted accordingly.³⁸²

381. For example: The gross federal tax is \$32,000, and the state tax is \$27,000, all of which would qualify for credit if paid. The employer had paid \$10,000 with his state tax return but had paid no federal tax. When insolvency occurs, the United States files claim for \$22,000. Preferred wage claims are \$7,000 and the amount available after expenses is \$21,000, leaving \$14,000 for taxes. There are no other tax claims. To calculate the division of the tax fund, the \$14,000 should be "grossed up" by including the prior collections. The resulting \$24,000 should be divided in the ratio of the net federal liability to the state liability (5 to 27), that is, \$3,750 to the United States and \$20,250 to the state, of which amount the state has previously received \$10,000. Thus, in the federal-state "partnership" in financing and administering unemployment compensation, no advantage would be gained by one government's having collected an amount outside the proceeding.

382. Assume the same facts as in note 381 *supra*, except that state law favors state taxes over wage claims. The state would file claim for its unpaid \$17,000 in order to take advantage of that priority but the United States would still make a contingent claim for \$22,000 since it may not be known initially how much the state will collect in the shoes of the wage claimants. To avoid duplication, the state claim should be allowed for an amount equal to the pre-empted wage claims (\$7,000) and the \$15,000 balance should be allowed as a federal claim. The \$14,000 fund available for tax claims would be divided by "grossing up" to reflect the \$17,000 collected by the state before and in the proceeding and the \$31,000 which would be apportioned in the 5 to 27 ratio, \$4,687.50 to the United States and \$26,312.50 to the state, against which is charged the \$17,000 collection. The general rule proposed for circular priorities is that the federal share should be determined by applying the federal scheme of priorities without reference to state law and the entire benefit of any circuitry is en-

Implicit in the foregoing recommendation, although not an indispensable part of it, is the view that the 10 per cent reduction in the allowable credit should not be applied to the detriment of the state or of junior creditors if bankruptcy or an insolvency administration has intervened. The general policy of the bankruptcy law is to avoid saddling the estate with penalties for the debtor's defaults that "would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors."³⁸³ The ABA has recommended extending this policy to other insolvency situations.³⁸⁴

The denial of 10 per cent of the otherwise allowable credit if payment to the state is delayed increases the net liability to the federal government, at present rates, by 54 per cent (from 0.5 per cent to 0.77 per cent) and is certainly as penal in its effect as any delinquency penalty.³⁸⁵ It is a sheer euphemism to say, as some district courts have, that the denial of the credit is not a penalty imposed for late payment but reflects the failure of the taxpayer to qualify for a reward or favor in the form of a tax reduction which was tendered in order to encourage timely payment.³⁸⁶ Although the Supreme Court has agreed that the additional federal tax resulting from denial of the credit was not a penalty disallowable in bankruptcy, the case before it was not one involving merely a delayed payment but one in which, by reason of the algebraic formula described above, the portion of the state tax for which credit was denied could never be paid at all.³⁸⁷ Congress may have had the latter type of case in mind when, in 1939, it sought to "set at rest the

joyed by those favored by the state law. See proposed § 3466(f)(2), set out in note 348 *supra*. Here, the federal share (\$4,687.50) exceeds what it would be in the absence of circuitry (\$3,750, see note 381 *supra*) as a portion of the state's priority advantage inures to the Government. This result, however, seems consistent with my suggested principle that the "partners" in the unemployment fund should gain no advantage over each other by independent collections, whether before or in the insolvency proceeding.

383. *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962); Bankruptcy Act § 57j, 11 U.S.C. § 93(j) (1964).

384. See pt. VI. *infra*.

385. Cf. *New York v. Jersawit*, 263 U.S. 493, 496 (1924).

386. *In re Illinois Art Indus., Inc.*, 27 F. Supp. 334, 335 (W.D. Mich. 1939); *In re Richmaid Creameries, Inc.*, 27 F. Supp. 828, 829 (S.D. Cal. 1937), *revd. on stip. sub nom.* Boteler v. Rogan, 97 F.2d 992 (9th Cir. 1938). *Contra*, *In re Hy-Grade Meat & Grocery Co.*, 26 F. Supp. 294, 295 (D.N.J. 1938); *In re Standard Composition Co.*, 23 F. Supp. 391, 395 (E.D. Mich. 1938).

387. *United States v. New York*, 315 U.S. 510, 516-17 (1942). The algebraic formula which the Court approved (see note 375 *supra*) in fact took into account the full credit for that portion of the state tax which it was possible to satisfy. By virtue of § 902(a) of the Social Security Act Amendments of 1939, 53 Stat. 1399, in certain cases of bankruptcy or receivership, full credit was allowed for amounts in fact paid, however long delayed. Social Security Act Amendments of 1939, ch. 666, § 609, 53 Stat. 1387.

question involved by expressly providing that no part" of the federal unemployment tax shall be deemed a penalty for purposes of the Bankruptcy Act,³⁸⁸ for it provided in the same legislation that no loss or reduction of credit should occur merely on account of lateness of payment if the "taxpayer's assets, at any time during the period from [the] last day for filing a return for such year to June 30 next following such last day, both dates inclusive, are in the custody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of, a court of competent jurisdiction."³⁸⁹ However, Congress eliminated that relief provision in 1943, declaring that it "does not appear to be warranted" in view of a further amendment then made by which the credit was no longer wholly forfeited for late payment but 90 per cent of the credit could be earned by payment at any time.³⁹⁰ But I submit that a relatively small penalty for a delay which is "necessitated by law if the courts are properly to preserve and protect the estate for the benefit of all interests involved"³⁹¹ is no more warranted than a large one.

I suggest, therefore, that the amount which I have proposed that the federal government collect on behalf of itself and the state, in bankruptcy or insolvency, should not be enlarged at the expense of the state or of junior creditors by any reduction of the credit that would have been allowable for timely payment. This principle should apply, unlike the relief in effect from 1939 to 1943,³⁹² whether or not the administration was in progress during the period immediately following the taxable year because, even if the employer had already forfeited a portion of the credit by his delinquency before the administration began, that forfeiture should be remitted, as is any penalty for the debtor's past defaults, when bankruptcy or insolvency follows. The same principle should also apply when the default occurs after the administration has begun since it "is preposterous for taxing agencies to penalize an insolvent estate for the mere fact that it is insolvent, the very reason for which it is in the hands of the court."³⁹³ Consideration should also be given to extend-

388. S. REP. NO. 734, 76th Cong., 1st Sess. 91 (1939), describing § 902(i) of the Social Security Act Amendments of 1939, 53 Stat. 1400.

389. Social Security Act Amendments of 1939, ch. 666, § 609, 53 Stat. 1387.

390. H.R. REP. NO. 871, 78th Cong., 1st Sess. 73 (1943), referring to § 601 of the Revenue Act of 1943. Before the 1939 Act, the entire credit was lost if payment of the state tax was a day late. From 1939 until passage of the 1943 Act, 90 per cent of the credit could be earned if payment was made by June 30, but none if it was later, except in the cases of bankruptcy or receivership that were relieved of forfeiture.

391. See *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946).

392. Social Security Act Amendments of 1939, ch. 666, § 609, 53 Stat. 1387.

393. Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141, 1176

ing the relief to cover assignments by an insolvent for the benefit of creditors, which were excluded from the 1939 relief because they were not under the control of a court.³⁹⁴

V. ANTECEDENT FEDERAL LIENS AND OTHER TAX LIENS

Even though federal claims may be secured by mortgage or lien, they are embraced in the present Section 3466 priority³⁹⁵ and may, in some circumstances, improve upon the standing that they would enjoy as against competing liens and claims in the absence of insolvency.³⁹⁶ Under the ABA 1970 proposal the new priority rules would not "impair" any pre-existing federal lien,³⁹⁷ but that prohibition would not preclude secured federal claims from still gaining an *advantage* from the insolvency priority. The proposal also states that nothing therein shall entitle an *unsecured* federal claim to priority over a nonfederal lien that meets certain minimum requirements.³⁹⁸ But it should further be made clear that the insolvency priority is not to detract from the standing that qualified competing liens would have as against *secured* federal claims, and that the relative priority of these liens shall be determined under the laws and judicial doctrines applicable in the absence of an insolvency administration.³⁹⁹

(1942). Although the Supreme Court has sustained penalties for the fiduciary's own failure to file returns (which, not being penalties imposed on the bankrupt, are not subject to disallowance under Bankruptcy Act § 57j, 11 U.S.C. § 93(j)(1964)) it has indicated that its earlier decision in *Boteler v. Ingels*, 308 U.S. 57 (1939), which penalized the estate for mere *nonpayment*, "may be open to some question." *Nicholas v. United States*, 384 U.S. 678, 694 (1966).

394. *People v. Advertising Review Pub. Co.*, 329 Ill. 29, 36-37, 62 N.E.2d 537, 540-41 (1945), *affd. sub nom. Illinois ex rel. Gordon v. United States*, 328 U.S. 8 (1946).

395. *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953); *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963).

396. *See United States v. Vermont*, 377 U.S. 351, 357-59 (1964). *See also* text accompanying notes 238-50 *supra*.

397. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (e) CERTAIN LIENS PRESERVED.—Nothing in this section shall—
(1) impair any lien in favor of the United States existing at the time of the divestment of the debtor's property in the manner provided in this section (or at the time of death in the case of an insolvent estate)

398. *See* proposed § 3466(e)(2), set out in note 172 *supra*.

399. It has been held in bankruptcy cases that priority between antecedent federal and other liens is determined by the lien law, not the bankruptcy law. *United States v. First Natl. Bank & Trust Co.*, 386 F.2d 646 (8th Cir. 1967); *California State Dept. of Employment v. United States*, 210 F.2d 242, 243 (9th Cir. 1954); *In re Freeze-In Mfg. Corp.*, 128 F. Supp. 259 (E.D. Mich. 1955). The rules of priority between federal *tax* liens and other liens and security interests, in the absence of an insolvency proceeding, were liberalized in INT. REV. CODE of 1954, § 6323, as amended by the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125. No comparable liberalization of the "federal common law" of lien priorities, including the infamous

Since executors, receivers, and other fiduciaries acting in insolvency administrations not conducted under the Bankruptcy Act do not enjoy the special status that a trustee in bankruptcy has as a universal judgment lien creditor,⁴⁰⁰ the preservation of federal liens and security interests as against unsecured claims in such insolvencies is not dependent upon such liens and security interests having been duly filed or recorded,⁴⁰¹ and the ABA apparently found no sufficient reason to grasp the nettle by proposing otherwise.⁴⁰² The proposed elevation of state and local taxes to parity with federal taxes in insolvency, therefore, would apply only where the federal tax is not

"choateness" doctrine (see notes 42-45 *supra* and accompanying text) has yet been enacted with respect to federal nontax liens. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 285-96 (1967). Therefore, such liens might still prevail, with or without insolvency, over competing liens deemed "inchoate" by federal standards, even though the ABA insolvency proposal would honor such liens against unsecured federal claims. The bolder courts, however, in decisions that border on judicial legislation, have applied the "spirit" of the federal tax lien amendments to liberalize the priorities of competing liens as against other types of federal liens on which Congress has failed to take action. *Ault v. Harris*, 317 F. Supp. 373 (D. Alaska), *aff'd.*, 432 F.2d 441 (9th Cir. 1970); *Standard Sav. & Loan Assn. v. Evans*, 255 S.C. 207, 178 S.E.2d 145 (1970). *Contra*, *Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 160 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968).

400. Having the rights of a judgment lien creditor under Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (Supp. V, 1965-1969), the trustee prevails over unfilled federal liens that are invalid against such creditors. *United States v. Speers*, 382 U.S. 266 (1965); 112 CONG. REC. 22226 (1966).

401. *In re Gibson Lithograph Co.*, 64-2 U.S. Tax Cas. ¶ 9749 (S.D. Cal. 1964) (assignment for creditors). Except as against the classes expressly protected by INT. REV. CODE of 1954, § 6323 (purchasers, holders of security interests, mechanic's lienors, and judgment creditors), the federal tax lien relates back to the time of assessment and is valid without filing. INT. REV. CODE of 1954, § 6322; *United States v. City of New Britain*, 347 U.S. 81, 87-88 (1954).

402. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 254 (1967). The matter of the bankruptcy trustee's protection against unfilled tax liens was a center of controversy in connection with the 1966 amendments of the Bankruptcy Act. S. REP. NO. 999, 89th Cong., 2d Sess. 3-6 (1966); Letter from assistant Treasury Secretary S. Surrey, Sept. 8, 1961, reproduced in S. REP. NO. 277, 89th Cong., 1st Sess. 14, 18 (1965), and quoted in part in *United States v. Speers*, 382 U.S. 266, 276 n.21 (1965). That controversy having been settled, however, there may be less justification for not extending the principle to insolvency administrations, although the circumstances are not truly the same. Administrations of insolvent decedents' estates, of course, occur without volition on the part of creditors, and in some other situations such as liquidations of banks and insurance companies, there may be no more favorable course that might have been taken if the lien were known. In other cases, a reorganization under the Bankruptcy Act might have been chosen, in which the trustee or debtor in possession would enjoy the same rights as a trustee in straight bankruptcy (Bankruptcy Act §§ 77(c)(3), 186-88, 11 U.S.C. §§ 205(c)(3), 586-88 (1964)), including the rights of a judgment lien creditor; but that advantage would be meaningless to creditors in the absence of amendment (as suggested in text accompanying notes 89-92 *supra*) of the statutory requirement that any plan, to be approved, must provide for payment of federal taxes, whether secured by valid lien or not. In any situation where straight bankruptcy is an available alternative, however, creditors may be misled to their detriment by the absence of filed notice of an antecedent tax lien and a requirement of filing could be justified in such cases.

secured by an antecedent lien, filed or unfilled. And the reduction of federal nontax claims, as well as federal tax claims that are dischargeable in bankruptcy, to the level of general creditor claims in insolvency proceedings would apply only to claims not secured by lien.⁴⁰³

The one qualification that the proposal makes to the preservation of the priority of antecedent tax liens is that every tax lien on personal property, not accompanied by possession at the time of the debtor's death or the divestment of his property, would be postponed to administration expenses, funeral and last illness expenses, and preferred wage claims.⁴⁰⁴ This change is modeled on a similar provision in the Bankruptcy Act⁴⁰⁵ which reflects the view of Congress that, with the ever-increasing burden of taxes, "[i]t would be grossly unfair for the bankruptcy court and the attorneys who have labored to wind up the bankrupt's affairs and to accumulate an estate for distribution to receive nothing for this labor," and that "it is also socially desirable that the claims of the wage earner who is normally entirely dependent upon his wages for the necessity of life should be paid to the extent of the restriction in section 64a(2) [\$600 earned within three months] before the estate is subject to the heavy burden of all tax liens."⁴⁰⁶ While Congress may have less concern with

403. For a discussion of dischargeable taxes, see text accompanying notes 299-302 *supra*. It is provided in Bankruptcy Act § 17a(1), 11 U.S.C. § 35(a)(1) (Supp. V, 1965-1969), that the discharge "shall not release or affect any tax lien." While the discharged liability cannot become a lien on after-acquired property, it enjoys lien priority status against property owned at the time of bankruptcy. *United States v. Sanabria*, 424 F.2d 1121 (7th Cir. 1970); *In re Braund*, 289 F. Supp. 604 (C.D. Cal. 1968), *affd.*, 423 F.2d 718 (9th Cir.), *cert. denied*, 400 U.S. 823 (1970). See Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 710-12 (1967). Such lien would likewise not be "impaired" by anything in the insolvency proposal. See proposed § 3466(e)(1), set out in note 397 *supra*.

404. S. 2197, 92d Cong., 1st Sess. (1971), provides:
[Sec. 3466] (e) CERTAIN LIENS PRESERVED.—

Notwithstanding the preceding sentence [set out in notes 172 & 397 *supra*], every tax lien on personal property not accompanied by possession at the time of divestment (or at the time of death in the case of an insolvent estate) shall be postponed to the claims specified in paragraphs (1), (2), and (3) of subsection (b) of this section [set out in notes 199, 236 & 279 *supra*].

Presumably neither the general interdiction against impairment of antecedent liens (see note 397 *supra*) nor the limited terms of the exception would affect the general principle that, if the proceeding is instituted for the enforcement of a federal lien (e.g., under INT. REV. CODE of 1954, § 7403(d)), the lien property, of whatever character, is chargeable with expenses of the proceeding. *United States v. Kensington Shipyard & Drydock Corp.*, 187 F.2d 709, 715-16 (3d Cir. 1951).

405. Bankruptcy Act § 67c(3), 11 U.S.C. § 107(c)(3) (Supp. V, 1965-1969). Probably by oversight, the ABA proposal omits a qualification found in § 67c(5) of the Bankruptcy Act, 11 U.S.C. § 107(c)(5) (Supp. V, 1965-1969), that the postponement shall not apply to liens enforced by sale before the proceeding, even if possession is not taken.

406. H.R. REP. NO. 686, 89th Cong., 1st Sess. 7 (1965). See also the history of the original 1938 amendment, set out in *Goggin v. Division of Labor Law Enforcement*, 336 U.S. 118, 127-29 n.8 (1949).

compensating the probate and other local courts and the fiduciaries and attorneys who administer proceedings therein,⁴⁰⁷ the principle of comity would favor extension of the above rule to proceedings other than in bankruptcy;⁴⁰⁸ and the social policy of enhancing the

This subordination of tax liens may result in circuitry if the postponed lien is itself superior to another lien or security interest that is recognized and indefeasible in the proceeding. For example, a decedent's personalty may be subject to federal tax liens of \$8,000 (not reduced to possession) and to an indefeasible security interest of \$4,000, which is junior to the tax lien. Suppose administration and funeral expenses and wage and last illness claims total \$3,000 and the net proceeds of the personalty are \$10,000. In order to accomplish the purpose of the postponement without diminishing what the junior but nonpostponable security interest would otherwise be entitled to, the ABA proposal applies a principle adopted, in 1966, by Congress in § 67c(3) of the Bankruptcy Act, 11 U.S.C. § 107(c)(3) (Supp. V, 1965-1969). Under this principle the circuitry would be resolved by first setting aside an amount equal to the senior tax lien (\$8,000) and applying the balance to the junior security interest. The priority items would then be satisfied from the amount set aside for the tax lien. See S. 2197, 92d Cong., 1st Sess. (1971), which provides:

[Sec. 3466] (f) CIRCULAR PRIORITIES.—

(1) If a tax lien on personal property not accompanied by possession referred to in subsection (e) [set out in note 404 *supra*] is prior in right to liens indefeasible under other applicable law, the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of sale, in an amount not in excess of the tax lien, shall be applied to the expenses and claims specified in paragraphs (1), (2), and (3) of subsection (b). If the amount realized from the sale exceeds the total of such expenses and claims, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the expenses and claims specified in paragraphs (1), (2), and (3) of subsection (b) of this section and the amount of the tax lien, is to be paid to the holder of the tax lien.

For a more detailed explanation of the working of the rule as applied in bankruptcy, see Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 160-66, 41 REF. J. 5, 9-11 (1967). The proposal, like that on which it is based, "is, perhaps, subject to some criticism on grounds of clarity," in that the first sentence "does not, in so many words, specify that after the amount of the tax is deducted from the available proceeds, the junior indefeasible lien is to be satisfied to the extent possible," and the second sentence "does not really shed any additional light." 4 W. COLLIER, BANKRUPTCY ¶ 67.27[3.1] (14th ed. rev. 1969).

407. It has been pointed out that the National Bankruptcy Conference and other organizations wanted to eliminate the postponement provision, which had been added to the Bankruptcy Act at their instance in 1938 but had caused serious circuitry problems, but the Administrative Office of the United States Courts, viewing such elimination as "a threat to the continued health of the Referees' Salary and Expense Fund," was insistent upon its retention and the Judicial Conference would not approve a bill without the postponement provision. Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 160 n.45, 41 REF. J. 5, 9 n.44 (1967). The ABA 1959 proposal refrained from recommending extension of the then controversial postponement rule to the area covered by Section 3466.

408. Although the postponement provision, Bankruptcy Act § 67c(3), 11 U.S.C. § 107(c)(3) (Supp. V, 1965-1969), is not now made applicable in reorganizations under the Bankruptcy Act (see Bankruptcy Act § 67c(5), 11 U.S.C. § 107(c)(5) (Supp. V, 1965-1969), which overturns the contrary interpretation of the pre-1966 law in *In re American Health Studios, Inc.*, 178 F. Supp. 553 (S.D. Tex. 1959)), the current state of the law does not appear to indicate a fixed congressional policy against making the postponement applicable in the type of proceedings to which Section 3466 applies. The same practical effect may be achieved by the prescription that, from whatever source, administration expenses must be provided for if a reorganization plan is to be approved (Bankruptcy Act §§ 77(e) & 216(3), 11 U.S.C. §§ 205(e) & 616(3) (1964)); if prior tax

assurance that wages, and perhaps also the funeral and last illness expenses that have no counterpart in the bankruptcy law, will be paid despite the fortuity that a tax was assessed before rather than after the date of death or divestment would seem to be the same whatever the form of the proceeding.

Not just federal tax liens, but state and local tax liens as well, are intended to be postponed under this proposal. This recommendation is consistent with the Bankruptcy Act and is premised upon the not unreasonable assumption that Congress would be resistant to postponing federal taxes if similarly situated state and local taxes escaped such treatment. Nevertheless, under what I have called the synthetic circuitry approach to the priority of nonfederal claims,⁴⁰⁹ the futility of the postponement rule is assured to the extent that state or local tax liens on personalty coexist with federal tax liens. To illustrate: *A* dies, leaving only personalty worth \$4,000. The personalty is subject to a \$10,000 lien for federal taxes and to a junior lien of \$3,000 for state taxes, neither of which has been reduced to possession. Administration and funeral expenses and preferred claims for wages and last illness amount to \$3,000. Under the synthetic circuitry rule, adopted by Section 3466(f)(2) of the ABA 1970 proposal, the amount to which the United States is entitled is first to be determined by application of subsections (b) through (e), the last of which includes the rule preserving antecedent tax liens but postponing them, in the circumstances here assumed, to the specified priority items. The remaining fund is then to be distributed in accordance with "other applicable law."⁴¹⁰ In our example, therefore, the amount of the priority items (\$3,000) would be set aside from the fund otherwise available for the senior federal tax lien and the remaining \$1,000 of the proceeds would be applied on the federal tax lien;⁴¹¹ but the \$3,000 set aside would be used to satisfy, not the priority items favored by Congress, but the junior state tax lien, unless *state law* makes provision for postponement of state tax liens to such items. Thus the purpose of the postponement provision can be achieved only if, in this circumstance if in no other, Congress asserts its supreme power under the bankruptcy clause of the Constitution, and makes it mandatory that unenforced state, as

liens leave insufficient funds for that purpose and no plan can be approved, an adjudication of bankruptcy will result and postponement under § 67c(3) will then apply.

409. See pt. IV. B. *supra*. This is to be distinguished from the more specialized circuitry rule described in note 406 *supra*.

410. See proposed § 3466(f)(2), set out in note 348 *supra*.

411. See proposed § 3466(f)(1), set out in note 406 *supra*.

well as federal, tax liens on personalty yield to the priority items.⁴¹²

If Congress doubts its power or prefers the carrot to the stick, it might adopt the permissive approach and prescribe that unenforced federal tax liens on personalty shall be postponed only to such of the designated priority items, if any, as are preferred over like state and local tax liens under state law. Then, if the state policy does not value the priority items sufficiently to subordinate the state's own taxes, the federal government would not do so either.

VI. PENALTIES AND FORFEITURES

In bankruptcy, although penalties and forfeitures may be imposed by federal, state, and local governments upon the estate for acts or omissions of the trustee or debtor in possession,⁴¹³ those penalties and forfeitures that were incurred by the debtor before bankruptcy are not allowable claims, except to the extent of the actual pecuniary loss sustained,⁴¹⁴ and even those secured by liens perfected before the proceeding may not be enforced for the disallowed amount.⁴¹⁵ In receiverships and assignments for creditors, on the

412. See text accompanying notes 323-42 *supra*. Oddly enough and perhaps not by design but as a result of the structure of the draft, the mandatory approach would apparently be applied under the ABA 1970 proposal if there happened to exist a nontax lien or security interest junior to the tax liens. Let us assume the same facts as in the text, except that there is also a junior security interest of \$1,000 in A's personalty. In that event, the applicable circuitry rule is that prescribed in proposed § 3466(f)(1) (set out in note 406 *supra*), which directs that when a postponed tax lien is prior in right to another indefeasible lien the net proceeds (\$4,000) "shall be applied" to the priority items (\$3,000) up to an amount not in excess of the postponed tax liens (emphasis added). The language here is mandatory. And the other, more general, circuitry rule of proposed § 3466(f)(2) (set out in note 348 *supra*), which nullifies the equally mandatory language of subsections (b) through (e) and divides the nonfederal fund in accordance with state law, would not apply since the payment of priority items is here directed, not by subsections (b) through (e), but by subsection (f)(1). Thus, the fortuitous presence or absence of a junior indefeasible lien or security interest would determine whether the postponement provision accomplishes its purpose of assuring funds for payment of administration and funeral expenses and wage and last illness claims or whether it merely enables the satisfaction of junior state and local tax liens at the expense of federal tax liens.

413. *Nicholas v. United States*, 384 U.S. 678, 692 (1966); *Boteler v. Ingels*, 308 U.S. 57, 60-61 (1939); *In re Samuel Chapman, Inc.*, 394 F.2d 340, 341 (2d Cir. 1968). *But cf. In re New York, N.H. & H.R.R.*, 304 F. Supp. 1121, 1135 (D. Conn. 1969). See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 282-83 (1967), for criticism of the imposition of penalties in such circumstances.

414. Bankruptcy Act § 57j, 11 U.S.C. § 93(j) (1964).

415. *Simonson v. Granquist*, 369 U.S. 38 (1962). The same principles apply in reorganizations and other rehabilitative proceedings under the Bankruptcy Act (*Simonson v. Granquist*, 369 U.S. 38 (1962), *revog.* *United States v. Harris*, 287 F.2d 491 (9th Cir. 1961) (Chapter X); *California State Bd. of Equalization v. Goggin*, 183 F.2d 489, 493 (9th Cir.), *cert. denied*, 340 U.S. 891 (1950) (Chapter XI)), with the possible exception of railroad reorganizations under Section 77 (*compare In re Chicago, M. & St. P.R.R.*, 27 F. Supp. 685 (N.D. Ill. 1939), *with In re Tennessee Cent. Ry.*, 316 F. Supp. 1103, 1113-14

other hand (and no doubt also in insolvent decedents' estates),⁴¹⁶ Section 3466 now requires that penalties owed to the United States, without regard to pecuniary loss and whether or not secured by lien, shall be paid before the claims of other creditors.⁴¹⁷

The ABA 1970 proposal would amend Section 3466 to provide that such penalties and forfeitures, to the extent that they exceed the pecuniary loss sustained, shall be paid only after claims of all other creditors, including general unsecured creditors but excluding similar state and local claims for penalties and forfeitures, have first been satisfied.⁴¹⁸ In this respect, the proposal follows the policy of the Bankruptcy Act not to make innocent creditors suffer the penalty for the debtor's wrongful acts but, consistent with the nature of insolvency administrations not under the Bankruptcy Act, this purpose would be accomplished by subordination rather than by disallowance and discharge.⁴¹⁹ Unlike the rule in bankruptcy, however, the priority of penalties for which liens had arisen before the debtor's death or the divestment of his property would apparently not be impaired.⁴²⁰ Further, as in bankruptcy, penalties incurred during

(M.D. Tenn. 1970), *appeal docketed*, No. 71-1228, 6th Cir., 1971). See 5 W. COLLIER, BANKRUPTCY ¶¶ 77.10, .20 (14th ed. rev. 1970).

416. Civil tax penalties are not abated by the death of the erring taxpayer. *Estate of Rau v. Commissioner*, 301 F.2d 51 (9th Cir.), *cert. denied*, 371 U.S. 823 (1962).

417. *County of Spokane v. United States*, 279 U.S. 80, 93 (1929); *Jobbers Credit Assn., Inc. v. United States*, 164 F. Supp. 22 (E.D.N.Y. 1958); Rev. Rul. 68-574, 1968-2 CUM. BULL. 595.

418. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec. 3466] (d) PENALTIES AND FORFEITURES.—All claims, other than claims of any State or subdivision thereof arising from a penalty or forfeiture, shall be paid prior to any claim of the United States arising from a penalty or forfeiture. Claims of any State or subdivision arising from a penalty or forfeiture shall be subordinated to claims of the United States not arising from a penalty or forfeiture and shall be paid ratably with any claim of the United States arising from a penalty or forfeiture. For purposes of this section, a claim shall not be regarded as arising from a penalty or forfeiture to the extent that it is for the amount of the pecuniary loss sustained by an act, transaction or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

The ABA 1959 proposal did not undertake to deal with this matter.

419. Since the penalties would have to be paid if the debtor had any funds left, the objection raised in 5 W. COLLIER, BANKRUPTCY ¶¶ 77.10, .20 (14 ed. rev. 1970) to disallowing and discharging penalties in rehabilitative proceedings would not be applicable.

420. Proposed § 3466(d) (set out in note 418 *supra*), draws no distinction between penalties that are and those that are not secured by lien, but proposed § 3466(e)(1) (set out in 397 *supra*), is an overriding provision that nothing in the section shall impair *any lien* in favor of the United States existing at divestment or death, and proposed § 3466(e)(2) (set out in note 172 *supra*) similarly would preclude subordinating state and local penalties, if secured by lien, to any unsecured federal claim. It is true that the Court in *Simonson v. Granquist*, 369 U.S. 38 (1962), was not deterred by the Bankruptcy Act's express recognition of statutory liens from overriding such liens when they secured penalties. But the overriding provision in that case (Bankruptcy Act § 57j, 11 U.S.C.

the administration for acts or omissions of the fiduciary would not be affected.⁴²¹

As does the lien postponement provision discussed in Part V, the penalty provision makes a show of treating state and local governments no more favorably than the United States. Under the wording of the proposal, all other claims are to be paid ahead of federal non-pecuniary loss penalties and forfeitures except similar state and local penalties and forfeitures, which "shall be subordinated" to all other federal claims and "shall be paid ratably" with the federal penalties and forfeitures.⁴²² But, here as elsewhere in the proposal, such parity of treatment is illusory because of the overriding "circular priority" provision which requires that after setting aside an amount for the United States calculated on the basis of the proposed federal law, the balance of the fund shall be divided according to "other applicable law."⁴²³ Unless state laws are in conformity, therefore, the actual effect of the proposal to subordinate state and local penalties will generally be to take a corresponding amount away from the other creditors whose superior equity the proposed federal law purports to recognize.⁴²⁴ That effect can be fully overcome only by making mandatory the subordination of state and local penalties and forfeitures, regardless of state laws to the contrary. If Congress is reluctant to test its power in that regard, it might adopt the per-

§ 93(j) (1964)) prescribed that the penalty "shall not be allowed," and the lien fell with the debt. The parallel provision here would merely rank such penalties behind all other claims, without disallowing them, and would thus yield more readily to the mandate that *nothing* in the proposed section shall impair any antecedent lien.

421. Only "claims" for penalties would be subordinated, and "claims" are defined as those which became legally due and owing before the debtor's death or the divestment of his property. See proposed § 3466(g)(2), set out in note 60 *supra*.

422. See proposed § 3466(d), set out in note 418 *supra*.

423. See proposed § 3466(f)(2), set out in note 348 *supra*.

424. To illustrate: A makes an assignment for the benefit of creditors. Sale of his property produces \$30,000. The expenses and claims are

Administration expenses	\$1,000
Preferred wage claims	2,000
Federal taxes	20,000
Federal fraud penalty	10,000
State taxes	6,000
State fraud penalty	3,000
General creditors	1,000

State law ranks state taxes, including penalties, immediately after administration expenses and ahead of wages. Under the proposal, the federal share of the fund would be determined by deducting \$3,000 for administration expenses and wages, setting aside the next \$26,000 for the federal and state taxes on a parity, and assigning the remaining \$1,000 to general creditors, whose claims are superior to the penalty claims. The federal share is thus \$20,000, and the other \$10,000 is to be divided according to state law—\$1,000 to administration expenses, \$9,000 to the state for taxes and penalty, and *nothing* to the wage claimants and general creditors.

missive approach and provide for subordination of federal non-pecuniary loss penalties and forfeitures only if state law makes similar provision respecting those penalties and forfeitures imposed by state and local governments.

VII. THE FIDUCIARY'S PERSONAL LIABILITY

An essential adjunct of the federal insolvency priority is the companion provision (Section 3467 of the Revised Statutes) which imposes *personal liability* upon "[e]very executor, administrator, or assignee, or other person who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate."⁴²⁵ Read literally, and without reference to its historic association with the insolvency priority statute, that language would even require the management of a solvent business, not under administration, to act at its peril in paying other debts while federal claims are owing, for if the business should later become unable to pay the federal claims the management could be liable; further, the provision would impose personal liability even on one who pays other debts innocently and with no reason to suppose that there may be obligations owing to the United States. But the courts have rejected such sweeping constructions of Section 3467⁴²⁶ and the ABA 1970 proposal would amend the provision principally to clarify those matters and to conform the provision to the changes proposed in Section 3466.⁴²⁷

425. 31 U.S.C. § 192 (1964), set out in note 1 *supra*.

426. See notes 429 & 436 *infra*.

427. S. 2197, 92d Cong., 1st Sess. (1971), provides:

[Sec.] 3467. LIABILITY OF FIDUCIARIES.

Every person who pays, in whole or in part, any claim against an insolvent debtor or estate for whom or for which he acts before he pays the claims of the United States against such debtor or estate of which he has actual knowledge and which under the preceding section [Section 3466] are entitled to priority over the claims so paid, shall become answerable in his own person and estate to the extent of such payments for the claims of the United States, or for so much thereof as may remain due and unpaid.

A person shall be deemed for purposes of a particular transaction to have actual knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the person had exercised due diligence. A person exercises due diligence if he maintains reasonable routines for communicating significant information to the individual conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the person to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

The definitions of "claim" (see proposed § 3466(g)(2), set out in note 60 *supra*) and "insolvent" (see proposed § 3466(g)(4), set out in note 107 *supra*) in proposed Section

One proposed amendment, already discussed,⁴²⁸ would make clear that the personal liability would be incurred only if the payment of a nonfederal claim is in derogation of the federal insolvency priority under Section 3466 (as proposed to be modified), thus confirming the judicial rejection of the Government's attempt to give Section 3467 a life of its own by imposing liability on the officers of a solvent, going business.⁴²⁹

A further amendment purports to "codify the present rule under which the fiduciary is relieved of liability if he has no reason to know of a claim of the United States."⁴³⁰ The proposed amendment, however, is not expressed in terms of having "no reason to know" of a federal claim, nor does it conform to the decisions which would have charged the fiduciary if he had acted in disregard of such knowledge as would put a reasonably prudent man upon inquiry.⁴³¹ Rather, the proposal would relieve the fiduciary unless he had

3466 would be applicable for purposes of Section 3467. The second paragraph, above, is broader in S. 2197 than was proposed by the ABA (1970 REPORT, *supra* note 53, at 418-19), which—following the precedent of the Uniform Commercial Code (§ 1-207(27)) and the Federal Tax Lien Act of 1966 (INT. REV. CODE of 1954, § 6323(i)(1))—would have charged vicarious "knowledge" to an "organization" (e.g., a trust company) rather than to a "person."

428. See text accompanying notes 149-62 *supra*.

429. *United States v. Lutz*, 295 F.2d 736 (5th Cir. 1961). Liability would be incurred, therefore, only by fiduciaries in proceedings involving general administration of assets for the benefit of creditors (*see* pt. II. A. *supra*) other than in bankruptcy (*see* text accompanying notes 93-105 *supra*), and only if the estate at the time of payment is insolvent in the sense of having insufficient assets to pay debts (*see* note 151 *supra*) and the claim which the fiduciary prefers is not one entitled to priority over the federal claim that goes unpaid. Because of the difficulty of knowing the precise time a solvent operating administration becomes insolvent, I have suggested the adoption of a more objective standard for subjecting the fiduciary to personal responsibility for seeing that federal claims are paid in accordance with their priorities. *See* text accompanying notes 155-57 *supra*.

430. 1970 REPORT, *supra* note 53, at 423.

431. *Leroy K. New*, 48 T.C. 671, 676 (1967); *Irving Trust Co.*, 36 B.T.A. 146, 148 (1937); *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 937 (S.D. Cal. 1966); *United States v. Clark*, 25 F. Cas. 447, 450 (No. 14,807) (C.C.N.Y. 1826); Treas. Reg. § 1.641(b)-2(a) (1956); Rev. Rul. 66-43, 1966-1 CUM. BULL. 291. Although the rule is expressed in Treas. Reg. § 301.6871(a)-2(c) (1957) in terms of "notice" and in *Want v. Commissioner*, 280 F.2d 777, 783 (2d Cir. 1960), in terms of "actual notice," both these terms embrace the concept of a duty of inquiry extending to matters that are fairly suggested by the facts really known. *See* note 435 *infra*. It has been held, however, that the fiduciary is not chargeable with mere *record notice* of a federal claim. *Livingston v. Becker*, 40 F.2d 673 (E.D. Mo. 1929). Yet, it might not be an undue burden on a fiduciary charged with paying the debts of an insolvent to require that he avail himself of so readily available a source of information (as a trustee in bankruptcy must, *see* note 105 *supra*); but a rule of reason should be applied, lest a fiduciary be deterred from serving by the risk of there being federal tax liens on file in the county of some past residence of the debtor of which the fiduciary may be unaware. *See Plumb, Federal Liens and Priorities—Agenda for the Next Decade II*, 77 YALE L.J. 605, 652 (1968).

"actual knowledge" of the federal claim.⁴³² While it is true that "actual knowledge" has, in some statutes, been construed to embrace "information on which to base inquiries" on which "a reasonable man would usually act . . . in the ordinary course of human affairs,"⁴³³ other interpretations hold that those words require more than mere "reason to believe"⁴³⁴ and are narrower than the term "actual notice," which includes both actual knowledge and such knowledge as reasonable investigation would have disclosed.⁴³⁵ It is desirable to express some form of notice requirement in the statute in order to stifle recurrent government arguments that, under the literal terms of Section 3467, the fiduciary "acts at his peril if he distributes the estate without first making certain that no branch of the federal government is holding a claim against the estate that it might assert in the near or remote future."⁴³⁶ But the nature of the duties of a fiduciary of an insolvent estate makes it appropriate to require at least that he make reasonable inquiries concerning possible federal liabilities,⁴³⁷ and the proposed amendment—at least if it is to be represented as a mere codification of existing decisions—should not be so worded as to suggest that the fiduciary need not assume that responsibility.⁴³⁸

Another proposed change in Section 3467 is the substitution of the word "claims" for "debts" wherever it appears, but since "claims"

432. See proposed § 3467, set out in note 427 *supra*.

433. *E.g.*, *Davidson v. Bermo, Inc.*, 272 Minn. 97, 101, 137 N.W.2d 567, 571 (1965). In cases not involving construction of statutory language, it has also been said that "[a]ctual knowledge consists, not only as to what one certainly knows, but it also consists in the information which he might obtain by investigating facts which he does know and which impose upon him the duty to investigate." *Smith v. Pacific Mut. Life Ins. Co.*, 192 F.2d 248, 252 (6th Cir. 1951), quoting *Cable Piano Co. v. Lewis*, 195 Ky. 666, 672, 243 S.W. 924, 926 (1922).

434. *Roberts Constr. Co. v. Brown*, 272 Ala. 440, 442, 131 S.2d 710, 712 (1961).

435. *The Tompkins*, 13 F.2d 552 (2d Cir. 1926). *Accord*, *Flack v. First Natl. Bank of Dalhart*, 148 Tex. 495, 499-501, 226 S.W.2d 628, 631-32 (1950). This distinction is also found in § 1-201(25) of the Uniform Commercial Code.

436. This argument was made and rejected in *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 935 (S.D. Cal. 1966).

437. Concerning the extent of the duty of inquiry, see Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 259-60 (1967). See also note 431 *supra*.

438. A proposal by the Committee on Estate and Gift Taxes of the Section of Taxation of the ABA, which was never passed upon by the ABA, would have conditioned the fiduciary's personal liability upon whether he "knows, or reasonably should know" of the federal claim. ABA SECTION OF TAXATION, 1960 PROGRAM & COMMITTEE REPORTS 35-37. The ABA 1970 proposal does incorporate a "due diligence" test (see proposed § 3467, set out in note 427 *supra*) but it relates to the duty of others acting for the responsible person to communicate their knowledge to him, rather than to the duty of such person to make further inquiries suggested by known facts.

must, by express definition, be amounts "legally due and owing,"⁴³⁹ it appears that no change in meaning is intended. It has been held under existing law that a liquidating trustee who distributes corporate property to stockholders does not thereby pay "any debt due," and hence does not incur personal liability for federal debts left unpaid;⁴⁴⁰ the distributees' rights with respect to their stock would appear to be no more in the nature of "claims . . . legally due and owing," under the proposed language, than they are a "debt due."⁴⁴¹ On the other hand, the Government contends, with some support in the case law,⁴⁴² that a beneficiary's distributive share of an estate is a "debt due," the payment of which may make an executor or administrator liable for unpaid obligations to the United States.⁴⁴³ It may well be appropriate to provide a remedy against the erring fiduciary in either or both of such cases, despite the availability of an alternative remedy (possibly ineffective or unduly burdensome) against the distributees,⁴⁴⁴ but if Congress intends that such payments cause personal liability to be imposed, it should use language more descriptive than either "debts" or "claims."⁴⁴⁵

VIII. EFFECTIVE DATE

The ABA proposal would make the new rules of priority effective immediately upon enactment and applicable in pending ad-

439. See proposed § 3466(g)(2), set out in note 60 *supra*.

440. Leon G. Grieb, 36 T.C. 156 (1961); Edward G. Leuthesser, 18 T.C. 1112, 1126-28 (1952).

441. Cf. *J.P. Morgan & Co. v. Missouri Pac. R.R.*, 85 F.2d 351, 352 (8th Cir. 1936), *cert. denied*, 299 U.S. 604 (1937), declaring (for purposes of Bankruptcy Act § 77(c)(7), 11 U.S.C. § 205(c)(7) (1964)) that "[a] stockholder has an interest in a corporation, even though entitled to no specific part of it, but can hardly be said to have a claim against it"

442. *Viles v. Commissioner*, 233 F.2d 376, 379 (6th Cir. 1956). See *Want v. Commissioner*, 280 F.2d 777, 783 (2d Cir. 1960), citing *United States v. Munroe*, 65 F. Supp. 213 (W.D. Pa. 1946), in which the court's reliance on Section 3467 was unnecessary since the executrix was also the distributee of the estate and was liable in that capacity.

443. Treas. Reg. § 25.2502-2 (1958) (gift tax).

444. When the fiduciary mispays a debt in disregard of the priority rights of others, the fiduciary himself may (or may not) have a right to recover the payment (see Annot., 105 A.L.R. 1519 (1936)), but the priority claimant himself has no direct right of action against the recipient of the payment. *Mills v. Ross*, 39 App. Div. 563, 57 N.Y. Supp. 680 (1899), *affd.*, 168 N.Y. 673, 61 N.E. 1131 (1901). When the fiduciary distributes assets to stockholders or beneficiaries, on the other hand, creditors have a direct right to recover the distribution under the trust fund doctrine (*Neill v. Phinney*, 245 F.2d 645, 651-52 (5th Cir. 1957) (liquidated corporation); *Viles v. Commissioner*, 233 F.2d 376, 379 (6th Cir. 1956) (decendent's estate)), either by suit (*Leighton v. United States*, 289 U.S. 506 (1933)) or alternatively, in the case of claims for the principal forms of federal taxes, by a transferee assessment (INT. REV. CODE of 1954, § 6901), but a multiplicity of proceedings against scattered persons may in some cases be necessary. See Plumb, *Federal Tax Liens and Transferee Proceedings*, 13 TULANE TAX INST. 148, 188-89 (1964).

445. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 257-58 (1967).

ministrations to the extent that distributions had not already been made by that date.⁴⁴⁶ Therefore, any payments already made to the United States in accordance with its present priority would not be recoverable for the benefit of those to whom the amendment would grant a higher priority, but any funds still in the hands of the fiduciary would be distributed first to the more favored claimants. The exception for previous distributions would have one possibly unanticipated effect, however, in that a fiduciary who had earlier improperly paid a claim which, under the amendment, would be entitled to priority over the United States, would suffer personal liability under Section 3467 even though the still unpaid federal claim had lost its priority status and the Government would not have been entitled to the misapplied funds if they remained on hand. Perhaps a separate effective date provision ought to be constructed for the Section 3467 amendment.⁴⁴⁷

The proposal to apply the new priorities to existing claims and pending proceedings conforms to the practice that has been followed since 1926 in amendments altering bankruptcy priorities,⁴⁴⁸ as well as to the precedent of the several enactments liberalizing the priorities of private creditors as against federal tax liens.⁴⁴⁹ No question of the validity of such retroactive application can arise since either the synthetic circuitry approach of the ABA 1970 proposal or the per-

446. Section 2 of S. 2197, 92d Cong., 1st Sess. (1971), provides:

The amendments made by the first section of this Act [amending Rev. Stat. §§ 3466 and 3467] shall apply—

(1) to administrations for the benefit of creditors pending on the date of enactment of this Act, to the extent that distributions have not theretofore been made;

(2) to any such administration commencing on or after that date; and

(3) to the estate of a debtor of the United States who dies on or after that date.

In the case of any bond given to the United States before the date of enactment of this Act, if the amount recoverable by the surety out of the estate and effects of an insolvent or deceased principal, pursuant to the priority provided by Section 3468 of the Revised Statutes (31 U.S.C. 193), is reduced as a consequence of the provisions of this Act, the United States shall indemnify the surety to the extent of such reduction, but the obligation of the bond shall not otherwise be affected.

The bill departs significantly from the ABA proposal (1970 REPORT, *supra* note 53, at 419) in making the amendments applicable to pending proceedings only in the case of administrations for the benefit of creditors, while denying the benefit thereof in pending administrations of decedents' estates.

447. Experience with § 114 of the Federal Tax Lien Act of 1966, 80 Stat. 1146, has demonstrated the folly (*see* note 97 *supra*) of making an effective date provision, framed with the priority rules in mind, serve generally for a variety of other sections involving matters other than priorities.

448. *E.g.*, Act of May 27, 1926, ch. 406, § 18, 44 Stat. 667-68; Act of June 22, 1938, ch. 575, § 6(b), 52 Stat. 940; Act of July 7, 1952, ch. 579, § 56(b), 66 Stat. 438; Pub. L. No. 89-496, § 5(b), 80 Stat. 271 (1966). Before 1926, the practice was to make amendments prospective only. *See In re John G. Gasteiger & Co.*, 25 F.2d 642, 643 (2d Cir. 1928).

449. Revenue Act of 1939, § 401, amending INT. REV. CODE of 1939, § 3672(b)(3); INT. REV. CODE of 1954, § 7851(a)(6)(B) (effective date for liberalized rules in § 6324); Federal Tax Lien Act of 1966, § 114(a) & (b). *See* 1959 REPORT, *supra* note 47, at 730-31, for a review of the precedents.

missive approach favored in 1959 and generally herein would take nothing from any existing nonfederal creditor but would merely redistribute funds which today would be taken by the United States.⁴⁵⁰ But, even if it should be decided in some limited respect to apply the mandatory approach, and thus derogate from the existing priority of a nonfederal claim, there would still be no doubt of the power to apply the new rules retroactively, at least if only unsecured claims (*e.g.*, state nonpecuniary loss penalties)⁴⁵¹ were affected.⁴⁵² On the other hand, if the mandatory approach should be applied to subordinate nonfederal liens (*e.g.*, state and local nonpossessory tax liens on personalty) to certain expenses and claims,⁴⁵³ the advisability, if not the constitutionality, of applying the rule to existing liens might be questioned.⁴⁵⁴

A surety who satisfies the obligation on a bond given to the United States, for taxes or otherwise, is entitled, except as against unsatisfied federal claims, to the same priority in the insolvent principal's estate that the United States would enjoy under Section 3466.⁴⁵⁵ The proposal to eliminate retroactively the priority of federal nontax claims and to inject other priorities ahead of or on a parity with federal tax claims would increase the risk on existing

450. Plainly the Government may abrogate or reduce its own priority in pending proceedings. *Cf. In re Pioneer Sample Book Co.*, 374 F.2d 953, 957 (3d Cir. 1967).

451. See text accompanying note 424 *supra*.

452. Retroactive alteration of priorities under Bankruptcy Act § 64a, 11 U.S.C. § 104(a) (Supp. V, 1965-1969), has uniformly been sustained. *New York Credit Men's Adjustment Bureau, Inc. v. A. Jesse Goldstein & Co.*, 276 F.2d 886 (2d Cir. 1960); *Coin Mach. Acceptance Corp. v. O'Donnell*, 192 F.2d 773 (4th Cir. 1951); *In re Old Algiers*, 100 F.2d 374 (2d Cir. 1938); *City of Chelsea v. Dolan*, 24 F.2d 522 (1st Cir.), *cert. denied*, 277 U.S. 606 (1928). Retroactive application of the Section 3466 insolvency priority in favor of a new class of federal claims was sustained in *Reconstruction Fin. Corp. v. Flynn*, 175 F.2d 761 (2d Cir.), *cert. denied*, 338 U.S. 859 (1949).

453. See note 412 *supra*. It is there observed that the ABA 1970 proposal, perhaps inadvertently, does apply the mandatory approach to lien postponement in limited circumstances.

454. The 1938 and 1952 amendments (cited in note 448 *supra*) which adversely affected liens were construed (despite general provisions directing retroactive application "so far as practicable") as not invalidating or subordinating existing liens; these liens were viewed as vested property rights—in contrast to mere priorities, which could be changed. *Ginsberg v. Lindel*, 107 F.2d 721 (8th Cir. 1939); *In re Freeze-In Mfg. Corp.*, 128 F. Supp. 259, 261 (E.D. Mich. 1955); *In re Edmunds*, 27 F. Supp. 196 (M.D. Pa. 1939). See 4 W. COLLIER, *BANKRUPTCY* ¶ 67.20[7] (14th ed. rev. 1969). On the other hand, retroactive legislation preferring certain unsecured claims (for pre-reorganization employee injuries) over existing mortgages has been upheld. *Thompson v. Siratt*, 95 F.2d 214, 218 (8th Cir. 1938). As against the bankruptcy power, a secured debt or lien is "a no more sacred kind of property than an unsecured debt." *Campbell v. Alleghany Corp.* 75 F.2d 947, 954 (4th Cir.), *cert. denied*, 296 U.S. 581 (1935). See also *In re Prima Co.*, 88 F.2d 785, 788-89 (7th Cir. 1937).

455. REV. STAT. § 3468, 31 U.S.C. § 193 (1964). See *United States v. National Surety Co.*, 254 U.S. 73 (1920).

bonds by impairing the surety's ability to reimburse himself out of the debtor's estate. While the surety may be said to have contracted with reference to the power of Congress to change the priorities established by law,⁴⁵⁶ so that the bond would not be legally discharged in whole or in part by the unanticipated increase in the risk,⁴⁵⁷ it seems inequitable that such an added burden should be imposed by the Government—the party indemnified on the bond.⁴⁵⁸ The ABA proposal, therefore, would relieve the surety, under a bond entered into before the amendment, to the extent that the recovery from the debtor is reduced as a result of the changes in priorities.⁴⁵⁹

IX. AMENDING THE PROPOSED AMENDMENT

I might close this regrettably critical commentary with a simple challenge to the draftsmen, "Back to the old drawing board!"⁴⁶⁰ But one who participated in the deliberations (failing under the pressures of the time to see some of the problems and being overruled on other matters) and who earnestly desires to see the early completion of the reform of federal priorities that was no more than begun with the Federal Tax Lien Act of 1966⁴⁶¹ has a responsibility to move the project along by embodying his suggestions in a new proposed draft, lest the doubts and difficulties that have been raised should deter congressional action.

Therefore, without pride of authorship and with an invitation to comment and criticism, I submit this revision of the draft, with alternatives offered where policy choices may be made, and with

456. Cf. note 452 *supra*.

457. Cf. *Wm. W. Bierce Ltd. v. Waterhouse*, 219 U.S. 320, 336-37 (1911); *United States v. Powell*, 81 U.S. (14 Wall.) 493, 501-02 (1872).

458. It is noted that where Congress, in order to preclude indirect preference of the person obtaining the judicial lien, voided the security for surety bonds that were given to dissolve judicial liens obtained within four months before bankruptcy (Bankruptcy Act § 67a(2), 11 U.S.C. § 107(a)(2) (1964)), it provided for discharging the surety from liability on the bond to the extent of the value of the security of which it was deprived (Bankruptcy Act § 67a(5), 11 U.S.C. § 107(a)(5) (1964)). While the situation is not strictly comparable, since the surety here is deprived of a priority rather than a security interest, the equity is similar.

459. See proposed Section 2 of S. 2197, 92d Cong., 1st Sess. (1971), set out in note 446 *supra*. See also 1970 REPORT, *supra* note 53, at 424. A similar provision was included in the earlier ABA proposals altering the priorities of *liens* for federal taxes (See 1959 REPORT, *supra* note 47, at 700-01), but Congress omitted such provision in enacting the Federal Tax Lien Act of 1966.

460. Cf. Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 735 (1967).

461. See Plumb, *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228 (1967).

footnote references to the points in the preceding discussion where the explanations of changes from the ABA 1970 proposal may be found.

Sec. 101. Priority in Insolvency.

Section 3466 of the Revised Statutes (31 U.S.C. 191) (relating to priority in insolvency) is amended to read as follows:

"Sec. 3466. PRIORITY IN INSOLVENCY.

"(a) APPLICABILITY.—

"(1) IN GENERAL.—This section shall apply whenever any person indebted to the United States is divested of the title or right to possession, or both title and right to possession, of all or substantially all of his property⁴⁶² for the purpose of effecting general administration thereof, whether with a view to liquidation, rehabilitation or reorganization,⁴⁶³ or whenever the estate of any deceased debtor of the United States is in the hands of an executor or administrator, if in either case such property or estate is at any time during the administration thereof⁴⁶⁴ insufficient to pay the debts of the debtor or decedent.⁴⁶⁵

"(2) BANKRUPTCY.—This section shall not be applicable to proceedings under the Bankruptcy Act except to the extent expressly provided therein.⁴⁶⁶

"(b) PRIORITY OF EXPENSES AND CLAIMS.—The following expenses and claims⁴⁶⁷ shall be entitled to the priority specified:

"(1) ADMINISTRATION⁴⁶⁸ EXPENSES.—Costs and expenses of administration allowable under other applicable law, to the extent that they are comparable in nature to the costs and expenses entitled to priority under section 64(a)(1) of the Bankruptcy Act (11 U.S.C. 104(a)(1)) as amended from time to time,⁴⁶⁹ including Federal, State and local taxes, with interest and penalties thereon,⁴⁷⁰ becoming legally due and owing following divestment or death,⁴⁷¹ shall be paid prior to the claims of the United States: *Provided*,

462. Or "of all or a greater portion of his property." See note 74 *supra*.

463. See text accompanying notes 166-69 *supra*.

464. See pt. II. C. *supra*.

465. See note 158 *supra*.

466. See pt. II. B. *supra*. The express provisions referred to are in text accompanying notes 524-25 *infra*.

467. Although the term "claims" is defined (see proposed § 3466(g)(2), set out in note 60 *supra*) to embrace only pre-proceeding obligations, the ABA proposal then loosely uses it in five places in a sense that embraces administration and funeral expenses. In those places, the words "expenses and claims" have been substituted.

468. See note 204 *supra*.

469. See text accompanying notes 202-13 & 251-62 *supra*. See also note 236 *supra*.

470. Cf. *Nicholas v. United States*, 384 U.S. 678, 680, 692-95 (1966), which treated interest and penalties incurred during bankruptcy as administration expenses.

471. See text accompanying notes 217-21 *supra*.

however, That expenses incurred in continuing the business of the debtor or decedent (exclusive of taxes and expenditures necessary for the protection and preservation of the physical properties and public franchises of the business) shall not be allowed priority over the claims of the United States except out of income derived from such continuation of the business, unless (A) such expenses in excess of income accrue not later than _____ days after divestment or death, or (B) if the Secretary of the Treasury consents to such priority (which consent shall be conclusively presumed if, within _____ days after receipt from the fiduciary of notice of his intention to continue the business, the Secretary fails to file objection to such priority with the court, or with the fiduciary if there is no court having jurisdiction), then not later than _____ days after notice of withdrawal of such consent is filed with the court or with the fiduciary, as the case may be.⁴⁷² If the property is insufficient to pay all costs and expenses entitled to priority under this paragraph, they shall be paid in such order of priority as may be provided by other applicable law or by lawful court order: *Provided*, That taxes and other expenses becoming legally due and owing to the United States following divestment or death shall be paid in an amount not less than the lesser of (A) the amount which bears the same ratio to the total property as the sum of such taxes and expenses owing to the United States bears to the total costs and expenses entitled to priority hereunder, or (B) the excess of the total property over the sum of the judicial costs, if any, and the reasonable compensation of the fiduciary and his attorney and auditor.⁴⁷³

“(2) EXPENSES OF FUNERAL AND LAST ILLNESS.—Expenses of the funeral and claims for expenses of the last illness of a deceased debtor of the United States, to the extent that other applicable law prefers them over general unsecured creditors and they are allowed by any court having jurisdiction thereof, shall be paid prior to claims of the United States. If such debtor dies following divestment of his property in the manner provided in this section, the expenses of his last illness and funeral may, if other applicable law so provides, be paid out of the property under administration, with priority over claims of the United States, but only to the extent that the debtor’s property not under administration is insufficient therefor.⁴⁷⁴

“(3) WAGES AND COMMISSIONS.—Notwithstanding any other applicable law, claims for wages and commissions described in, and subject to the limitations of, section 64(a)(2) of the Bankruptcy Act (11 U.S.C. 104(a)(2)) as amended from time to time, shall be paid prior to claims of the United States and prior to any other

472. This proviso is suggested if such restriction is desired. See text accompanying notes 214-16 *supra*.

473. This is one possible resolution of the matters discussed in text accompanying notes 222-34 *supra*.

474. See note 283 *supra*.

expenses, claims and allowances except those entitled to priority under paragraphs (1) and (2) of this subsection.⁴⁷⁵

"(4) TAXES.—

"(A) IN GENERAL.—Claims for taxes⁴⁷⁶ of any State or subdivision thereof which would not be dischargeable under Section 17(a)(1) of the Bankruptcy Act (11 U.S.C. 35(a)(1)) as amended from time to time, and which are entitled to priority over general unsecured creditors under other applicable law,⁴⁷⁷ shall be accorded equal priority with claims for taxes of the United States which are not so dischargeable, and shall be paid prior to any other claims of the United States. Claims for taxes of the United States which are not so dischargeable shall be paid prior to all other claims and expenses⁴⁷⁸ except those entitled to equal or higher priority under this subsection or subsection (e).

"(B) UNEMPLOYMENT TAXES.—Whenever the United States and a State both present claims for unemployment taxes with respect to the same wages for any taxable year, the principal amount of the claim of the United States shall be limited to (i) the amount of tax (adjusted for amounts previously collected) which would have been payable to the United States if credit were allowable for full and timely payment of the State tax, plus (ii) any additional amount which the State elects to have allowed as a claim of the United States rather than of the State.⁴⁷⁹ If the credit allowable is subject to reduction pursuant to section 3302(a)(3) of the Internal Revenue Code of 1954, the additional tax resulting shall be allowed as a claim of the United States but shall be subordinated as provided in subsection (d) of this section.⁴⁸⁰

"(c) OTHER CLAIMS.—Except as provided in subsection (d), all

475. This provision adopts the mandatory approach, in order to preclude diversion of the wage fund to other claims and allowances favored by state law. See text accompanying note 361 *supra*. If the permissive approach of the ABA 1959 proposal (see 1959 REPORT, *supra* note 47, at 732) is preferred, this subsection might read:

(3) WAGES AND COMMISSIONS.—Claims for wages and commissions described in, and subject to the limitations of, section 64(a)(2) of the Bankruptcy Act (11 U.S.C. 104(a)(2)) as amended from time to time, but only if and to the extent that such claims are entitled to priority over general unsecured creditors [or "over unsecured state taxes," see text accompanying note 360 *supra*] under other applicable law, shall be paid prior to claims of the United States.

Both suggested drafts utilize the device adopted in the ABA 1970 proposal of cross-referring to the terms of the Bankruptcy Act "as amended from time to time" rather than setting them out in full, thereby enabling Section 3466 to keep pace with changes in that Act. See 1970 REPORT, *supra* note 53, at 420.

476. Since the word "claims" is defined in proposed Section 3466(g)(2) and imports the concept of "legally due and owing," it is unnecessary to use those words here, as the ABA drafts do.

477. See note 302 *supra*. This clause adopts the permissive approach, in order to avoid creating circuitries, for the benefit of creditors other than the state or local government, where no priority is provided by state law. See notes 306-07 *supra* and accompanying text.

478. See note 467 *supra*.

479. See text accompanying notes 379-82 *supra* and text accompanying note 530 *infra*.

480. See text accompanying notes 383-94 *supra* and text accompanying notes 526-28 *infra*.

claims of the United States other than those referred to in paragraph (4) of subsection (b) shall be paid without priority and on a parity with all claims not otherwise entitled to priority under subsection (b).⁴⁸¹

"(d) PENALTIES AND FORFEITURES.—Notwithstanding any other applicable law,⁴⁸² all claims of the United States or of any

481. In the event that Congress rejects the proposal to deny priority for federal claims other than nondischargeable taxes, subsection (c) would be deleted, and a new paragraph (5) should be added to subsection (b), as follows:

(5) OTHER CLAIMS.—Claims for rent to the extent of the amount legally due for actual use and occupancy during the three months before divestment or death shall, if entitled to priority under state law or under subsection (h)(8) of this section, be accorded equal priority with claims of the United States other than those entitled to priority under paragraph (4) of this subsection. Such claims of the United States shall be paid prior to all unsecured claims and expenses other than those entitled to a higher priority under this subsection.

See note 268 *supra*. In addition, a new subsection (c) might be added, as follows:

(c) CLAIMS ASSIGNED OR TRANSFERRED TO UNITED STATES.—

(1) The priority provided for claims of the United States under paragraph (5) of subsection (b) shall extend to claims assigned or otherwise transferred to the United States—

(A) Pursuant to the terms of a contract by the United States for insurance or guaranty of or participation in a loan to the debtor, whether such assignment or other transfer occurs before or after divestment or death, but only if (i) the recorded evidence of the mortgage or other security interest, if any, securing the loan or a separate instrument recorded therewith disclosed the fact of insurance, guaranty or participation by the United States, or (ii) notice of such insurance, guaranty or participation or of such assignment or other transfer was filed in the place and manner provided in section 6323(f) of the Internal Revenue Code of 1954 for filing notices of federal tax liens on personal property of the debtor.

(B) In any other case, if such assignment or other transfer occurs before divestment or death, but only if notice thereof is filed in the place and manner provided in paragraph (1)(A)(ii) of this subsection.

(2) If the notice provided in paragraph (1) of this subsection may not be filed in the office designated by State law for filing notices of federal tax liens, or if no such office has been designated, such notice shall be effective if filed in the office of the clerk of the United States district court for the judicial district in which the debtor resides.

(3) Any person who became a creditor before such recording or filing of notice as provided in this subsection, without actual notice or knowledge of the interest of the United States, shall receive in the distribution of the estate of the debtor or decedent an amount not less than he would have received if the United States had no interest in the claim. The claims of the United States entitled to priority shall be postponed to other claims to the extent necessary to prevent any claimant from being prejudiced by the operation of this paragraph.

See notes 56 & 60 *supra*. The need for the second sentence of paragraph (3) may be illustrated thusly: The Government guarantees an unsecured loan for \$50,000, but delays filing notice of its interest. A becomes a creditor for \$20,000 before such filing and without actual notice or knowledge of the guaranty. B becomes a creditor for \$30,000 after such filing or with knowledge. In insolvency, there is \$80,000 left after claims and expenses of higher priority. Under the above provision, A would be entitled to the \$16,000 which he would have received in a pro rata distribution if the United States were not involved. But without the last sentence above, the burden would simply fall on B, over whom the United States has priority, since the full federal claim of \$50,000 would be paid immediately after A's \$16,000, leaving only \$14,000 for B. That sentence postpones the federal claim to the extent necessary to assure that B will get no less than the \$18,000 he would have received if the Government had enjoyed priority over both A and B, who then shared proportionately in the \$30,000 remaining.

482. This language adopts the mandatory approach with respect to state and local penalties, placing such claims, in any insolvent estate, in the position they would

State or subdivision thereof arising from a penalty or forfeiture, whether or not secured by lien,⁴⁸³ shall be subordinated to all other claims against the debtor or estate.⁴⁸⁴ For purposes of this subsection, a claim shall not be regarded as arising from a penalty or forfeiture to the extent of the amount of the pecuniary loss sustained by the act, transaction or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

"(e) CERTAIN LIENS PRESERVED.—Except as provided in subsections (d) and (f), nothing in this section shall:

"(1) impair any lien in favor of the United States existing at the time of divestment or death: *Provided*, That in the case of any debtor who at the time of divestment was subject to being adjudged an involuntary bankrupt pursuant to section 4(b) of the Bankruptcy Act (11 U.S.C. 22(b)) as amended from time to time, no such lien of the United States shall be valid in the proceeding if it would not have been valid at such time against a trustee in bankruptcy;⁴⁸⁵

"(2) entitle an unsecured claim of the United States to priority over a competing claim secured by a lien existing at the time of divestment or death if such lien is recognized in the proceeding under other applicable law and would have been valid against a trustee in bankruptcy under sections 67 and 70 of the Bankruptcy Act (11 U.S.C. 107 and 110) if bankruptcy had occurred at such time (whether or not the debtor or decedent was subject to be adjudged a bankrupt),⁴⁸⁶ nor

"(3) entitle a secured claim of the United States to priority over a competing claim secured by a lien which is recognized in the proceeding under other applicable law if such claim of the United States would not have been prior to such competing lien apart from this section.⁴⁸⁷

"(f) CERTAIN TAX LIENS POSTPONED.—Notwithstanding subsection (e), and notwithstanding any other applicable law,⁴⁸⁸ every tax lien on personal property not accompanied by possession at time of divestment or death and not theretofore enforced by sale⁴⁸⁹ shall be postponed to the expenses and claims⁴⁹⁰ specified in

occupy in bankruptcy, except that they would not be discharged. *See* text accompanying notes 422-24 *supra*.

483. *See* note 420 *supra*.

484. Concerning penalties arising during the proceeding, which are not within the definition of "claims," *see* text accompanying note 470 *supra*.

485. *See* note 402 *supra*.

486. *See* text accompanying notes 177-88 & 195 *supra*. Alternatively: "if such lien would have been valid against a lien under section 6321 of the Internal Revenue Code of 1954 if notice thereof had been duly filed at the time of divestment or death." *See* text accompanying notes 189-94 *supra*.

487. *See* note 399 *supra*.

488. *See* text accompanying notes 410-12 *supra*; note 412 *supra*.

489. *See* note 405 *supra*.

490. *See* note 467 *supra*.

paragraphs (1), (2) and (3) of subsection (b) of this section;⁴⁹¹ and any lien of the United States shall be postponed to the expenses specified in paragraph (1) of subsection (b) if the proceeding was instituted for the foreclosure or enforcement of such lien.⁴⁹² The proceeds of sale of the property subject to liens, after providing for the actual cost of the sale, shall be set aside for the claims secured by liens, in the order of their priority without regard to this subsection. The amounts set aside for the most junior of the liens subject to postponement under this subsection shall then be applied first to the expenses and claims to which such liens are postponed, in order of their priorities. The postponed liens shall next be satisfied, to the extent possible, from the balance of the amount set aside for them and from the funds, if any, which would otherwise have been applicable to the expenses and claims to which such liens were postponed.⁴⁹³

"(g) CIRCULAR PRIORITIES.—The amount to which the United States is entitled shall be determined pursuant to subsections (b), (c), (d), (e) and (f) without regard to other priority or lien laws except as provided in such subsections. After the amount to be paid to the United States has been so determined, the order of distribution among other expenses and claims⁴⁹⁴ shall be as prescribed by other applicable law, except so far as reference to such other law is expressly excluded by this section.

"(h) DEFINITIONS.—For the purposes of this section and section 3467—

"(1) 'divestment or death' means the divestment of the title or right to possession or both title and right to possession of the property of a debtor in the manner described in subsection (a), or the death of a debtor in the case of property not previously under administration as therein provided, and 'divestment' includes a mortgage or pledge of property of a debtor for the benefit of all or a substantial portion of his creditors, whether or not for the purpose of rehabilitation with a reversion to the debtor;⁴⁹⁵

"(2) in applying provisions of the Bankruptcy Act referred to in this section, the date of divestment or death shall be regarded as the date of 'bankruptcy' or the date of 'commencement of the proceeding,' as the case may be;⁴⁹⁶

"(3) 'claims' means claims found to be legally due and owing

491. See notes 407-08 *supra*.

492. See note 404 *supra*.

493. See note 406 *supra*.

494. See note 467 *supra*. Since the approach of this draft would never create a fund for general creditors before federal priority claims have been fully paid, the problem discussed in note 350 *supra* does not arise. However, if the "synthetic circuitry" approach of the ABA 1970 proposal is adopted, it should be made clear that "other claims" includes any unsatisfied federal priority claims.

495. See notes 163 & 165 *supra*.

496. This provision is derived from the flush material at the end of § 3466(b) in the ABA 1970 proposal (set out in notes 236 & 292 *supra*), but has been moved to give it more general application.

by the debtor as of the time of divestment or death, subject to reduction by reason of any proper credit or other event thereafter occurring;⁴⁹⁷

"(4) an amount shall be considered 'legally due and owing' when all the events have occurred giving rise to a liability to pay such amount, whether or not the amount is then ascertained or has become payable;⁴⁹⁸

"(5) 'taxes' includes contributions payable into an unemployment fund maintained under the unemployment compensation law of a State;⁴⁹⁹

"(6) a 'general unsecured creditor' means a creditor with a claim that is neither secured by a lien nor entitled to priority;

"(7) the term 'lien' means an interest in real or personal property which secures payment or performance of an obligation or indemnifies against loss or liability,⁵⁰⁰ whether arising by agreement, statute or other rule of law, application of principles of equity, judgment, levy, or other judicial proceedings or distraint,⁵⁰¹ but such term does not include any lien which first becomes effective upon the insolvency of the debtor, upon an assignment by the debtor for the benefit of creditors, upon the commencement of any other proceeding intended to rehabilitate the debtor or liquidate his property, or upon execution against his property levied at the instance of one other than the lienor;⁵⁰²

"(8) any claim secured by a lien existing under other applicable law, which is not recognized as valid against the United States under the preceding paragraph or under subsection (e), shall be considered for purposes of subsection (b) to be a claim entitled to priority under other applicable law;⁵⁰³

"(9) 'other applicable law' means the statutes and judicial doctrines⁵⁰⁴ of the State in which the property of the debtor or decedent is administered,⁵⁰⁵ except so far as such law purports to prescribe the priority of claims of the United States;⁵⁰⁶ and

"(10) 'State' includes the District of Columbia, the Territories and possessions, and the Commonwealth of Puerto Rico.⁵⁰⁷

"(i) EFFECT OF OTHER LAWS.—Except as expressly provided herein, this section shall prevail over any other law to the extent inconsistent herewith."⁵⁰⁸

497. See note 376 *supra*.

498. See text accompanying notes 217-21 *supra*.

499. See note 374 *supra*.

500. See note 173 *supra*.

501. Limitations on the recognition of certain liens would be imposed by § 3466(e)(2). See text accompanying note 486 *supra*.

502. See notes 174-75 *supra*.

503. See note 363 *supra*.

504. See note 349 *supra*.

505. See notes 304-05 *supra* and accompanying text.

506. See text accompanying note 356 *supra*.

507. See notes 295-96 *supra*.

508. See note 295 *supra*.

Sec. 102. Liability of Fiduciaries.

(a) Section 3467 of the Revised Statutes (31 U.S.C. 192) (relating to liability of fiduciaries) is amended to read as follows:

"Sec. 3467. LIABILITY OF FIDUCIARIES.

"(a) **LIABILITY IMPOSED.**—Except as provided in subsections (b), (c) and (d), every person (other than a trustee or other officer subject to the power of a bankruptcy court to surcharge his account)⁵⁰⁹

"(1) who pays, in whole or in part, any claim against the debtor or estate for whom or for which he acts⁵¹⁰ before he pays the claims of the United States against such debtor or estate which under the preceding section are entitled to priority over or parity of payment with⁵¹¹ the claims so paid, or

"(2) who pays, in whole or in part, any expense of administration (other than judicial costs and the reasonable compensation of the fiduciary and his attorney and auditor) without paying or providing for payment, on account of expenses of administration then owing to the United States, of the proportionate amount to which the United States would be entitled under paragraph (1) of subsection (b) of the preceding section if the administration were then terminated,⁵¹²

shall become answerable in his own person and estate to the extent of such payments for the claims and expenses then owing to the United States, or for so much thereof as may remain unpaid.

"(b) **ABSENCE OF NOTICE OR KNOWLEDGE OF EXPENSES OR CLAIMS.**—No liability shall be imposed under subsection (a) with respect to any claim of or expense owing to the United States of which such person did not, at the time of such payment, have actual notice or knowledge. A person shall be deemed to have actual notice or knowledge of a claim or expense if its existence, whether liquidated or unliquidated, had been brought to his attention in any manner subsequent to his assumption of the administration of the property or estate, or was actually known to him at that time or at any subsequent time before the payment giving rise to liability under subsection (a), or if at any such time he possessed such information as would put a reasonably prudent fiduciary upon inquiry.⁵¹³ Such person shall be chargeable with notice of any tax claims of the United States which would have been disclosed by a search for federal tax liens made at the time of divestment or death in the office prescribed by section 6323(f) of the Internal Revenue Code of 1954 as in effect at that time, at the residence of the debtor at such

509. See text accompanying notes 93-105 *supra*.

510. If it is intended that liability be incurred by the fiduciary for distributions to beneficial owners (see text accompanying notes 440-45 *supra*), insert "or who makes any distributions to shareholders, legatees or other beneficial owners" at this point, and insert "or distributions so made" after "claims so paid."

511. The words "or parity of payment with" have been added to the ABA proposal since the Government can be injured by premature payment of claims having equal standing as well as of claims of lower rank.

512. See text accompanying note 234 *supra*.

513. See text accompanying notes 430-38 *supra*.

time and at each place where the debtor then owned real property which comes under the administration of such person;⁵¹⁴ and he shall be chargeable with notice of any tax liability constituting an administration expense, for the then current or any preceding tax period, which he should reasonably anticipate will be asserted by the United States on the basis of facts then known to him, whether or not he acknowledges such tax liability.

"(c) OPERATION OF BUSINESS.—No liability shall be imposed under paragraph (1) of subsection (a) upon a person who, under the terms of his appointment or by subsequent order of the court, if any, having jurisdiction, is directed or empowered to continue the operation of a business of the debtor or decedent unless—

"(1) at the time of divestment or death the fair realizable value of the property or estate under administration was insufficient to pay the reasonably anticipated expenses of administration and all the claims of which such person had acquired actual knowledge prior to the payment giving rise to liability;

"(2) subsequently, but prior to the payment giving rise to liability—

"(A) the property or estate under administration has been found by the court, if any, having jurisdiction over the administration, to be insufficient (after expenses) to pay the debts of the debtor or decedent, or has been ordered by such court to be liquidated, or

"(B) if the administration is not under the jurisdiction of a court, the person responsible for the administration had actual knowledge of facts from which he should reasonably conclude that the fair realizable value of the property or estate under administration was insufficient to pay the reasonably anticipated expenses and the debts of the debtor or decedent, or has determined that the property is to be liquidated; or

"(3) the payment giving rise to liability was made under such circumstances that, under the law applicable to the proceeding, the person responsible for the administration was obligated to make provision for the priorities or equal rights of other creditors.⁵¹⁵

"(d) SUFFICIENCY OF ASSETS FOR EXPENSES.—No liability shall be imposed under paragraph (2) of subsection (a) unless—

"(1) at the time of the payment giving rise to such liability the court, if any, having jurisdiction over the administration had determined that the property or estate under administration was insufficient to pay all expenses of administration;

"(2) if the administration is not under the jurisdiction of a court, the person responsible for the administration had actual knowledge at such time of facts from which he should reasonably conclude that the fair realizable value of the property or estate under administration was insufficient to pay all expenses of administration; or

"(3) the payment giving rise to liability was made under such circumstances that, under the law applicable to the proceeding, the

514. See note 431 *supra*.

515. See text accompanying notes 155-57 *supra*.

person responsible for the administration was obligated to make provision for the rights of others to whom administration expenses were owing.⁵¹⁶

“(e) ACTUAL KNOWLEDGE.—A person shall be deemed for purposes of a particular transaction to have actual knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual’s attention if the person had exercised due diligence. A person exercises due diligence if he maintains reasonable routines for communicating significant information to the individual conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the person to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.”⁵¹⁷

(b) The amendments made by this section shall apply to payments made on or after the date of its enactment, and shall also apply to payments theretofore made—

(1) in administrations pending on such effective date, if such payments were consistent with the priorities made applicable by the amendments made by section 101;⁵¹⁸ and

(2) in any case, if the imposition of liability would be precluded by subsection (b), (c), (d) or (e) of Section 3467 of the Revised Statutes, as amended hereby, if such amendments had been in effect on the date of the payment.

Sec. 201. Death of a Bankrupt

Section 8 of the Bankruptcy Act (11 U.S.C. 26) (relating to death or insanity of bankrupts) is amended by changing the period at the end thereof to a colon and adding the following proviso:

“*And provided further*, That upon the death of a bankrupt during the proceedings, the expenses of his last illness and funeral shall be paid out of the property under administration, with priority over all debts except costs and expenses of administration, but only to the extent that the debtor’s property not under administration is insufficient therefor.”⁵¹⁹

Sec. 202. Claims for Unemployment Taxes in Bankruptcy.

Section 57 of the Bankruptcy Act (11 U.S.C. 93) (relating to proof and allowance of claims) is amended by adding at the end thereof the following new subsection:

“o. Whenever the United States and a State both present claims for unemployment taxes with respect to the same wages for any tax-

516. See text accompanying note 234 *supra*.

517. See note 427 *supra*.

518. See text accompanying note 447 *supra*.

519. See note 283 *supra*.

able year, the principal amount of the claim of the United States shall be limited to the amount of tax (adjusted for amounts previously collected) which would have been payable to the United States if credit were allowable for full and timely payment of the State tax."⁵²⁰

Sec. 203. Priority of Wages in Bankruptcy.

Clause (2) of subsection a of section 64 of the Bankruptcy Act (11 U.S.C. 104(a)(2)) (relating to priority of wages) is amended by adding at the end thereof the following:

"and for the purposes of this clause the term 'proceeding' shall include any receivership, trusteeship, or general assignment for creditors constituting an act of bankruptcy, if followed by a proceeding under this Act;"⁵²¹

Sec. 204. Priority of Debts Other Than for Taxes in Bankruptcy.

Clause (5) of subsection a of section 64 of the Bankruptcy Act (11 U.S.C. 104(a)(5)) (relating to priority of debts other than for taxes) is amended by striking out the words:

"debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and"⁵²²

Sec. 205. Postponement of Tax Liens.

Paragraph (3) of subsection c of section 67 of the Bankruptcy Act (11 U.S.C. 107(c)(3)) (relating to postponement of certain tax liens) is amended by striking out the second and third sentences thereof and substituting the following:

"The proceeds of sale of the property subject to liens, after providing for the actual cost of the sale, shall be set aside for the claims secured by liens, in the order of their priority without regard to this paragraph. The amounts set aside for the most junior of liens subject to postponement under this paragraph shall then be applied first to the expenses and liens to which such liens are postponed, in order of their priorities. The postponed liens shall next be satisfied, to the extent possible, from the balance of the amount set aside for them and from the funds, if any, which would other-

520. See notes 379-81 *supra*. By omission, the effect of the language would be to disallow any portion of the tax resulting from reduction of the credit on account of late payment, without need to label the amount a penalty under section 57j of the Bankruptcy Act, 11 U.S.C. § 93(j) (1964). See text accompanying notes 383-94 *supra*.

521. This provision adopts the rule of *Manly v. Hood*, 37 F.2d 212 (4th Cir. 1930). See note 237 *supra*. Wages earned during the superseded proceeding, if unpaid at the time of bankruptcy, would enjoy priority under the rule of *Randolph v. Scruggs*, 190 U.S. 533 (1903).

522. See note 80 *supra*. Additional amendments to § 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) (Supp. V, 1965-1969), as well as to § 17a, 11 U.S.C. § 35(a) (Supp. V, 1965-1969), relating to the priority and dischargeability of taxes in bankruptcy, are proposed in Plumb, *Federal Tax Liens and Priorities in Bankruptcy—Recent Developments*, 43 REF. J. 37, 45-46 (1969), and will not be repeated here.

wise have been applicable to the expenses and claims to which such liens were postponed."⁵²³

Sec. 206. Railroad Reorganizations.

The second and third provisos of the third paragraph of subsection (e) of section 77 of the Bankruptcy Act (11 U.S.C. 205(e)) (relating to claims of the United States in railroad reorganizations) are amended to read as follows:

*"Provided further, that if, in any reorganization proceeding under this section, the United States is a secured or unsecured creditor, no plan which does not provide for first payment in cash of the value of the interest of the United States as determined by the judge in accordance with the priorities established by section 3466 of the Revised Statutes (31 U.S.C. 191) (which value, if the plan makes provision for shareholders, other than for new capital, shall be not less than the full amount of the claims) shall be confirmed except upon the acceptance, certified to the court, of a lesser amount or of payment in another form or at a later time by the President of the United States or the officer or agency designated by him pursuant to the provisions of the preceding paragraph hereof: Provided further, That if the President of the United States or such officer or agency shall fail to accept or reject such lesser amount or such other form or time of payment for more than ninety days after receipt of written notice so to do from the court, accompanied by a certified copy of the plan, the consent of the United States shall be conclusively presumed."*⁵²⁴

Sec. 207. Corporate Reorganizations.

The second sentence of section 199 of the Bankruptcy Act (11 U.S.C. 599) (relating to claims of the United States in corporate reorganizations) is amended to read as follows:

*"If, in any proceeding under this chapter, the United States is a secured or unsecured creditor, no plan which does not provide for first payment in cash of the value of the interest of the United States as determined by the judge in accordance with the priorities established by section 3466 of the Revised Statutes (31 U.S.C. 191) (which value, if the plan makes provision for shareholders, other than for new capital, shall be not less than the full amount of the claims) shall be confirmed except upon the acceptance, certified to the court, of a lesser amount or of payment in another form or at a later time by the Secretary of the Treasury."*⁵²⁵

Sec. 301. Unemployment Tax.

(a) Paragraph (3) of subsection (a) of section 3302 of the Internal Revenue Code of 1954 (relating to credits against unemployment taxes) is amended to read as follows:

⁵²³. This is merely a clarification. See note 406 *supra*.

⁵²⁴. See text accompanying notes 88-92 *supra*; notes 81-82 *supra*.

⁵²⁵. See *id.* Similar amendment of Bankruptcy Act § 455, 11 U.S.C. § 855 (1964), relating to real property arrangements, should be considered.

"(3) If contributions for any taxable year are paid after the last day upon which the taxpayer is required under section 6071 to file a return for such year, the credit against the tax shall not exceed 90 percent of the amount which would have been allowable as credit on account of such contributions had they been paid on or before such last day:⁵²⁶ *Provided*, that this paragraph shall not apply if the taxpayer's assets, at any time during the period from such last day for filing a return for such year to June 30 next following such last day, both dates inclusive, are in the custody of a receiver, trustee, assignee for the benefit of creditors, or other fiduciary charged with the administration thereof for the benefit of creditors,⁵²⁷ and if the contributions are paid during or within _____ days after termination of such administration."⁵²⁸

(b) Section 3302 of the Internal Revenue Code of 1954 is further amended by adding at the end of subsection (a) the following new paragraph:

"(5)(A) Any amount of the tax for any taxable year which is collected in any proceeding under the Bankruptcy Act or to which section 3466 of the Revised Statutes (31 U.S.C. 191) is applicable, or by setoff or levy or proceeding to enforce a lien,⁵²⁹ shall be deemed, to the extent provided in subparagraph (B), to be a collection of tax on behalf of the unemployment fund of the State or States to which the employer is liable for any unpaid contributions for the period to which such collection relates.⁵³⁰

"(B) The proportionate shares of the State or States and the United States in any amount so collected shall be determined by—

"(i) Adding thereto any other amounts collected at any time by the United States and by the State or States as unemployment tax or contributions for the taxable year;⁵³¹

"(ii) If the employer is liable for or has made contributions to unemployment funds of two or more States for the taxable year, dividing the amount determined under clause (i) in proportion to the amount of wages with respect to which contributions are payable to each State;⁵³²

526. The foregoing language is simply a less circumlocutory restatement of the provision now in effect.

527. This clause is drawn from the 1939 provision quoted in text accompanying note 389 *supra*, with the addition of relief in the case of assignments for the benefit of creditors even though not under court control. *See* text accompanying note 394 *supra*.

528. This last condition was not imposed by the 1939 provision but there is no apparent reason to relieve the employer of the 10 per cent reduction of the credit if the property reverts to him without the contributions having been paid. As under the 1939 provision, the employer would also not be relieved of the reduction if he was already delinquent in his contributions, by more than a limited period, at the time the administration of his assets for the benefit of creditors commenced. This reduction of the credit would not, however, prejudice the state (*see* text accompanying note 533 *infra*) or other creditors. *See* text accompanying notes 480 & 520 *supra*.

529. *See* note 376 *supra*.

530. *See* note 380 *supra*.

531. *See* note 381 *supra*.

532. Alternatively, the division between states might be made in proportion to the

“(iii) Dividing the amount apportioned to a State under clause (ii) in the proportion which the total liability for contributions to the unemployment fund of such State for the taxable year bears to the amount of tax imposed by section 3301 reduced by the credit which would have been allowable under this section if full and timely payment of the contributions to the unemployment fund of the State had been made;⁵³³ and

“(iv) Subtracting from the State’s share determined under clause (iii) the amount at any time collected by the State from or on account of the employer as contributions to its unemployment fund for the taxable year.⁵³⁴

“(v) In no event shall the share of any State in collections by the United States, as determined under this paragraph, exceed the amount of the employer’s liability for contributions to the State unemployment fund for such taxable year, exclusive of interest and penalties, reduced by the amount collected by the State at any time on account of such contributions.”⁵³⁵

(c) Subsection (d) of section 901 of the Social Security Act (42 U.S.C. 1101(d)) (relating to transfers from the employment security administration account) is amended by renumbering paragraph (3) as paragraph (4) and inserting after paragraph (2) the following new paragraph:

“(3) To the account (in the Unemployment Trust Fund) of a State the amount determined pursuant to paragraph (5) of section 3302(a) of the Federal Unemployment Tax Act as such State’s share of any tax collections described therein. Proper adjustments shall thereafter be made to reflect recomputation of the State’s share in the event of subsequent collections by either the State or the United States on the same liabilities.”⁵³⁶

Sec. 401. Effective Date.

Except as otherwise provided in section 102(b), the amendments made by this Act shall be effective upon the date of its enactment, and shall apply to proceedings pending on such effective date, to the extent that distributions have not theretofore been made;⁵³⁷ *Provided, however:* That no lien existing on that date, other than a lien of the United States, shall be denied any priority to which it would have been entitled if this Act had not been enacted.⁵³⁸

liabilities for contributions to the respective states, thereby giving a greater share to the state imposing a higher rate of tax on the employer.

533. See note 379 *supra*.

534. See note 381 *supra*.

535. This limitation secures to the United States any amount attributable to the 10 per cent reduction of the credit if not relieved by proposed § 3302(a)(3) (see text accompanying note 527 *supra*), but only after the state has recovered the full principal amount of the contributions owed to its fund, so that the fund will not be penalized for the employer’s delinquency.

536. See note 380 *supra*.

537. See note 446 *supra*.

538. See note 454 *supra*.

Sec. 402. Surety Bonds.

In the case of any bond given for taxes or other debts owing to the United States before the date of enactment of this Act, if the amount recoverable by the surety out of the estate and effects of an insolvent or bankrupt principal, pursuant to the priority provided by Section 3468 of the Revised Statutes (31 U.S.C. 193 (1964)) or by subrogation, is reduced as a consequence of the provisions of sections 101, 202, 204, 206 or 207 of this Act, the United States shall indemnify the surety to the extent of such reduction, but the obligation of the bond shall not otherwise be affected.⁵³⁹

539. See text accompanying notes 455-59 *supra*.